PAPER

1

FOUNDATION COURSE

STUDY MATERIAL

ACCOUNTING

MODULE 1 OF 2

Board of Studies (Academic)
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)

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BEFORE WE BEGIN

SKILL REQUIREMENTS AT FOUNDATION LEVEL

The Board of Studies, ICAI has revised and updated the study material for Foundation (Entry Level Exam to the Chartered Accountancy Course). The contents have been designed and developed with an objective to synchronize the syllabus with the guidelines prescribed by IESB (International Education Standards Board) of IFAC (International Federation of Accountants), to instill and enhance the necessary pre-requisites for becoming a well-rounded, competent and globally competitive Accounting Professional.

The requirements of "IES 1 Entry Level Requirements" have been kept in mind while developing the different chapters of study material.

This study material also lays emphasis on National Education Policy 2020 (NEP 2020) initiatives like conceptual clarity rather than rote learning and new pedagogical and curriculum restructuring based on the use of technology while teaching.

The nomenclature of Paper -1 at Foundation level is 'Accounting' which concentrates on conceptual understanding of fundamentals of accounting. This is a subjective paper and the basic objective is to develop an understanding of the basic concepts and principles of Accounting and apply the same in preparing financial statements of non-corporate entities and simple problem solving.

This Study Material endeavouring towards accounting education, is committed to provide a framework for understanding accounting discipline and describing the fundamental accounting concepts and conventions of the basic accounting system. An attempt has been made to provide a solid foundation on which students can successfully build and enhance their studies.

KNOW YOUR SYLLABUS AND STUDY MATERIAL

The Study Material of Accounting has been designed to overcome the needs of home study and distance learning students. The Study Material has been divided into eleven chapters, each addressing to a special aspect of accounting.

Chapters 1 to 5 lay emphasis on bookkeeping aspect of accounting which forms the basis for preparing financial statement. Chapter 7- Preparation of Financial statements of Sole proprietors and Chapter 8- Financial statements of Not-for-Profit Organizations explains how accounting is done in different entities. Chapter 6 covers Bills of exchange and Promissory notes which explains the accounting treatment of various bills, whereas Chapter 10 discusses accounting of Partnership firms and LLP's. Chapter 11 discusses concepts of

Company Accounts covering instances for issue of shares and debentures and redemption thereof. The topic Accounts from Incomplete Records, Intangibles and its Amortisation, Accounting of GST and Accounting for LLP's have been introduced in New Scheme considering their importance in current business environment.

The study material has been bifurcated into two modules (Module I : Chapters 1 to 7 and Module II: Chapters 8 to 11) for easy handling and convenience of students. It is important to read the Study Material thoroughly and practice the questions for understanding the coverage of syllabus.

FRAMEWORK OF CHAPTERS-UNIFORM STRUCTURE COMPRISING OF SPECIFIC COMPONENTS

Efforts have been made to present each topic of the syllabus in a lucid manner. Care has been taken to present the chapters in a logical sequence to facilitate easy understanding by the students. Sincere efforts have been undertaken to review and update the study material so that it reflects the current position.

The content for each chapter/unit of the study Material has been structured in the following manner –

	Components of each Chapter	**about the component**
1	**Learning Outcomes**	Learning outcomes which you need to demonstrate after learning each topic have been detailed in the first page of each chapter/unit. Demonstration of these learning outcomes would help you to achieve the desired level of technical competence.
2	**Chapter/Unit Overview**	As the name suggests, the flow chart/table/diagram given at the beginning of each chapter would give a broad outline of the contents covered in the chapter.
3	**Content of each Unit/ Chapter**	The concepts and provisions of each topic is explained in student-friendly manner with the aid of Examples/ Illustrations/ Diagrams/Flow charts. These value additions would help you develop conceptual clarity and get a good grasp of the topic. Diagrams and Flow charts would help you understand the concept/ application of topic in a better

		manner.
4	**Illustrations Involving Conceptual Understanding**	Illustrations would help the students to understand the application of concepts. In effect, it would test understanding of concepts as well as ability to apply the concepts learnt in solving problems and addressing issues.
5	**Summary**	A summary of the chapter is given at the end to help you revise what you have learnt. It would especially facilitate quick revision of the chapter the day before the examination.
6	**Test Your Knowledge**	This section comprises of number of multiple choice questions, questions based on True and False statements, theoretical questions and practical questions which would help students to evaluate what they have understood after studying the chapter. The questions given in this section have also been supplemented with the answers to help the students in evaluating their solutions so that they can know where they have gone wrong.

We hope that these student-friendly features in the Study Material makes your learning process more enjoyable, enriches your knowledge and sharpens your application skills.

Happy Reading and Best Wishes!

SYLLABUS

PAPER – 1: ACCOUNTING

(One Paper – Three Hours – 100 Marks)

Objective:

To develop an understanding of the basic concepts and principles of accounting and apply the same in preparing financial statements and simple problem solving.

Contents:

1. **Theoretical framework**
   - (i) Meaning and Scope of accounting
   - (ii) Accounting Concepts, Principles and Conventions
   - (iii) Capital and revenue expenditure, Capital and revenue receipts, Contingent assets and contingent liabilities
   - (iv) Accounting Policies
   - (v) Accounting as a Measurement Discipline – Valuation Principles, Accounting Estimates.
   - (vi) Accounting Standards – Concepts and Objectives.
2. **Accounting Process**
   - (i) Recording accounting transactions: principles of double entry book- keeping, books of original entry - journal, subsidiary books, cash book, ledger-format, posting from journal and subsidiary books, balancing of accounts
   - (ii) Preparation of Trial Balance
   - (iii) Rectification of Errors.
3. **Bank Reconciliation Statement**

   Introduction, reasons, preparation of Bank Reconciliation Statement.
4. **Inventories**

   Meaning, Basis and technique of inventory valuation, Cost of Inventory, Net Realizable value and Record System.

5. Depreciation and Amortisation

Tangible and Intangible Assets - Meaning and difference, concepts, methods of computation and accounting treatment of depreciation/ amortisation, change in depreciation method.

6. Bills of Exchange and Promissory Notes

Meaning of Bills of Exchange and Promissory Notes and their accounting treatment; Accommodation Bills.

7. Preparation of Final accounts of Sole Proprietors

Elements of financial statements, Closing Adjustment Entries, Trading Account, Profit and Loss Account and Balance Sheet of Manufacturing and Non-manufacturing entities.

8. Financial Statements of Not-for-Profit Organizations

Significance and preparation of Receipt and Payment Account, Income and Expenditure Account and Balance Sheet, difference between Profit and Loss Account and Income and Expenditure Account.

9. Accounts from Incomplete Records (excluding preparation of accounts based on ratios)

10 Partnership and LLP Accounts

(i) Final Accounts of Partnership Firms and LLPs

(ii) Admission, Retirement and Death of a Partner including Treatment of Goodwill

(iii) Dissolution of partnership firms and LLPs including piecemeal distribution of assets.

11. Company Accounts

(i) Definition of shares and debentures

(ii) Issue of shares and debentures, forfeiture of shares, re-issue of forfeited shares

(iii) Redemption of preference shares and debentures (excluding purchase and redemption of own debentures and sinking fund method)

(iv) Accounting for Bonus Issue and Right Issue

CONTENTS

DETAILED CONTENTS: MODULE – 1

CHAPTER 1

THEORETICAL FRAMEWORK

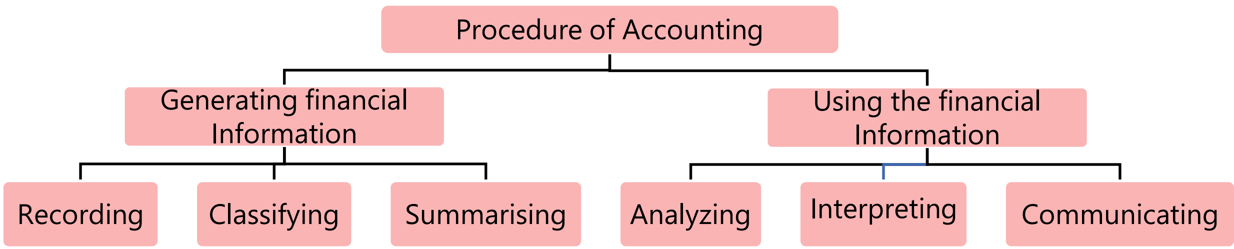
UNIT - 1 MEANING AND SCOPE OF ACCOUNTING

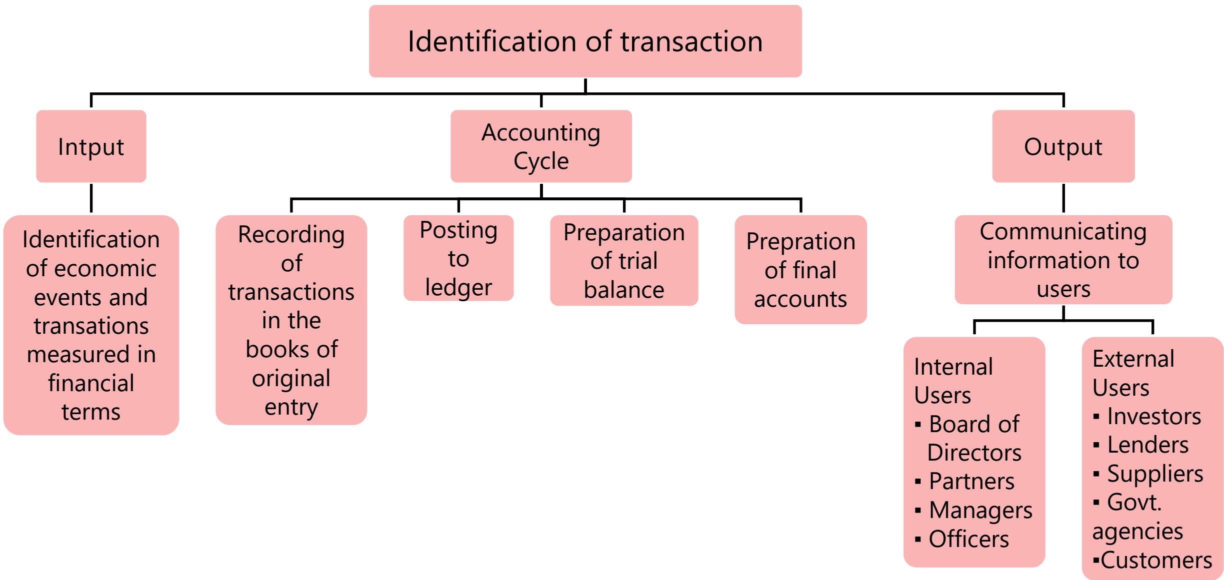
LEARNING OUTCOMES

After studying this unit, you would be able to:

- Understand the meaning and significance of accounting.
- Understand the meaning of book-keeping and the distinction of accounting with book-keeping.
- Appreciate the evolutionary process of accounting as a social science.
- Explain sub-fields of accounting.
- Identify the various user groups for whom accounting information is to be generated.
- Understand the relationship of Accounting with Economics, Statistics, Mathematics, Law and Management.
- Explain the limitations of accounting.
- Appreciate the enlarged boundary of accounting profession and the areas where in a chartered accountant plays an important role of rendering useful services to the society.

UNIT OVERVIEW





1.1 INTRODUCTION

Every individual performs some kind of economic activity. A salaried person gets salary and spends to buy provisions and clothing, for children's education, construction of house, etc. A sports club formed by a group of individuals, a business run by an individual or a group of individuals, a company running a business in telecom sector, a local authority like Calcutta Municipal Corporation, Delhi Development Authority, Governments, either Central or State, all are carrying some kind of economic activities. Not necessarily all the economic activities are run for any individual benefit; such economic activities may create social benefit i.e. benefit for the public, at large. Anyway, such economic activities are performed through '**transactions and events**'. **Transaction** is used to mean 'a business, performance of an act, an agreement' while **event** is used to mean 'a happening, as a consequence of transaction(s), a result.'

Example 1

An individual invests ₹ 2,00,000 for running a stationery business. On 1st January, he purchases goods for ₹ 1,15,000 and sells for ₹ 1,47,000 during the month of January. He pays shop rent for the month ₹ 5,000 and finds that still he has goods worth ₹ 15,000 in hand. The individual performs an economic activity. He carries on a few transactions and encounters with some events. Is it not logical that he will want to know the result of his activity?

We see that the individual, who runs the stationery business, earns a surplus of ₹ 42,000.

		₹
Goods sold		1,47,000
Goods in hand		15,000
		1,62,000
Less : Goods purchased	1,15,000	
Shop rent paid	5,000	(1,20,000)
Surplus		42,000

Earning of ₹ 42,000 surplus is an event; also having the inventories in hand is another event, while purchase and sale of goods, investment of money and payment of rent are transactions.

Similarly, a municipal corporation got government grant ₹ 500 lakhs for adult education; it spent ₹ 250 lakhs for purchasing literacy kits, paid ₹ 200 lakhs to the tutors and is left with a balance of ₹ 50 lakhs. These are also transactions and events.

Similarly, the Central Government raised money through taxes, paid salaries to the employees, and spent on various developmental activities. Whenever receipts of the Government are more than expenses it has surplus, but if expenses are more than receipts it runs in deficit. Here raising money through various sources can be termed as transaction and surplus or deficit at the end of the accounting year can be termed as an event.

A telecom company would need to ensure that it is providing the services for its millions of users for post-paid and pre-paid connections. Each activity done by a user (call, message, data usage) results into an economic event. The entity needs to keep appropriate and timely records to be able to collect money from post-paid connection users for the services availed by them. Likewise, the company will need to ensure that pre-paid connection customers are provided the support and the records confirm how much balance still remains to be utilized.

So, everybody wants to keep records of all transactions and events and to have adequate information about the economic activity as an aid to decision-making. Accounting discipline has been developed to serve this purpose as it deals with the measurement of economic activities involving inflow and outflow of economic resources, which helps to develop useful information for decision-making process.

Accounting has universal application for recording transactions and events and presenting suitable information to aid decision-making regarding any type of economic activity ranging from a family function to functions of the national government. But hereinafter we shall concentrate only on business activities and their accounting because the objective of this study material is to provide a basic understanding on accounting for business activities. Nevertheless, it will give adequate knowledge to think coherently of accounting as a field of study for universal application.

The growth of accounting discipline is closely associated with the development of the business world. Thus, to understand accounting as a field of study for universal application, it is best identified with recording of business transactions and communication of financial information about business enterprise to facilitate decision-making. The aim of accounting is to meet the information needs of the rational and sound decision- makers, and thus, called the **language of business**.

1.2 MEANING OF ACCOUNTING

The Committee on Terminology set up by the American Institute of Certified Public Accountants formulated the following definition of accounting in 1961:

"Accounting is the art of recording, classifying, and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof."

As per this definition, accounting is simply an art of record keeping. The process of accounting starts by first identifying the events and transactions which are of financial character and then be recorded in the books of account. Continuing with the same example of the telecom company, which needs to capture all transactions (transactions made by the user, raising invoice to the customer, receipt of money, payment towards salaries, marketing etc.). Likewise, the individual running the stationery business, would need to record all business transactions.

This recording is done in Journal or subsidiary books, also known as primary books. Every good record keeping system includes suitable classification of transactions and events as well as their summarisation for ready reference. For example, the telecom company performing thousands of transactions on a daily basis, is not expected to publish all those transactions for the users to be able to make a decision. Surely, those transactions need to be summarized appropriately.

After the transactions and events are recorded, they are transferred to secondary books, i.e., Ledger. In ledger, transactions and events are classified in terms of income, expense, assets and liabilities according to their characteristics and summarised in profit and loss account and balance sheet.

Essentially the transactions and events are to be measured in terms of money. Measurement in terms of money means measuring at the ruling currency of a country, for example, rupee in India, dollar in U.S.A. and like. The transactions and events must have at least in part, financial characteristics. The inauguration of a new branch of a bank is an event without having financial character, while the business disposed of by the branch is an event having financial character. Accounting also interprets the recorded, classified and summarized transactions and events. However, the above-mentioned definition does not reflect the present day accounting function. According to the above definition, accounting ends with interpretation of the results of the financial transactions and events but in the modern world with the diversification of management and ownership, globalization of business and society gaining more interest in the functioning of the enterprises, the importance of communicating the accounting results has increased.

Therefore, this requirement of communicating and motivating informed judgement has also become the part of accounting as defined in the widely accepted definition of accounting, given by the American Accounting Association in 1966 which treated accounting as:

"The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounts."

In 1970, the Accounting Principles Board (APB) of American Institute of Certified Public Accountants (AICPA) enumerated the functions of accounting as follows:

"The function of accounting is to provide quantitative information, primarily of financial nature, about economic entities, that is needed to be useful in making economic decisions."

Thus, accounting may be defined as the process of recording, classifying, summarising, analysing and interpreting the financial transactions and communicating the results thereof to the persons interested in such information.

The above definition requires accountants to assume a bigger responsibility than to merely do book-keeping. Accountants need to be ready to provide the information ready for the intended users to be able to make economic decisions.

1.2.1 Procedural aspects of Accounting

On the basis of the above definitions, procedure of accounting can be basically divided into two parts:

(i) Generating financial information and

(ii) Using the financial information.

Generating Financial Information

1. **Recording –** This is the basic function of accounting. All business transactions of a financial character, as evidenced by some documents such as sales bill, pass book, salary slip etc. are recorded in the books of account. Recording is done in a book called "Journal." This book may further be divided into several subsidiary books according to the nature and size of the business. Students will learn how to prepare journal and various subsidiary books in chapter 2.

2. **Classifying –** Classification is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature at one place so as to put information in compact and usable form. The book containing classified information is called "Ledger". This book contains on different pages, individual account heads under which, all financial transactions of similar nature are collected. For example, there may be separate account heads for Salaries, Rent, Printing and Stationeries, Advertisement etc. All expenses under these heads, after being recorded in the Journal, will be classified under separate heads in the Ledger. This will help in finding out the total expenditure incurred under each of the above heads. Students will learn how to prepare ledger books in chapter 2.

3. **Summarising –** It is concerned with the preparation and presentation of the classified data in a manner useful to the internal as well as the external users of financial statements. This process leads to the preparation of the financial statements.

4. **Analysing –** The term 'Analysis' means methodical classification of the data given in the financial statements. The figures given in the financial statements will not help anyone unless they are in a simplified form. For example, all items relating to fixed assets are put at one place while all items relating to current assets are put at another place. It is concerned with the establishment of relationship between the items of the Profit and Loss Account and Balance Sheet i.e. it provides the basis for interpretation. Students will learn this aspect of financial statements in the later stages of the Chartered Accountancy Course.

5. **Interpreting** – This is the final function of accounting. It is concerned with explaining the meaning and significance of the relationship as established by the analysis of accounting data. The recorded financial data is analysed and interpreted in a manner that will

enable the end-users to make a meaningful judgement about the financial condition and profitability of the business operations. The financial statement should explain not only what had happened but also why it happened and what is likely to happen under specified conditions.

6. **Communicating –** It is concerned with the transmission of summarised, analysed and interpreted information to the end-users to enable them to make rational decisions. This is done through preparation and distribution of accounting reports, which include besides the usual profit and loss account and the balance sheet, additional information in the form of accounting ratios, graphs, diagrams, fund flow statements etc. Students will learn this aspect of financial statements in the later stages of the Chartered Accountancy Course.

The first two procedural stages of the process of generating financial information along with the preparation of trial balance are covered under book-keeping while the preparation of financial statements and its analysis, interpretation and also its communication to the various users are considered as accounting stages. Students will learn the term book-keeping and its distinction with accounting, in the coming topics of this unit.

Using the Financial Information

There are certain users of accounts. Earlier it was viewed that accounting is meant for the proprietor or owner of the business, but changing social relationships diluted the earlier thinking. Since earlier businesses were simple and not scaled, probably that view could hold true for those.

It is now believed that besides the owner or the management of the business enterprise, users of accounts include the investors, employees, lenders, suppliers, customers, government and other agencies and the public at large. For example, if an airlines company borrows money from a bank, buys oil from oil companies, sells tickets to the customers, has staff to be paid salaries to, all these group of people and entities are key stakeholders in that airlines business. They would like to know and understand whether the business of the company is going well or there are challenges for the company to run the business. Accounting provides the art of presenting information systematically to the users of accounts.

Accounting data is more useful if it stresses economic substance rather than technical form. Information is useless and meaningless unless it is relevant and material to a user’s decision. The information should also be free of any biases. The users should understand not only the financial results depicted by the accounting figures, but also should be able to assess its reliability and compare it with information about alternative opportunities and the past experience. The owners or the management of the enterprise, commonly known as internal users, use the accounting information in an analytical manner to take the valuable decisions for the business. So the information served to them is presented in a manner different to the information presented to the external users. Even the small details which can affect the internal working of the business are given in the management report while financial statements presented to the external users contains key information regarding assets, liabilities and capital which are summarised in a logical manner that helps them in their respective decision-making.

1.3 EVOLUTION OF ACCOUNTING AS A SOCIAL SCIENCE

History & Development of Accounting

Accounting finds its roots as early as around 4000 BC, where Egyptians used some form of accounting for their treasuries. The in-charge of treasuries had to send day wise reports to their superiors known as Wazirs and monthly reports were sent to kings. Babylonia, known as the city of commerce, used accounting for business to identify the losses that took place due to frauds and lack of efficiency. Greece used accounting to divide the revenues received among treasuries, maintaining receipts, payments and balance of government financial transactions. Romans used memorandum or daybook where in receipts and payments were recorded. (700 B.C to 400 A.D).

China used sophisticated form of government accounting as early as 2000 B.C. Accounting practices in India could be traced back to a period where, Kautilya, a minister in Chandragupta's kingdom wrote a book named Arthashasthra, which also described how accounting records had to be maintained.

Luca Pacioli's, a Franciscan friar (merchant class), book Summa de Arithmetica, Geometria, Proportion at Proportionality (Review of Arithmetic and Geometric proportions) in Venice (1494) is considered as the first book on double entry bookkeeping. A portion of this book contains knowledge of business and book-keeping. He used the terms Debit (Dr.) and Credit (Cr.) in his books. These were the concepts used in Italian terminology. Debit comes from the Italian *debito* which comes from the Latin debita and debeo which means owed to the proprietor. Credit comes from the Italian *credito* which comes from the Latin 'credo' which means trust or belief (in the proprietor or owed by the proprietor.

In explaining double entry system, Pacioli wrote that 'All entries... have to be double entries, that is if you make one creditor, you must make some debtor'. He also mentioned that a merchant's responsibility is to give glory to God in their enterprises, to be ethical in all business activities and to earn a profit. He discussed the details of memorandum, journal, ledger and specialised accounting procedures.

In its oldest form, accounting aided the stewards to discharge their stewardship function. The wealthy men employed stewards to manage their property; the stewards in turn rendered an account periodically of their stewardship. This 'Stewardship Accounting' was the root of financial accounting system. Although double-entry system was followed, 'stewardship accounting' served the purpose of businessmen and wealthy persons at that time. In most of the countries, stewardship accounting was prevalent till the emergence of large-scale enterprises in the form of public limited companies.

In the second phase, the idea of financial accounting emerged with the concept of joint stock company and divorce of ownership from the management. To safeguard the interest of the shareholders and investors, disclosure of financial statements (mainly, profit and loss account and balance sheet) and other accounting information was moulded by law. Financial statements give periodic performance report by way of profit and loss account and financial position at the end of the period by way of Balance Sheet. It got the legal status due to changing relationships between the owners, economic entity and the managers. With the democratisation of society, the relationships between the enterprise on the one hand, the investors, employees, managers and governments on the other, have also undergone a sea-change. Also, the prospective investors and other business contact groups want to know a lot about the business before entering into transactions. Thus, financial accounting emerged as an information system to identify, measure and communicate useful information for informed judgements and decisions by a broad group of users. In the third phase, accounting information was generated to aid management decision- making in particular. It contributed a lot to improve the quality of management decisions. This new dimension of accounting is called Management Accounting and it is the development of 20th Century only. It is pervasive enough to cover all spheres of management decisions.

Lastly, Social Responsibility Accounting is in the formative process, which aims at accounting for the social cost incurred by business as well as the social benefit, created by it. It emerges from the growing social awareness about the undesirable by-products of economic activities. While earning profit, an enterprise incurs numerous social costs like pollution, using the resources of society like materials, land, labour etc. To compensate for this social cost, in today's world, an enterprise is expected to generate some social benefits also like employment opportunities, recreation activities, more choice to customers at reasonable price, better quality products etc. Therefore, it is demanded that the accounting system should produce a report measuring the social cost incurred and social benefits generated.

Social Science study man as a member of society; they concern about social processes and the results and consequences of social relationships. The usefulness of accounting to society as a whole is the fundamental criterion to treat it as a social science. Although individuals may benefit from the availability of accounting information, the accounting system generates information for social good. It serves social purpose, it contributes for social progress; also it is being adapted to keep pace with social progress. So, accounting is treated as a social science.

1.4 OBJECTIVES OF ACCOUNTING

The objectives of accounting can be given as follows:

1. **Systematic recording of transactions –** Basic objective of accounting is to systematically record the financial aspects of business transactions, i.e., book-keeping. These recorded transactions are later on classified and summarized logically for the preparation of financial statements and for their analysis and interpretation.

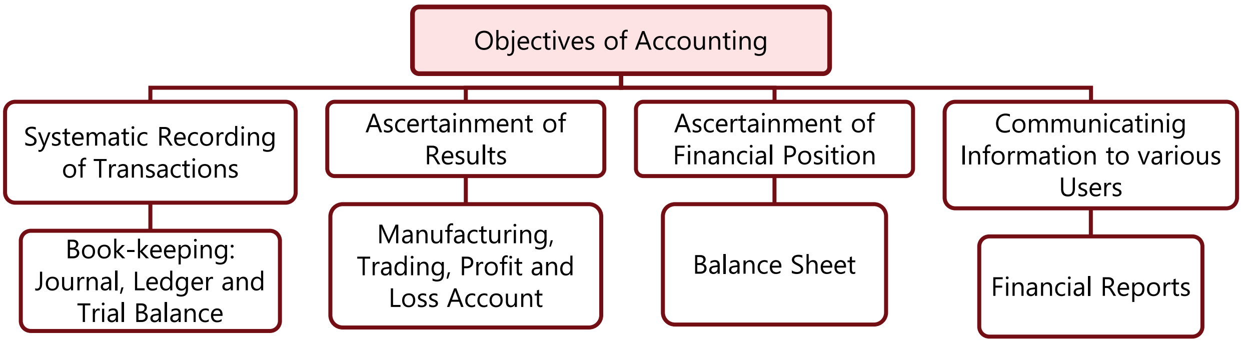
2. **Ascertainment of results of above recorded transactions –** Accountant prepares profit and loss account to know the results of business operations for a particular period of time. If revenue (Sales) exceeds expenses then it is said that business is running profitably but if expenses exceed revenue, then it can be said that business is running under loss. The profit and loss account helps the management and different stakeholders in taking rational decisions. For example, if business is not proved to be remunerative or profitable, the cause of such a state of affair can be investigated by the management for taking remedial steps.

3. **Ascertainment of the financial position of the business –** A businessman is not only interested in knowing the results of the business in terms of profits or loss for a particular period but is also anxious to know that what he owes (liability) to the outsiders and what he owns (assets) on a certain date. To know this, accountant prepares a financial position statement popularly known as Balance Sheet. The balance sheet is a statement of assets and liabilities of the business at a particular point of time and helps in ascertaining the financial health of the business.

4. **Providing information to the users for rational decision-making –** Accounting as a 'language of business' communicates the financial results of an enterprise to various stakeholders by means of financial statements. Accounting aims to meet the information needs of the decision-makers and helps them in rational decision-making.

5. **To know the solvency position –** By preparing the balance sheet, management not only reveals what is owned and owed by the enterprise, but also it gives the information regarding concern's ability to meet its liabilities in the short run (liquidity position) and also in the long-run (solvency position) as and when they fall due.

An overview of objectives of accounting is depicted in the chart given below:



1.5 FUNCTIONS OF ACCOUNTING

The main functions of accounting are as follows:

(a) **Measurement:** Accounting measures past performance of the business entity and depicts its current financial position.

(b) **Forecasting:** Accounting helps in forecasting future performance and financial position of the enterprise using past data and analysing trends.

(c) **Decision-making:** Accounting provides relevant information to the users of accounts to aid rational decision-making.

(d) **Comparison & Evaluation:** Accounting assesses performance achieved in relation to targets and discloses information regarding accounting policies and contingent liabilities which play an important role in predicting, comparing and evaluating the financial results.

(e) **Control:** Accounting also identifies weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.

(f) **Government Regulation and Taxation:** Accounting provides necessary information to the government to exercise control on the entity as well as in collection of tax revenues.

1.6 BOOK-KEEPING

Book-keeping is an activity concerned with the recording of financial data relating to business operations in a significant and orderly manner. It covers procedural aspects of accounting work and embraces record keeping function. Obviously, book-keeping procedures are governed by the end product, the financial statements. The term 'financial statements' means Profit and Loss Account, Balance Sheet and cash flow statements including Schedules and Notes forming part of Accounts.

Book-keeping also requires suitable classification of transactions and events. This is also determined with reference to the requirement of financial statements. A book-keeper may be responsible for keeping all the records of a business or only of a minor segment, such as position of the customers' accounts in a departmental store. Accounting is based on a careful and efficient book-keeping system.

The essential idea behind maintaining book-keeping records is to show correct position regarding each head of income and expenditure. A business may purchase goods on credit as well as in cash. When the goods are bought on credit, a record must be kept of the person to whom money is owed. The proprietor of the business may like to know, from time to time, what amount is due on credit purchase and to whom. If proper record is not maintained, it is not possible to get details of the transactions in regard to the income and expenses. At the end of the accounting period, the proprietor wants to know how much profit has been earned or loss has been incurred during the course of the period. For this lot of information is needed which can be gathered from a proper record of the transactions. Therefore, in book-keeping, the proper maintenance of books of account is indispensable for any business.

At this level, the major concern of the curriculum is with book-keeping and preparation of financial statements. It seems important to mention at this point that book-keeping and preparation of financial statements have legal implications also. Maintenance of books of accounts and the preparation of financial statements of a company are guided by the Companies Act, banks and insurance companies by special Acts governing these institutions and so on. However, for sole-proprietorship and partnership business, there is no specific legislation regarding maintenance of books of accounts and preparation of financial statements.

1.6.1 Objectives of Book-keeping

1. **Complete Recording of Transactions –** It is concerned with complete and permanent record of all transactions in a systematic and logical manner to show its financial effect on the business.

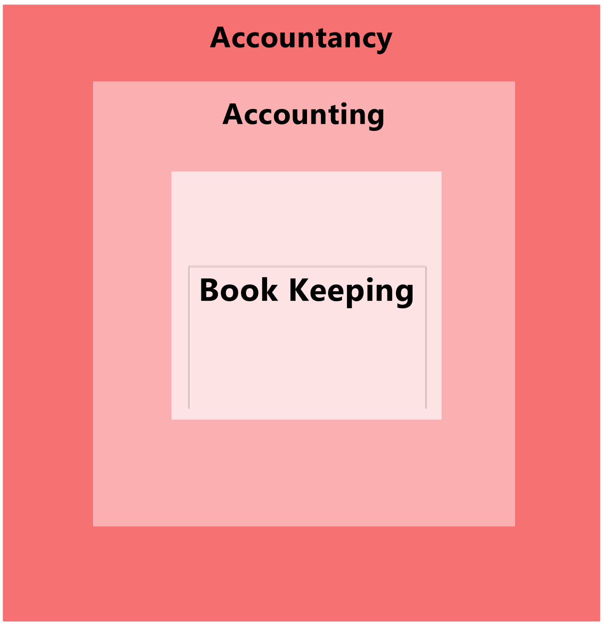
2. **Ascertainment of financial Effect on the Business –** It is concerned with the combined effect of all the transactions made during the accounting period upon the financial position of the business as a whole.

1.7 DISTINCTION BETWEEN BOOK-KEEPING AND ACCOUNTING

Some people mistake book-keeping and accounting to be synonymous terms, but in fact they are different from each other. Accounting is a broad subject. It calls for a greater understanding of records obtained from book-keeping and an ability to analyse and interpret the information provided by book-keeping records. Book-keeping is the recording phase while accounting is concerned with the summarising phase of an accounting system. Book-keeping provides necessary data for accounting and accounting starts where book-keeping ends.

S. No.	Book-keeping	Accounting
1.	It is a process concerned with recording of transactions.	It is a process concerned with summarising of the recorded transactions.
2.	It constitutes as a base for accounting.	It is considered as a language of the business.
3.	Financial statements do not form part of this process.	Financial statements are prepared in this process on the basis of book-keeping records.
4.	Managerial decisions cannot be taken with the help of these records.	Management takes decisions on the basis of these records.
5.	There is no sub-field of book-keeping.	It has several sub-fields like financial accounting, management accounting etc.
6.	Financial position of the business cannot be ascertained through book-keeping records.	Financial position of the business is ascertained on the basis of the accounting reports.

Relationship of Accounting and Book-keeping can be depicted in the following chart as



1.8 SUB-FIELDS OF ACCOUNTING

The various sub-fields of accounting are:

(i) **Financial Accounting** – It covers the preparation and interpretation of financial statements and communication to the users of accounts. It is historical in nature as it records transactions which had already been occurred. The final step of financial accounting is the preparation of Profit and Loss Account and the Balance Sheet. It primarily helps in determination of the net result for an accounting period and the financial position as on the given date.

(ii) **Management Accounting** – It is concerned with internal reporting to the managers of a business unit. To discharge the functions of stewardship, planning, control and decision- making, the management needs variety of information. The different ways of grouping information and preparing reports as desired by managers for discharging their functions are referred to as management accounting. A very important component of the management accounting is cost accounting which deals with cost ascertainment and cost control. Management Accounting will be dealt with at higher levels of the Chartered Accountancy Course.

(iii) **Cost Accounting –** The terminology of Cost Accounting published by the Institute of Cost and Management Accountants of England defines cost accounting as:

"the process of accounting for cost which begins with the recording of income and expenditure or the bases on which they are calculated and ends with the preparation of periodical statements and reports for ascertaining and controlling costs."

(iv) **Social Responsibility Accounting –** The demand for social responsibility accounting stems from increasing social awareness about the undesirable by-products of economic activities. As already discussed earlier, social responsibility accounting is concerned with accounting for social costs incurred by the enterprise and social benefits created.

(v) **Human Resource Accounting –** Human resource accounting is an attempt to identify, quantify and report investments made in human resources of an organisation that are not presently accounted for under conventional accounting practice.

1.9 USERS OF ACCOUNTING INFORMATION

Generally users of accounts are classified into two categories, (a) internal users and (b) external users. Management accounting is concerned with identifying information requirements as well as methods of providing such information to management while information requirements of the outside users are generally served by financial statements. Following are the various users of accounting information:

(i) Investors: They provide risk capital to the business. They need information to assess whether to buy, hold or sell their investment. Also they are interested to know the ability of the business to survive, prosper and to pay dividend. In non-corporate sector, where ownership and management are not essentially separated, the owners still need information about performance of the business and its financial position to decide whether to continue or shut down.

(ii) Employees: Growth of the employees is directly related to the growth of the organisation and therefore, they are interested to know the stability, continuity and growth of the enterprise and its ability to provide remuneration, retirement and other benefits and to enhance employment opportunities.

(iii) Lenders: They are interested to know whether their loan-principal and interest will be paid back when due.

(iv) Suppliers and Creditors: They are also interested to know the ability of the enterprise to pay their dues, that helps them to decide the credit policy for the relevant concern, rates to be charged and so on. Sometimes, they also become interested in long-term continuation of the enterprise if their existence becomes dependent on the survival of that business.

(v) Customers: Customers are also concerned with the stability and profitability of the enterprise because their functioning is more or less dependent on the supply of goods, suppose, a company produces some chemicals used by pharmaceutical companies and supplies chemicals on three month's credit. If all of a sudden it faces some trouble and is unable to supply the chemical, the customers will also be in trouble.

(vi) Government and their agencies: They regulate the functioning of business enterprises for public good, allocate scarce resources among competing enterprises, control prices, charge excise duties and taxes, and so they have continued interest in the business enterprise.

(vii) Public: The public at large is interested in the functioning of the enterprise because it may make a substantial contribution to the local economy in many ways including the number of people employed and their patronage to local suppliers.

(viii) Management: Management as whole is also interested in the accounts for various managerial decisions. On the basis of the accounts, management determines the effects of their various decisions on the functioning of the organisation. This helps them to make further managerial decisions.

1.10 RELATIONSHIP OF ACCOUNTING WITH OTHER DISCIPLINES

Accounting is closely related with several other disciplines and thus to acquire a good knowledge in accounting one should be conversant with the relevant portions of such disciplines. In many cases they overlap accounting. The accountant should have a working knowledge of the related disciplines so that he can understand such overlapping areas and apply the knowledge of other disciplines in his own work wherever possible, or he can take the expert advice.

(a) **Accounting and Economics:** Economics is viewed as a science of rational decision-making about the use of scarce resources. It is concerned with the analysis of efficient use of scarce resources for satisfying human wants. This may be viewed either from the perspective of a single firm or of the country as a whole.

Accounting is viewed as a system, which provides data to the users to permit informed judgement and decisions. Some non-accounting data are also relevant for decision-making.

Accounting overlaps economics in many respects. It contributed a lot in improving the management decision-making process. But, economic theories influenced the development of the decision-making tools used in accounting.

However, there exists a wide gulf between economists' and accountants' concepts of income and capital. Accountants got the ideas of value, income and capital maintenance from economists, but brushed suitably to make them usable in practical circumstances. Accountants developed the valuation, measurement and decision-making techniques which may owe to the economic theorems for origin but these are moulded in the work environment and suitably tempered with reference to relevance, verifiability, freedom from bias, timeliness, comparability, reliability and understandability.

An example may be given to explain the nexus between accounting and economics. Economists think that value of an asset is the present value of all future earnings which can be derived from such assets. Now think about a plant whose working life is more than one hundred years. How can you estimate future stream of earnings? So accountants developed the workable valuation base – the acquisition cost i.e., the price paid to acquire the assets.

At the macro-level, accounting provides the database over which the economic decision models have been developed; micro-level data arranged by the accounting system is summed up to get macro-level database.

Non-overlapping zones of accounting are not negligible. Development of the systems of recording, classifying and summarising transactions and events, harmonising the systems by uniform rules and communicating the data is essentially a non-overlapping area of accounting.

(b) Accounting and Statistics: The use of statistics in accounting can be appreciated better in the context of the nature of accounting records. Accounting information is very precise; it is exact to the last paisa. But, for decision-making purposes such precision is not necessary and hence, the statistical approximations are sought.

In accounts, all values are important individually because they relate to business transactions. As against this, statistics is concerned with the typical value, behaviour or trend over a period of time or the degree of variation over a series of observations. Therefore, wherever a need arises for only broad generalisations or the average of relationships, statistical methods have to be applied in accounting data.

Further, in accountancy, the classification of assets and liabilities as well as the heads of income and expenditure has been done as per the needs of financial recording to ascertain financial results of various operations. Other types of classification like the geographical and historical ones and ad hoc classification are done depending on the purpose to make such classification meaningful.

Accounting records generally take a short-term view of events and are confined to a year while statistical analysis is more useful if a longer view is taken for the purpose. For example, to fit the trend line a longer period will be required. However, statistical methods do use past accounting records maintained on a consistent basis.

The functional relations showing mathematical relations of one variable with one or more other variables are based on statistical work. These relations are used widely in making cost or price estimates for some estimated future values assigned to the given independent variables. For example, given the functional relation of total cost to the price of an input, the effect of changes in future prices on the cost of production can be calculated.

In accountancy, a number of financial and other ratios are based on statistical methods, which help in averaging them over a period of time. Several accounting and financial calculations are based on statistical formulae.

Statistical methods are helpful in developing accounting data and in their interpretation. For example, time series and cross-sectional comparison of accounting data is based on statistical techniques. Now- a-days multiple discriminate analysis is popularly used to identify symptoms of sickness of a business firm. Therefore, the study and application of statistical methods would add extra edge to the accounting data.

(c) Accounting and Mathematics: Double Entry book-keeping can be converted in algebraic form; in fact the first known book on this subject was part of a treatise on algebra. The fundamental accounting equation will be discussed in detail under 'Dual Aspect Concept' of this chapter.

Knowledge of arithmetic and algebra is a pre-requisite for accounting computations and measurements. Calculations of interest and annuity are the examples of such fundamental uses. While computing depreciation, finding out installments in hire-purchase and instalments payment transactions, calculating amount to be set aside for repayment of loan and replacement of assets and calculating lease rentals, mathematical techniques are frequently used. Accounting data are also presented in ratio form.

With the advent of the computer, mathematics is becoming a vital part of accounting. Instead of writing accounts in traditional fashion, the transactions and events can be recorded in the matrix form and the rules of matrix algebra can be applied for classifying and summarising data.

Now-a-days statistics and econometric models are largely used for developing decision models for the users of accounts. Also, Operations Research Techniques provide lot of decision models. Since accounting is meant for providing information to the users, to be effective, accounting data should feed the information requirements of such statistical, econometric and operations research models. Understanding mathematics has become a must to grasp the decision models framed by statisticians, econometricians and the O.R. experts.

Presently graphs and charts are being extensively used for communicating accounting information. In addition to statistical knowledge, knowledge in geometry and trigonometry seems to be essential to have a better understanding about the accounting communications system.

(d) Accounting and Law: An economic entity operates within a legal environment. All transactions with suppliers and customers are governed by the Contract Act, the Sale of Goods Act, the Negotiable Instruments Act, etc. The entity itself is created and controlled by laws. For example, a company is created by the Companies Act and also controlled by Companies Act.

Similarly, every country has a set of economic, fiscal and labour laws. Transactions and events are always guided by laws of the land. Very often the accounting system to be followed has been prescribed by the law. For example, the Companies Act has prescribed the format of financial statements for companies.

Banking, insurance and electric supply undertakings may also have to produce financial statements as prescribed by the respective legislations controlling such entities.

However, legal prescription about the accounting system is the product of developments in accounting knowledge. That is to say, legislation about accounting system cannot be enacted unless there is a corresponding development in the accounting discipline. In that way accounting influences law and is also influenced by law.

(e) Accounting and Management: Management is a broad occupational field, which comprises many functions and encompasses application of many disciplines including those mentioned above. Accountants are well placed in the management and play a key role in the management team. A large portion of accounting information is prepared for management decision-making. Although management relies on other data sources, accounting data are used as basic source documents. In the management team, an accountant is in a better position to understand and use such data. In other words, since an accountant plays an active role in management, he understands the data requirements. So the accounting system can be moulded to serve the management purpose.

1.11 LIMITATIONS OF ACCOUNTING

There are certain misconceptions regarding financial statements. A common man presumes that an income statement shows the correct income or loss of the enterprise and that a balance sheet depicts a perfectly true and fair picture of financial standing of that enterprise. It must be recognised that the accounting as a language has its own limitations. The figures of profit or loss generated by the accounting process are subject to various constraints within which the accounting works. The assumptions and conventions, on which the accounting is based, become the limitations of accounting. The financial statements are never free from subjectivity factor as these are largely the outcome of personal judgement of the accountant with regard to the adoption of the accounting policies. Following are certain instances:

1. The factors which may be relevant in assessing the worth of the enterprise don't find place in the accounts as they cannot be measured in terms of money. The Balance sheet cannot reflect the value of certain factors like loyalty and skill of the personnel which may be the most valuable asset of an enterprise these days.
2. Balance Sheet shows the position of the business on the day of its preparation and not on the future date while the users of the accounts are interested in knowing the position of the business in the near future and also in long run and not for the past date.
3. Accounting ignores changes in some money factors like inflation etc.

4. There are occasions when accounting principles conflict with each other.

5. Certain accounting estimates depend on the sheer personal judgement of the accountant, e.g., provision for doubtful debts, method of depreciation adopted, recording certain expenditure as revenue expenditure or capital expenditure, selection of method of valuation of inventories and the list is quite long.

6. Financial statements consider those assets which can be expressed in monetary terms. Human resources although the very important asset of the enterprise are not shown in the balance sheet. There is no generally accepted formula for the valuation of human resources in money terms.

7. Different accounting policies for the treatment of same item adds to the probability of manipulations. Though through various laws and Accounting Standards, efforts are made to reduce these options to minimum but certainly could not be reduced to one.

In nutshell, it can be said that the language of accounting has certain practical limitations and, therefore, the financial statements should be interpreted carefully keeping in mind all various factors influencing the true picture.

1.12 ROLE OF ACCOUNTANT IN THE SOCIETY

There are only a few types of profession in the world which are held in high esteem in public eyes and there is no denying the fact that the accounting profession is one of them. Goethe had called the accountant's profession as 'the fairest invention of the human mind'. At the core of all types of learned profession, there is the desire of public good and of finding the best way to serve society. By the use of the science of accountancy and under the spell of its art, a dynamic pattern which assists business in planning its future is woven by accountants out of the inert mass of non-speaking silent figures. This is what makes their profession an instrument of socio-economic change and welfare of the society.

An accountant with his education, training, analytical mind and experience is best qualified to provide multiple need-based services to the ever growing society. The accountants of today can do full justice not only to matters relating to taxation, costing, management accounting, financial lay-out, company legislation and procedures but they can delve deep into the fields relating to financial policies, budgetary policies and even economic principles. The area of activities which can be undertaken by the accountants is not limited but it can also cover many additional facets.

1.12.1 Areas of Service

The practice of accountancy has crossed its usual domain of preparation of financial statements, interpretation of such statements and audit thereof. Accountants are presently taking active role in company laws and other corporate legislation matters, in taxation laws matters (both direct and indirect) and in general management problems. Some of the services rendered by accountants to the society are briefly mentioned hereunder:

(i) **Maintenance of Books of Accounts:** An accountant is able to maintain a systematic record of financial transactions in order to establish the net result of the transactions entered into during a period and to state the financial position of the concern as at a particular date.

For the fulfillment of the twin objective of ascertaining the profit earned or loss suffered and the financial position, it is necessary that all transactions be recorded in a systematic manner, which can be done only by an accountant. Proper maintenance of books of accounts assists management in planning, decision-making, controlling functions.

(ii) **Statutory Audit:** Every limited company is required to appoint a chartered accountant or a firm of chartered accountants as their auditor who are statutorily required to report each year whether in their opinion the balance sheet shows a true and fair view of the state of affairs on the balance sheet date, and the profit and loss account shows a true and fair view of the profit or loss for the year.

Auditing is not confined to the accounts of companies; other organisations may also have their accounts audited, either because the law so requires (for example, the Co-operative Societies Act, the Income-tax Act, etc.) or because the proprietors wisely decided so (for example, a partnership firm or an individual trader).

(iii) **Internal Audit:** It is a management tool whereby an internal auditor thoroughly examines the accounting transactions and also the system, according to which these have been recorded with a view to ensure the management that the accounts are being properly maintained and the system contains adequate safeguards to check any leakage of revenue or misappropriation of property or assets and the operations have been carried out in conformity with the plans of management.

Now-a-days internal auditing has developed as a service to management. The internal auditor constructively contributes in improving the operational efficiency of the business through an independent review and appraisal of all business operations.

(iv) **Taxation:** An accountant can handle taxation matters of a business or a person and he can represent that business or person before the tax authorities and settle the tax liability under the statute prevailing. He can also assist in avoiding or reducing tax burden by proper planning of tax affairs.

Accountants also have a social obligation to express their views on broad tax policy, on the effect of tax rate on business and the economy in general and on all other aspects of taxation in which they have knowledge superior to that of the general public.

(v) **Management Accounting and Consultancy Services:** Management accountant performs an advisory function. He is largely responsible for internal reporting to the management for planning and controlling current operations, decision-making on special matters and for formulating long-range plans. His job is to collect, analyse, interpret and present all accounting information which is useful to the management. Accountant provides management consultancy services in the areas of management information system, expenditure control and evaluation of appraisal techniques for new investments and divestments, working capital management, corporate planning etc.

(vi) **Financial Advice:** Many people need help and guidance in planning their personal financial affairs. An accountant who knows about finances, taxation and family problems is well placed to give such advice. Some of the areas in which an accountant can render financial advice are:

(a) Investments: An accountant can explain the significance of the formidable documents which shareholders receive from companies and help in making decisions relating to their investments.

(b) Insurance: An accountant can provide information to his clients on various insurance policies and helps in choosing appropriate policy.

(c) Business Expansion: As businesses grow in size and complexity and mergers are being considered, accountants are in the forefront in interpreting accounts, making suggestions as to the form of schemes and the fairness of proposals considering cost and financial consequences and generally advising their clients. They also advise on how to set about the problem of borrowing money or whether this is an appropriate method of finance. Accountants can render extremely useful service in connection of negotiations with foreign collaborators.

(d) Investigations: Financial investigations are required for a variety of purposes. Examples are:

(i) To ascertain the financial position of a business, for the information of interested parties in connection with an issue of capital, the purchase or sale of the business or a reconstruction or amalgamation.

(ii) To help the management to decide whether it is cheaper to manufacture an article or to buy out.

(iii) To ascertain why profits have fallen.

(iv) To achieve greater efficiency in management.

(v) To ascertain whether fraud has occurred and if so, its nature and extent and to make suggestions which will help to prevent a recurrence.

(vi) To value businesses and shares in private companies for purposes such as purchase, sale, estate duty or wealth tax etc.

For such problems requiring financial investigation, you need an accountant. His task as an independent professional is to establish the facts fairly and clearly for the benefit of those who have to make decisions and to give advice in many areas in which he has competence and experience.

(e) Pension schemes: Specialist advice from actuaries, insurance agents or insurance company is needed before launching or amending a provident fund or pension scheme in a business. But before making a final decision, an accountant has to be consulted. Later on, his help may be needed for managing the scheme or obtaining tax relief.

(vii) Other Services

(a) Secretarial Work: Companies, clubs, and associations indeed, virtually all organisations involve secretarial work. Accountants frequently do this work.

(b) Share Registration Work: Accountants are often used by many companies to undertake the work involved in registering share transfers and new issues.

(c) Company Formation: In conjunction with legal advisers, accountants help in the formation of a company or advise against doing so.

(d) Receiverships, Liquidations, etc.: An accountant has to sometimes take on the onerous duties of liquidator when a company is being wound up or receiver when a debenture holder exercises a right to recover a loan on which the borrower has defaulted. Accountant is just the man for the job. He is also just the man to help you to keep insolvency away if you consult him in time.

(e) Arbitrations: At times, accountants are invited by parties to act as arbitrators in a dispute or settle disputes of various kinds.

(f) As regards the Cost Accounts: A cost accountant's job is to continuously report cost data and related information at frequent intervals to the management.

(g) Accountant and Information Services: An accountant will be effective in his role if he supplies the information promptly and in an unambiguous language. He should develop a system by which there is a regular flow of information both horizontally and vertically.

The information system should be such that comparability of financial statement is possible both business-wise and year-wise so that it benefits both the management and the investors. Dependence on data from the computerised information system will put new responsibilities on an accountant but his product will command greater attention and respect.

1.12.2 Chartered Accountant in Industry

An accountant, though he is a part of the highest planning team is not a planner in an industry. He works with the functional departments and translates the organisation's aims in terms of financial expectations. Therefore, he has to make a thorough study of the business and of individuals in the functional departments, whether they are engineers or salesmen. A qualified accountant will be able to play an important role in performing important functions of a business relating to accounting, costing and budgetary control, estimating and treasury.

1.12.3 Chartered Accountant in Public Sector Enterprises

Both in the developed and developing countries, public sector enterprises have become a special feature of the national economy. The system of financial and budgetary control and of accounting, auditing and reporting has, therefore, become a matter of interest and concern to the nation, and does not remain confined merely to a limited number of shareholders. The form of accounting followed by these corporations or companies is different from that of ordinary government accounting. It is the duty of the accountants to prepare the accounts and reports of these public corporations in such a way that they enable the general public to know how far the items appearing in the various types of records and financial statements justify their existence.

1.12.4 Chartered Accountant in Framing Fiscal Policies

Accountants have a positive role to play in the determination of proper fiscal policies and advancement of trade, commerce and industry. They should develop new techniques and prepare themselves for new fields of service towards their commitment to the concept of the public goods and services. A business enterprise can be successful in the commercial sense only if accounting and business knowledge are pooled together. It is a social obligation for both accountants in industry and in practice to disclose greater information regarding the corporate results. The state of affairs of the economy can be ascertained only when such consolidated corporate information is disclosed.

1.12.5 Chartered Accountant and Economic Growth

In the present times accountants should conceive their duties as broadly as the conditions might require and do not restrict them to only literal compliance of the law. Their aim should be not to allow any individual to gain at the cost of the nation. Accountants have to accept a positive role and do their best to encourage efficiency in individual business units and encourage those social objectives which form the main foundation of a welfare state.

SUMMARY

- "Accounting is the art of recording, classifying, and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof."
- Accounting procedure can be basically divided into two parts:
  - (i) Generating financial information and
  - (ii) Using the financial information.
- The objectives of accounting can be given as follows:
  - (i) Systematic recording of transactions
  - (ii) Ascertainment of results of above recorded transactions
  - (iii) Ascertainment of the financial position of the business
  - (iv) Providing information to the users for rational decision-making
  - (v) To know the solvency position

  The main functions of accounting are as follows:
  - (i) Measurement
  - (ii) Forecasting
  - (iii) Decision-making
  - (iv) Comparison & Evaluation
  - (v) Control
  - (vi) Government Regulation and Taxation
- Objectives of Book-keeping:
  - (i) Complete Recording of Transactions and
  - (ii) Ascertainment of Financial Effect on the Business
- The various sub-fields of accounting are:
  - (i) Financial Accounting
  - (ii) Management Accounting

(iii) Cost Accounting (iv) Social Responsibility Accounting

(v) Human Resource Accounting

- The various users of accounting information:

  (i) Investors (ii) Employees

  (iii) Lenders (iv) Suppliers and Creditors

  (v) Customers (vi) Government and their agencies

  (vii) Public (viii) Management

- Accounting is closely related with several other disciplines and thus to acquire a good knowledge in accounting one should be conversant with the relevant portions of such disciplines.

An accountant with his education, training, analytical mind and experience is best qualified to provide multiple need-based services to the ever growing society. The accountants of today can do full justice not only to matters relating to taxation, costing, management accounting, financial lay-out, company legislation and procedures but they can delve deep into the fields relating to financial policies, budgetary policies and even economic principles.

TEST YOUR KNOWLEDGE

True and False

1. *There is no difference between book keeping and accounting, both are same.*
2. *Management Accounting covers the preparation and interpretation of financial statements and communication to the users of accounts.*
3. *Financial accounting is concerned with internal reporting to the managers of a business unit.*
4. *Customers of business should not be considered as users of accounts prepared by business. They are not interested to know performance of the business*
5. *Summarising is the basic function of accounting. All business transactions of a financial characters evidenced by some documents such as sales bill, pass book, salary slip etc. are recorded in the books of account.*
6. *Balance sheet shows the position of the business on the day of its preparation and not on the future date.*
7. *Objectives of book-keeping are complete recording of transactions & ascertainment of financial effect on the business.*

Multiple Choice Questions

1. *Which of the following is not a subfield of accounting?*

   (a) *Management accounting.*

   (b) *Cost accounting.*

   (c) *Book-keeping*

2. *Purposes of an accounting system include all the following except*

   (a) *Interpret and record the effects of business transaction.*

   (b) *Classify the effects of transactions to facilitate the preparation of reports.*

   (c) *Dictate the specific types of business enterprise transactions that the enterprises may engage in.*

3. *Book-keeping is mainly concerned with*

   (a) *Recording of financial data.*

   (b) *Designing the systems in recording, classifying and summarising the recorded data.*

   (c) *Interpreting the data for internal and external users.*

4. *All of the following are functions of Accounting except*

   (a) *Decision making.*

   (b) *Ledger posting.*

   (c) *Forecasting.*

5. *Financial statements are part of*

   (a) *Accounting.*

   (b) *Book-keeping.*

   (c) *Management Accounting.*

6. *Financial position of the business is ascertained on the basis of*

   (a) *Records prepared under book-keeping process.*

   (b) *Trial balance.*

   (c) *Balance Sheet.*

7. *Users of accounting information include*

   (a) *Creditors/Suppliers*

(b) Lenders/ Customers

(c) Both (a) and (b)

8. Financial statements do not consider

(a) Assets expressed in monetary terms.

(b) Liabilities expressed in monetary terms.

(c) Assets and liabilities expressed in non-monetary terms

9. On January 1, Sohan paid rent of ₹5,000. This can be classified as

(a) An event.

(b) A transaction.

(c) A transaction as well as an event.

10. On March 31, 2022 after sale of goods worth ₹2,000, he is left with the closing inventory of ₹ 10,000. This is

(a) An event.

(b) A transaction.

(c) A transaction as well as an event.

11. Which of the following is not a business transaction?

(a) Bought a machine of ₹10,000 for business

(b) Paid towards salaries of employees ₹ 5,000

(c) Paid son's fees from her personal bank account ₹ 8,000

12. Which qualitative characteristics of accounting information is reflected when accounting information is clearly presented?

(a) Understandability

(b) Relevance

(c) Comparability

Theoretical Questions

1. Define accounting. What are the sub-fields of accounting?

2. Who are the users of accounting information?

3. Discuss briefly the relationship of accounting with

(i) Economics (ii) Statistics (iii) Law

4. *Discuss the limitations which must be kept in mind while evaluating the Financial Statements.*

5. *What services can a Chartered Accountant provide to the society?*

ANSWER/HINTS

True and False

1. False: Book-keeping and accounting are different from each other. Accounting is a broad subject. It calls for a greater understanding of records obtained from book-keeping and an ability to analyse and interpret the information provided by book-keeping records.

Book-keeping is the recording phase while accounting is concerned with the summarizing phase of an accounting system.

2. False: Financial accounting covers the preparation and interpretation of financial statements and communication to the users of accounts.

3. False: Management accounting is concerned with internal reporting to the managers of a business unit.

4. False: Customers are also concerned with the stability and profitability of the enterprise because their functioning is more or less dependent on the supply of goods

5. False: Recording is the basic function of accounting. Summarising is concerned with the preparation and presentation of the classified data in a manner useful to the internal as well as the external users of financial statements

6. True: Balance Sheet is a statement of the financial position of an enterprise at a given date.

7. True: Book-keeping is concerned with complete recording and combined effect of transactions made during the accounting period.

Multiple Choice Questions

1.	**(c)**	2.	**(c)**	3.	**(a)**	4.	**(b)**	5	**(a)**	6	**(c)**
7.	**(c)**	8.	**(c)**	9.	**(b)**	10.	**(a)**	11.	**(c)**	12.	**(a)**

Theoretical Questions

1. Accounting is the art of recording, classifying, and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof. Various subfields of accounting are listed as: Financial Accounting; Management Accounting; Cost Accounting; Social Responsibility Accounting and Human Resource Accounting.

2. Users of accounts can be listed as Investors, Employees, Lenders, Suppliers and Creditors, Customers, Govt. and their agencies, public and Management.

3. Refer para 1.10 for understanding the relationship of Accounting with Economics, Statistics and Law.

4. Limitations which must be kept in mind while evaluating the Financial Statements are as follows:

- ♦ The factors which may be relevant in assessing the worth of the enterprise don't find place in the accounts as they cannot be measured in terms of money.
- ♦ Balance Sheet shows the position of the business on the day of its preparation and not on the future date while the users of the accounts are interested in knowing the position of the business in the near future and also in long run and not for the past date.
- ♦ Accounting ignores changes in some money factors like inflation etc.
- ♦ There are occasions when accounting principles conflict with each other.
- ♦ Certain accounting estimates depend on the sheer personal judgement of the accountant.
- ♦ Different accounting policies for the treatment of same item adds to the probability of manipulations.

5. The practice of accountancy has crossed its usual domain of preparation of financial statements, interpretation of such statements and audit thereof. Accountants are presently taking active role in company laws and other corporate legislation matters, in taxation laws matters (both direct and indirect) and in general management problems. For details, refer Para 1.12.

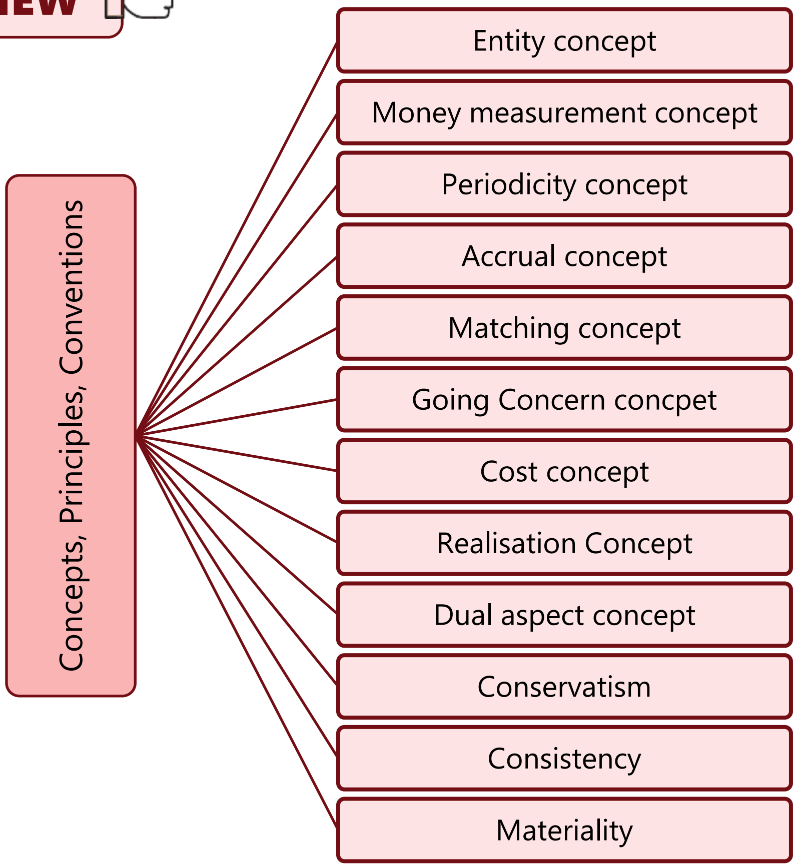
UNIT – 2 ACCOUNTING CONCEPTS, PRINCIPLES AND CONVENTIONS

LEARNING OUTCOMES

After studying this unit, you would be able to:

- Grasp the basic accounting concepts, principles and conventions and observe their implications while recording transactions and events.
- Identify the three fundamental accounting assumptions:
  - Going Concern
  - Consistency
  - Accrual
- Understand the qualitative characteristics that will help to develop the skill in course of time to prepare financial statements.

UNIT OVERVIEW



2.1 INTRODUCTION

Let us imagine a situation where you are a proprietor and you take copies of your books of account to five different accountants. You ask them to prepare the financial statements on the basis of the above records and to calculate the profits of the business for the year. After few days, they are ready with the financial statements and all the five accountants have calculated five different amounts of profits and that too with very wide variations among them. Guess in such a situation what impact would it leave on you about accounting profession. To avoid this, a generally accepted set of rules have been developed. This generally accepted set of rules provides unity of understanding and unity of approach in the practice of accounting and also in better preparation and presentation of the financial statements.

Accounting is a language of the business. Financial statements prepared by the accountant communicate financial information to the various stakeholders for decision-making purpose. Therefore, it is important that financial statements prepared by different organizations should be prepared on uniform basis. Also, there should be consistency over a period of time in the preparation of these financial statements. If every accountant starts following his own norms and notions for accounting of different items, then there will be an utter confusion.

To avoid confusion and to achieve uniformity, accounting process is applied within the conceptual framework of 'Generally Accepted Accounting Principles'(GAAPs). The term GAAPs is used to describe rules developed for the preparation of the financial statements and are called concepts, conventions, postulates, principles etc. These GAAPs are the backbone of the accounting information system, without which the whole system cannot even stand erectly. These principles are the ground rules, which define the parameters and constraints within which accounting reports are generated. Accounting principles are basic norms and assumptions on which the whole accounting system has been developed and established. Accountant also adheres to various accounting standards issued by the regulatory authority for the standardization of accounting policies to be followed under specific circumstances. These conceptual frameworks, GAAPs and accounting standards are considered as the theory base of accounting. Globally, for achieving the standardization, countries use the framework under International Financial Reporting Standards (IFRS). However, countries may apply their respective GAAPs and related conceptual frameworks. For example, in India, companies are required to use AS or Ind-AS frameworks as applicable.

2.2 ACCOUNTING CONCEPTS

Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared. Certain concepts are perceived, assumed and accepted in accounting to provide a unifying structure and internal logic to accounting process. The word concept means idea or notion, which has universal application. Financial transactions are interpreted in the light of the concepts, which govern accounting methods. Concepts are those basic assumptions and conditions, which form the basis upon which the accountancy has been laid. Unlike physical science, accounting concepts are only result of broad consensus. These accounting concepts lay the foundation on the basis of which the accounting principles are formulated.

2.3 ACCOUNTING PRINCIPLES

"Accounting principles 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."

Accounting principles must satisfy the following conditions:

1. They should be based on real assumptions;

2. They must be simple, understandable and explanatory;
3. They must be followed consistently;
4. They should be able to reflect future predictions;
5. They should be informational for the users.

2.4 ACCOUNTING CONVENTIONS

Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time. These conventions are derived by usage and practice. The accountancy bodies of the world may change any of the convention to improve the quality of accounting information. Accounting conventions need not have universal application.

In the study material, the terms 'accounting concepts', 'accounting principles' and 'accounting conventions' have been used interchangeably to mean those basic points of agreement on which financial accounting theory and practice are founded.

2.5 CONCEPTS, PRINCIPLES AND CONVENTIONS - AN OVERVIEW

Now we shall study in detail the various accounting concepts on which accounting is based. The following are the widely accepted accounting concepts:

(a) **Entity concept:** Entity concept states that business enterprise is a separate identity apart from its owner. Accountants should treat a business as distinct from its owner. Business transactions are recorded in the business books of accounts and owner's transactions in his personal books of accounts. The practice of distinguishing the affairs of the business from the personal affairs of the owners originated only in the early days of the double-entry book-keeping. This concept helps in keeping business affairs free from the influence of the personal affairs of the owner. This basic concept is applied to all the organizations whether sole proprietorship or partnership or corporate entities.

Entity concept keeps the business separate from its owner. In a way, the entity concept helps to ascertain how much amount of money is due to the owner in form of his capital and share of profits earned. It also helps to perform accounting from the point of view of the business and not that of the owner. For example, if a person runs a business and pays money from his own pocket for his son's school fee, it will not constitute a transaction in the books of the business. However, if the person withdraws money from the business to pay for his son's school fee it will constitute a transaction to be recorded in the books of the business as amount withdrawn by the owner.

Entity concept means that the enterprise is liable to the owner for capital investment made by the owner. Since the owner invested capital, which is also called risk capital, he has claim on the profit of the enterprise. A portion of profit which is apportioned to the owner and is immediately payable becomes current liability in the case of corporate entities.

Example 1: Mr. X started business investing ₹ 7,00,000 with which he purchased machinery for ₹ 5,00,000 and maintained the balance in hand. The financial position of the will be as follows:

	₹
Capital	7,00,000
Machinery	5,00,000
Cash	2,00,000

This means that the enterprise owes to Mr. X ₹ 7,00,000. Now if Mr. X spends ₹ 5,000 to meet his family expenses from the business fund, then it should not be taken as business expenses and would be charged to his capital account (i.e., his investment would be reduced by ₹ 5,000). Following the entity concept the revised financial position would be

Liability	₹	₹
Capital	7,00,000	
Less : Drawings	(5,000)	6,95,000
Machinery		5,00,000
Cash		1,95,000

(b) Money measurement concept: As per this concept, only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts. Transactions, even if, they affect the results of the business materially, are not recorded if they are not convertible in monetary terms.

For example, a business owning a factory on a piece of 1 acre of land, with an office building with 2 floors, having 20 computers, and 10 units of machine cannot show these items under different measurement units. These items need to be expressed in monetary terms. The factory price might be 50 Cr, cost of land might be 30 Cr, building with a cost of 15 Cr, computers at a cost of 10 lac and machines with a cost of 10 Cr need to be recorded.

However, the concept has its own limitations. Transactions and events that cannot be expressed in terms of money are not recorded in the business books. For example; employees of the organization are, no doubt, the assets of the organizations but their measurement in monetary terms is not possible therefore, not included in the books of account of the organization. Measuring unit for money is taken as the currency of the ruling country i.e., the ruling currency of a country provides a common denomination for the value of material objects.

It may be mentioned that when transactions occur across the boundary of a country, one may see many currencies. Suppose a businessman sells goods worth ₹ 50 lakhs at home and he also sells goods worth of 1 lakh Euro in the United States. What is his total sales? ₹ 50 lakhs plus 1 lakh Euro.

These are not amenable to even arithmetic treatment. So, transactions are to be recorded at uniform monetary unit i.e. in one currency. Suppose EURO 1 = ₹ 71.

Total Sales = ₹ 50 lakhs plus 71 lakhs = ₹ 121 lakhs. Money Measurement Concept imparts the essential flexibility for measurement and interpretation of accounting data.

This concept ignores that money is an inelastic yardstick for measurement as it is based on the implicit assumption that purchasing power of the money is not of sufficient importance as to require adjustment. For example, a unit of land purchased 10 years ago for 40 Cr and a similar unit of land purchased now for 90 Cr will still be shown at the respective values, i.e., total of 130 Cr. Though in real world, the true value of the units together might be 180 Cr (90 + 90). Accordingly, accounting does not give a true and fair view of the affairs of the business.

As mentioned earlier, many material transactions and events are not recorded in the books of accounts just because they cannot be measured in monetary terms. Yet it is used for accounting purposes because it is not possible to adopt a better measurement scale.

Entity and money measurement are viewed as the basic concepts on which other procedural concepts hinge.

(c) **Periodicity concept:** This is also called the concept of definite accounting period. As per going concern' concept an indefinite life of the entity is assumed. For a business entity it causes inconvenience to measure performance achieved by the entity in the ordinary course of business.

If a textile mill lasts for 100 years, it is not desirable to measure its performance as well as financial position only at the end of its life.

So, a small but workable fraction of time is chosen out of infinite life cycle of the business entity for measuring performance and looking at the financial position. Generally, one year period is taken up for performance measurement and appraisal of financial position. However, it may also be 6 months or 9 months or 15 months.

According to this concept accounts should be prepared after every period & not at the end of the life of the entity. Usually, this period is one calendar year. We generally follow from 1st April of a year to 31st March of the immediately following year.

Thus, for performance appraisal it is not necessary to look into the revenue and expenses of an unduly long time-frame. This concept makes the accounting system workable and the term 'accrual' meaningful. If one thinks of indefinite time-frame, nothing will accrue. There cannot be unpaid expenses and non- receipt of revenue. Accrued expenses or accrued revenue is only with reference to a finite time-frame which is called accounting period.

Thus, the periodicity concept facilitates in:

(i) Comparing of financial statements of different periods

(ii) Uniform and consistent accounting treatment for ascertaining the profit and assets of the business

(iii) Matching periodic revenues with expenses for getting correct results of the business operations

(d) **Accrual concept:** Under accrual concept, the effects of transactions and other events are recognised on mercantile basis i.e., when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future.

To understand accrual assumption knowledge of revenues and expenses is required. Revenue is the gross inflow of cash, receivables and other consideration arising in the course of the ordinary activities of an enterprise from sale of goods, from rendering services and from the use by others of enterprise's resources yielding interest, royalties and dividends. **For example**, (1) Mr. X started a cloth merchandising. He invested ₹ 50,000, bought merchandise worth ₹ 50,000. He sold such merchandise for ₹ 60,000. Customers paid him ₹ 50,000 cash and assure him to pay ₹ 10,000 shortly. His revenue is ₹ 60,000. It arose in the ordinary course of cloth business; Mr. X received ₹ 50,000 in cash and ₹ 10,000 by way of receivables.

Take another example; (2) an electricity supply undertaking supplies electricity spending ₹ 16,00,000 for fuel and wages and collects electricity bill in one month ₹ 20,00,000 by way of electricity charges. This is also revenue which arose from rendering services.

Lastly, (3) Mr. A invested ₹ 1,00,000 in a business. He purchased a machine paying ₹ 1,00,000. He rented it for ₹ 20,000 annually to Mr. B. ₹ 20,000 is the revenue of Mr. A; it arose from the use PG the enterprise's resources.

Expense is a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period.

In the first example, Mr. X spent ₹ 50,000 to buy the merchandise; it is the expense of generating revenue of ₹ 60,000. In the second instance ₹ 16,00,000 are the expenses. Also whenever any asset is used it has a finite life to generate benefit. Suppose, the machine purchased by Mr. A in the third example will last for 10 years only. Then ₹ 10,000 is the expense every year relating to the cost of machinery.

Accrual means recognition of revenue and costs as they are earned or incurred and not as money is received or paid. The accrual concept relates to measurement of income, identifying assets and liabilities.

Example: Mr. J D buys clothing of ₹ 50,000 paying cash ₹ 20,000 and sells at ₹ 60,000 of which customers paid only ₹ 50,000.

His revenue is ₹ 60,000, not ₹ 50,000 cash received. Expense (i.e., cost incurred for the revenue) is ₹ 50,000, not ₹ 20,000 cash paid. So the accrual concept based profit is ₹ 10,000 (Revenue – Expenses).

As per Accrual Concept: Revenue – Expenses = Profit

Accrual Concept provides the foundation on which the structure of present-day accounting has been developed.

Alternative as per Cash basis

Cash received in ordinary course of business – Cash paid in ordinary course of business = profit.

Timing of revenue and expense booking could be different from cash receipt or paid.

(i)	when cash received before revenue is booked	-	a liability is created when cash is received in advance

(ii) when cash received after revenue is booked	-	an asset called Trade receivables is created
(iii) when cash paid before expense is booked	-	creates an asset called Trade Advance when cash is paid in advance
(iv) when cash paid after expense is booked	-	creates a liability called payables or Trade payables or outstanding liabilities

(e) **Matching concept:** In this concept, all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.

This concept is based on accrual concept as it considers the occurrence of expenses and income and do not concentrate on actual inflow or outflow of cash. This leads to adjustment of certain items like prepaid and outstanding expenses, unearned or accrued incomes.

It is not necessary that every expense identify every income. Some expenses are directly related to the revenue and some are time bound. For example:- selling expenses are directly related to sales but rent, salaries etc are recorded on accrual basis for a particular accounting period. In other words periodicity concept has also been followed while applying matching concept.

Mr. P K started cloth business. He purchased 10,000 pcs. garments @ ₹ 100 per piece and sold 8,000 pcs. @ ₹ 150 per piece during the accounting period of 12 months 1st January to 31st December, 2022. He paid shop rent @ ₹ 3,000 per month for 11 months and paid ₹ 8,00,000 to the suppliers of garments and received ₹ 10,00,000 from the customers.

Let us see how the accrual and periodicity concepts operate.

Periodicity Concept fixes up the time-frame for which the performance is to be measured and financial position is to be appraised. Here, it is January 2022 - December, 2022. Therefore, revenues and expenses are to be measured for the year 2022 and assets and liabilities are to be ascertained as on 31st December, 2022.

Accrual Concept operates to measure revenue of ₹ 12,00,000 (arising out of sale of garments 8,000 Pcs × ₹ 150) which accrued during 2022, not the cash received ₹ 10,00,000 and also the expenses correctly. Shop rent for 12 months is an expense item amounting to ₹ 36,000, not ₹ 33,000 the cash paid.

Should the accountant treat ₹ 10,00,000 as expenses for purchase of merchandise? And should he treat ₹ 1,64,000 as profit? (Revenue ₹ 12,00,000-Merchandise ₹ 10,00,000. Shop Rent ₹ 36,000). Obviously, the answer is No. Matching links revenue with expenses.

Revenue – Expenses = Profit

But this unqualified equation may create misconception.

It should be defined as: Periodic Profit = Periodic Revenue – Matched Expenses

From the revenue of an accounting period such expenses are deducted which are expended to generate the revenue to determine profit of that period.

In the given example revenue relates to only sale of 8,000 pcs. of garments. Therefore, the cost of 8,000 pcs of garments should be treated as expenses.

	₹	₹
Thus, Profit = Revenue		12,00,000
Less Expenses:		
Merchandise	8,00,000	
Shop Rent	36,000	(8,36,000)
		3,64,000
Assets:		
Inventory (2,000 pcs x ₹100)		2,00,000
Trade receivables		2,00,000
Cash (Cash Receipts ₹10,00,000 – cash payments ₹ 8,33,000)		1,67,000
		5,67,000
Liabilities:		
Trade Payables		2,00,000
Expenses Payables		3,000
Capital (Profit)		3,64,000
		5,67,000

Thus, accrual, matching and periodicity concepts work together for income measurement and recognition of assets and liabilities.

(f) **Going Concern concept:** The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used needs to be disclosed.

The valuation of assets of a business entity is dependent on this assumption. Traditionally, accountants follow historical cost in majority of the cases.

Suppose Mr. X purchased a machine for his business paying ₹ 5,00,000 out of ₹ 7,00,000 invested by him. He also paid transportation expenses and installation charges amounting to ₹ 70,000. If he is still willing to continue the business, his financial position will be as follows:

BALANCE SHEET

Liability	₹	Assets	₹
Capital	7,00,000	Machinery	5,70,000
		Cash	1,30,000
	7,00,000		7,00,000

Now if he decides to back out and desires to sell the machine, it may fetch more than or less than ₹ 5,70,000. So his financial position should be different. If going concern concept is taken, increase/ decrease in the value of assets in the short-run is ignored. The concept indicates that assets are kept for generating benefit in future, not for immediate sale; current change in the asset value is not realisable and so it should not be counted.

This can be understood differently with some examples we may have come across in real life. Recently during pandemic, many businesses were shutting down due to heavy losses. If the financial statement of these entities does not reveal the fact of winding up due to losses, it will mislead the stakeholders. And, a sudden news of the business shutting down would be a setback to those stakeholders.

Therefore, entities need to assess at the time of preparation of financial statements, whether they are likely to continue to operate their business. If the Going Concern assumption is under question, the same information should be communicated to the stakeholders.

(g) **Cost concept:** By this concept, the value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. Although there are various measurement bases, accountants traditionally prefer this concept in the interests of objectivity. When a machine is acquired by paying ₹ 5,00,000, following cost concept the value of the machine is taken as ₹ 5,00,000. It is highly objective and free from all bias. Other measurement bases are not so objective. Current cost of an asset is not easily determinable. If the asset is purchased on 1.1.1995 and such model is not available in the market, it becomes difficult to determine which model is the appropriate equivalent to the existing one. Similarly, unless the machine is actually sold, realisable value will give only a hypothetical figure. Lastly, present value base is highly subjective because to know the value of the asset one has to chase the uncertain future.

However, the cost concept creates a lot of distortion too as outlined below:

(a) In an inflationary situation when prices of all commodities go up on an average, acquisition cost loses its relevance. For example, a piece of land purchased on 1.1.1995 for ₹ 2,000 may cost ₹ 1,00,000 as on 1.1.2022. So if the accountant makes valuation of asset at historical cost, the accounts will not reflect the true position.

(b) Historical cost-based accounts may lose comparability. Mr. X invested ₹ 1,00,000 in a machine on 1.1.1995 which produces ₹ 50,000 cash inflow during the year 2022, while Mr. Y invested ₹ 5,00,000 in a machine on 1.1.2005 which produced ₹ 50,000 cash inflows during the year. Mr. X earned at the rate 50% while Mr. Y earned at the rate 10%. Who is more efficient? Since the assets are recorded at the historical cost, the results are not comparable. Obviously, it is a corollary to (a).

(c) Many assets do not have acquisition costs. Human assets of an enterprise are an example. The cost concept fails to recognise such asset although it is a very important asset of any organization.

Many other controversial issues have arisen in financial accounting that revolves around the cost concept which will be discussed at the advanced stage. However, later on we shall see that in many circumstances, the cost convention is not followed. See conservatism concept for an example, which will be discussed later on in this unit.

(h) Realisation concept: It closely follows the cost concept. Any change in value of an asset is to be recorded only when the business realises it. When an asset is recorded at its historical cost of ₹ 5,00,000 and even if its current cost is ₹ 15,00,000 such change is not counted unless there is certainty that such change will materialize.

However, accountants follow a more conservative path. They try to cover all probable losses but do not count any probable gain. That is to say, if accountants anticipate decrease in value they count it, but if there is increase in value they ignore it until it is realised. Economists are highly critical about the realisation concept. According to them, this concept creates value distortion and makes accounting meaningless.

Example: Mr. X purchased a piece of land on 1.1.1995 paying ₹ 2,000. Its current market value is ₹ 1,02,000 on 31.12.2022. Should the accountant show the land at ₹ 2,000 following cost concept and ignoring ₹1,00,000 value increase since it is not realised? If he does so, the financial position would be:

BALANCE SHEET

Liabilities	₹	Asset	₹
Capital	2,000	Land	2,000
	2,000		2,000

Is it not proper to show it in the following manner?

BALANCE SHEET

Liabilities	₹	Asset	₹
Capital	2,000	Land	1,02,000
Unrealised Gain	1,00,000		
	1,02,000		1,02,000

Now-a-days the revaluation of assets has become a widely accepted practice when the change in value is of permanent nature. Accountants adjust such value change through creation of revaluation (capital) reserve.

Thus, the going concern, cost concept and realization concept gives the valuation criteria.

(i) **Dual aspect concept:** This concept is the core of double entry book-keeping. Every transaction or event has two aspects:

(1) It increases one Asset and decreases other Asset;

(2) It increases an Asset and simultaneously increases Liability;

(3) It decreases one Asset, increases another Asset;

(4) It decreases one Asset, decreases a Liability.

Alternatively:

(5) It increases one Liability, decreases other Liability;

(6) It increases a Liability, increases an Asset;

(7) It decreases Liability, increases other Liability;

(8) It decreases Liability, decreases an Asset.

Example :

BALANCE SHEET

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,00,000
Bank Loan	75,000	Cash	1,00,000
Other Loan	75,000		
	3,00,000		3,00,000

Transactions:

(a) A new machine is purchased paying ₹ 50,000 in cash.

(b) A new machine is purchased for ₹ 50,000 on credit, cash is to be paid later on.

(c) Cash paid to repay bank loan to the extent of ₹ 50,000.

(d) Raised bank loan of ₹ 50,000 to pay off other loan.

Effect of the Transactions:

(a) Increase in machine value and decrease in cash balance by ₹ 50,000.

BALANCE SHEET (1 & 3)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,50,000
Bank Loan	75,000	Cash	50,000
Other Loan	75,000		
	3,00,000		3,00,000

(b) Increase in machine value and increase in Creditors by ₹ 50,000.

BALANCE SHEET (2 & 6)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,50,000
Creditors for machinery	50,000	Cash	1,00,000
Bank Loan	75,000		
Other Loan	75,000		
	3,50,000		3,50,000

(c) Decrease in bank loan and decrease in cash by ₹ 50,000.

BALANCE SHEET (4 & 8)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,00,000
Bank Loan	25,000	Cash	50,000
Other Loan	75,000		
	2,50,000		2,50,000

(d) Increase in bank loan and decrease in other loan by ₹ 50,000.

BALANCE SHEET (5 & 7)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,00,000
Bank Loan	1,25,000	Cash	1,00,000
Other Loan	25,000		
	3,00,000		3,00,000

We may conclude that every transaction and event has two aspects.

This gives basic accounting equation :

Equity (E) + Liabilities (L) = Assets (A)

or

Equity (E)= Assets (A) – Liabilities(L)

Or, Equity + Long Term Liabilities + Current Liabilities = Fixed Assets + Current Assets

Or, Equity + Long Term Liabilities = Fixed Assets + (Current Assets – Current Liabilities)

Or, Equity = Fixed Assets + Working Capital – Long Term Liabilities

ILLUSTRATION 1

Develop the accounting equation from the following information: -

Particulars	*March 31, 2021 (₹)*	*March 31, 2022 (₹)*
Capital	*1,00,000*	*?*
12% Bank Loan	*1,00,000*	*1,00,000*

Trade Payables	*75,000*	*70,000*
Fixed Assets	*1,25,000*	*1,10,000*
Trade Receivables	*75,000*	*80,000*
Inventory	*70,000*	*80,000*
Cash & Bank	*5,000*	*6,000*

Required

Find the profit for the year & the Balance sheet as on 31/3/2022.

SOLUTION

For the year ended March 31, 2021:

Equity = Capital ₹ 1,00,000

Liabilities = Bank Loan + Trade Payables

₹ 1,00,000 + ₹ 75,000 = ₹ 1,75,000

Assets = Fixed Assets + Trade Receivables + Inventory + Cash & Bank

₹ 1,25,000 + ₹ 75,000 + ₹ 70,000 + ₹ 5,000 = ₹ 2,75,000

Equity + Liabilities = Assets

₹ 1,00,000 + ₹ 1,75,000 = 2,75,000

For the year ended March 31, 2022:

Assets = ₹ 1,10,000 + ₹ 80,000 + ₹ 80,000 + ₹ 6,000 = ₹ 2,76,000

Liabilities = ₹ 1,00,000 + ₹ 70,000 = ₹ 1,70,000

Equity = Assets – Liabilities = ₹ 2,76,000 – ₹ 1,70,000 = ₹ 1,06,000 Profits = New Equity – Old Equity = ₹ 1,06,000 – ₹1,00,000 = ₹ 6,000

(j) **Conservatism:** Conservatism states that the accountant should not anticipate any future income however they should provide for all possible losses. When there are many alternative values of an asset, an accountant should choose the method which leads to the lesser value. Later on, we shall see that the golden rule of current assets valuation - 'cost or market price whichever is lower' originated from this concept.

The Realisation Concept also states that no change should be counted unless it has materialised. The Conservatism Concept puts a further brake on it. It is not prudent to count unrealised gain but it is desirable to guard against all possible losses.

For this concept there should be at least three qualitative characteristics of financial statements, namely,

(i) *Prudence,* i.e., judgement about the possible future losses which are to be guarded, as well as gains which are uncertain.

(ii) *Neutrality,* i.e., unbiased outlook is required to identify and record such possible losses, as well as to exclude uncertain gains,

(iii) *Faithful representation of alternative values.*

This concept is of wider importance to investors since they would need to take a decision about their money being invested in the business. Recording future profits when these have not been earned would suggest that the business is booming, and the investors would be tempted to put more money into the same. However, eventually if the profit is not earned, the investors are likely to loose their investments. At the same time, if the entity expects to make a loss in future, it is prudent to show that loss in the books in present itself. This acts as a safeguard for the investors as they would be prudent to make the investment decisions. For example: Mr. X runs a business of computers. He purchased 10 computers at a cost of ₹ 20,000 each and is expecting to be able to sell these computers at the current market price of ₹ 25,000 each. Note that the conservatism principle does not allow to recognise the profit on the computers unless the sale has been made. Since, this is a future profit, Mr. X needs to follow a prudent approach while recording the transactions in his books and ignore the profit until it is earned

However, before sale, the market price of the computers declines to ₹ 17,000 each. Under the conservatism approach, Mr. X needs to recognise that loss of ₹ 3,000 per computer, even though the sale has not been made.

Many accounting authors, however, are of the view that conservatism essentially leads to understatement of income and wealth and it should not be the basis for the preparation of financial statements.

(k) **Consistency:** In order to achieve comparability of the financial statements of an enterprise through time, the accounting policies are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.

The concept of consistency is applied particularly when alternative methods of accounting are equally acceptable. For example, a company may adopt any of several methods of depreciation such as written-down-value method, straight-line method, etc. Likewise, there are many methods for valuation of inventories. But following the principle of consistency it is advisable that the company should follow consistently over years the same method of depreciation or the same method of valuation of Inventories which is chosen. However, in some cases though there is no inconsistency, they may seem to be inconsistent apparently. In case of valuation of Inventories if the company applies the principle 'at cost or market price whichever is lower' and if this principle accordingly results in the valuation of Inventories in one year at cost price and the market price in the other year, there is no inconsistency here. It is only an application of the principle.

But the concept of consistency does not imply non-flexibility as not to allow the introduction of improved method of accounting.

An enterprise should change its accounting policy in any of the following circumstances only:

a. To bring the books of accounts in accordance with the issued Accounting Standards.

b. To comply with the provision of law.

c. When under changed circumstances, it is felt that new method will reflect a true and fair picture in the financial statement.

(l) **Materiality:** Materiality principle permits other concepts to be ignored, if the effect is not considered material. This principle is an exception to full disclosure principle. According to materiality principle, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements and any insignificant item which will only increase the work of the accountant but will not be relevant to the users' need should not be disclosed in the financial statements.

The term materiality is the subjective term. It is on the judgement, common sense and discretion of the accountant that which item is material and which is not. For example, stationary purchased by the organization though not used fully in the accounting year purchased still shown as an expense of that year because of the materiality concept. Similarly, depreciation on small items like books, calculators etc. is taken as 100% in the year of purchase though used by the entity for more than a year. This is because the amount for books or calculator is very small to be shown in the balance sheet though it is the asset of the company.

The materiality depends not only upon the amount of the item but also upon the size of the business, nature and level of information, level of the person making the decision etc. Moreover, an item material to one person may be immaterial to another person. What is important is that omission of any information should not impair the decision-making of various users.

2.6 FUNDAMENTAL ACCOUNTING ASSUMPTIONS

There are three fundamental accounting assumptions:

(i) Going Concern

(ii) Consistency

(iii) Accrual

All the above three fundamental accounting assumptions have already been explained in para 2.5.

If nothing has been written about the fundamental accounting assumption in the financial statements then it is assumed that they have already been followed in their preparation of financial statements. However, if any of the above-mentioned fundamental accounting assumption is not followed then this fact should be specifically disclosed.

2.7 FINANCIAL STATEMENTS

The aim of accounting is to keep systematic records to ascertain financial performance and financial position of an entity and to communicate the relevant financial information to the interested user groups. The financial statements are basic means through which the management of an entity makes public communication of the financial information along with selected quantitative details. They are structured financial representations of the financial position and the performance of an enterprise. To have a record of all business transactions and also to determine whether all these transactions resulted in either 'profit or loss' for the period, all the entities will prepare financial statements viz., balance sheet, profit and loss account, cash flow statement etc. by following various accounting concepts, principles, and conventions which have been already discussed in detail.

2.7.1 Qualitative Characteristics of financial Statements

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The following are the important qualitative characteristics of the financial statements:

1. **Understandability:** An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business, economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand.

2. **Relevance:** To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

   The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

   Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, share price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the statement of profit and loss is enhanced if unusual, abnormal and infrequent items of income and expense are separately disclosed.

3. **Reliability:** To be useful, information must also be reliable, Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

   Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action against the enterprise are highly uncertain, it may be inappropriate for the enterprise to recognise the amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

4. **Comparability:** Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those polices and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

Users wish to compare the financial position, performance and cash flows of an enterprise over time. Hence, it is important that the financial statements show corresponding information for the preceding period(s).

The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

5. **Materiality:** The relevance of information is affected by its materiality. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

6. **Faithful Representation:** To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

   Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

7. **Substance over Form:** If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial interest in an immovable property are transferred but the documentations and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

8. **Neutrality:** To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

9. **Prudence:** The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of receivables, the probable useful life of plant and machinery, and the warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would then not be neutral and, therefore, not have the quality of reliability.

10. **Full, fair and adequate disclosure:** The financial statement must disclose all the reliable and relevant information about the business enterprise to the management and also to their external users for which they are meant, which in turn will help them to take a reasonable and rational decision. For it, it is necessary that financial statements are prepared in conformity with generally accepted accounting principles i.e the information is accounted for and presented in accordance with its substance and

economic reality and not merely with its legal form. The disclosure should be full and final so that users can correctly assess the financial position of the enterprise.

The principle of full disclosure implies that nothing should be omitted while principle of fair disclosure implies that all the transactions recorded should be accounted in a manner that financial statement purports true and fair view of the results of the business of the enterprise and adequate disclosure implies that the information influencing the decision of the users should be disclosed in detail and should make sense.

This principle is widely used in corporate organizations because of separation in management and ownership. The Companies Act in pursuant of this principle came out with the format of balance sheet and profit and loss account. The disclosures of all the major accounting policies and other information are to be provided in the form of footnotes, annexures etc. The practice of appending notes to the financial statements is the outcome of this principle.

11. **Completeness:** To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

Thus, if accounting information is to present faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality, not by their legal form. For example, if a business enterprise sells its assets to others but still uses the assets as usual for the purpose of the business by making some arrangement with the seller, it simply becomes a legal transaction. The economic reality is that the business is using the assets as usual for deriving the benefit. Financial statement information should contain the substance of this transaction and should not only record going by legality. In order to be reliable, the financial statements information should be neutral i.e., free from bias. The prepares of financial statements however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that many occur. Such uncertainties are recognised by the disclosure of their nature and extent and by exercise of prudence in the preparation of financial statements. Prudence is the inclusion of a degree of caution in the exercise of judgement needed in making the estimates required under condition of uncertainty such that assets and income are not overstated and loss and liability are not understated.

SUMMARY

- Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared.

  The following are the widely accepted accounting concepts:

(a)	Entity concept	(b)	Money measurement concept
(c)	Periodicity concept	(d)	Accrual concept
(e)	Matching concept	(f)	Going Concern concept
(g)	Cost concept	(h)	Realisation concept
(i)	Dual aspect concept	(j)	Conservatism
(k)	Materiality		

- Accounting principles 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."
- Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time.
- There are three fundamental accounting assumptions:

  (i) Going Concern (ii) Consistency (iii) Accrual
- Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. Understandability, Relevance, Reliability, Comparability, Materiality, Faithful Representation, Substance over Form, Neutrality, Prudence, Full, fair and adequate disclosure and Completeness are the important qualitative characteristics of the financial statements.

TEST YOUR KNOWLEDGE

True and False

1. *The concept helps in keeping business affairs free from the influence of the personal affairs of the owner is known as the matching concept.*
2. *Entity concept means that the enterprise is liable to the owner for capital investment made by the owner.*
3. *Accrual means recognition as money is received or paid and not of revenue and costs as they are earned or incurred.*

4. *The Conservatism Concept states that no change should be counted unless it has materialized.*

5. *The concept of consistency implies non-flexibility as not to allow the introduction of improved method of accounting.*

6. *The materiality depends only upon the amount of the item and not upon the size of the business, nature and level of information, level of the person making the decision etc.*

7. *Accrual basis of accounting is the method of recording transactions by which revenues and costs and assets and liabilities are reflected in the accounts in the period in which actual receipts or actual payments are made.*

Multiple Choice Questions

1. (i) *All the following items are classified as fundamental accounting assumptions except*

   (a) *Consistency.*

   (b) *Business entity.*

   (c) *Going concern.*

   (ii) *Two primary qualitative characteristics of financial statements are*

   (a) *Understandability and materiality.*

   (b) *Relevance and reliability.*

   (c) *Neutrality and understandability.*

   (iii) *Kanika Enterprises follows the written down value method of depreciating machinery year after year due to*

   (a) *Comparability.*

   (b) *Convenience.*

   (c) *Consistency.*

   (iv) *A purchased a car for ₹ 5,00,000, making a down payment of ₹ 1,00,000 and signing a ₹4,00,000 bill payable due in 60 days. As a result of this transaction*

   (a) *Total assets increased by ₹ 5,00,000.*

   (b) *Total liabilities increased by ₹ 4,00,000.*

   (c) *Total assets increased by ₹ 4,00,000 with corresponding increase in liabilities by ₹ 4,00,000.*

(v) *Mohan purchased goods for ₹15,00,000 and sold 4/5th of the goods amounting ₹18,00,000 and met expenses amounting ₹ 2,50,000 during the year, 2022. He counted net profit as ₹ 3,50,000. Which of the accounting concept was followed by him?*

(a) *Entity.*

(b) *Periodicity.*

(c) *Matching.*

(vi) *A businessman purchased goods for ₹25,00,000 and sold 80% of such goods during the accounting year ended 31st March, 2022. The market value of the remaining goods was ₹ 4,00,000. He valued the closing Inventory at cost. He violated the concept of*

(a) *Money measurement.*

(b) *Conservatism.*

(c) *Cost.*

(vii) *Capital brought in by the proprietor is*

(a) *Increase in asset and increase in liability*

(b) *Increase in liability and decrease in asset*

(c) *Increase in asset and decrease in liability*

(viii) *During the life-time of an entity, accounting provides financial statements in accordance with which basic accounting concept:*

(a) *Conservatism*

(b) *Matching*

(c) *Accounting period*

(ix) *A concept that a business enterprise will not be liquidated in the near future is known as :*

(a) *Going concern*

(b) *Economic entity*

(c) *Monetary unit*

2. (i) *Assets are held in the business for the*

   (a) *Resale.*

   (b) *Conversion into cash*

   (c) *Earning revenue.*

   (ii) *Revenue from sale of products, is generally, realised in the period in which*

   (a) *Cash is collected.*

   (b) *Sale is made*

   (c) *Products are manufactured.*

   (iii) *The concept of conservatism when applied to the balance sheet results in*

   (a) *Understatement of assets.*

   (b) *Overstatement of assets.*

   (c) *Overstatement of capital.*

   (iv) *Decrease in the amount of trade payables results in*

   (a) *Increase in cash.*

   (b) *Decrease in bank over draft account.*

   (c) *Decrease in assets.*

   (v) *The determination of expenses for an accounting period is based on the principle of*

   (a) *Objectivity.*

   (b) *Materiality.*

   (c) *Matching.*

   (vi) *Economic life of an enterprise is split into the periodic interval to measure its performance is as per*

   (a) *Entity.*

   (b) *Matching.*

   (c) *Periodicity.*

3. (i) *If an individual asset is increased, there will be a corresponding*

   (a) *Increase of another asset or increase of capital.*

   (b) *Decrease of another asset or increase of liability.*

   (c) *Decrease of specific liability or decrease of capital.*

(ii) Purchase of machinery for cash

(a) Decreases total assets.

(b) Increases total assets.

(c) Retains total assets unchanged.

(iii) Consider the following data pertaining to Alpha Ltd.:

Particulars	*₹*
Cost of machinery purchased on 1st April, 2021	*10,00,000*
Installation charges	*1,00,000*
Market value as on 31st March, 2022	*12,00,000*

While finalizing the annual accounts, if the company values the machinery at ₹ 12,00,000. Which of the following concepts is violated by the Alpha Ltd.?

(a) Cost.

(b) Matching.

(c) Accrual.

Theoretical Questions

1. Write short notes on:

(i) Fundamental accounting assumptions.

(ii) Periodicity concept.

(iii) Accounting conventions.

2. Distinguish between:

(i) Money measurement concept and matching concept

(ii) Going concern and cost concept

3. Briefly explain the qualitative characteristics of the financial statements.

ANSWERS/HINTS

Ture and False

1. False: Under matching concept all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.

2. True: Since the owner invested capital, he has claim on the profits of the enterprise.

3. False: Under accrual concept, the effects of transactions and other events are recognised on mercantile basis i.e., when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.

4. False: The Realisation Concept states that no change should be counted unless it has materialised.

5. False: The concept of consistency does not imply non-flexibility as not to allow the introduction of improved method of accounting.

6. False: As per materiality principle, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements.

7. False: Cash Basis of Accounting is the method of recording transactions by which revenues and costs and assets and liabilities are reflected in the accounts in the period in which actual receipts or actual payments are made.

Multiple Choice Questions

1.(i)	**(b)**	(ii)	**(b)**	(iii)	**(c)**	(iv)	**(c)**	(v)	**(c)**	(vi)	**(b)**
(vii)	**(a)**	(viii)	**(c)**	(ix)	**(a)**	2.(i)	**(c)**	(ii)	**(b)**	(iii)	**(a)**
(iv)	**(c)**	(v)	**(c)**	(vi)	**(c)**	3.(i)	**(b)**	(ii)	**(c)**	(iii)	**(a)**

Theoretical Questions

1. **(i)** **Fundamental accounting assumptions:** There are three fundamental accounting assumptions: Going Concern; Consistency and Accrual. If nothing has been written about the fundamental accounting assumption in the financial statements then it is assumed that they have already been followed in their preparation of financial statements.

(ii) **Periodicity concept:** According to this concept accounts should be prepared after every period & not at the end of the life of the entity. For details, refer para 2.5.

(iii) Accounting conventions: Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time. For details, refer para 2.4.

2. (i) Distinction between Money measurement concepts and matching concept

As per **Money Measurement concept,** only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts. Transactions and events that cannot be expressed in terms of money are not recorded in the business books.

In **Matching concept** all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized them expenses related to earn that revenue should also be recognized.

(ii) Distinction between Going concern and cost concept

Going Concern Concept

The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future.

Cost concept

By this concept, the value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. For details refer para 2.5.

3. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. For details, refer para 2.7.1.

UNIT – 3 CAPITAL AND REVENUE EXPENDITURES AND RECEIPTS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Learn the criteria for identifying Revenue Expenditure and distinguishing from Capital Expenditure
- Learn the distinction between capital and revenue receipts.
- Understand the linkage of such distinction with the preparation of final accounts.

UNIT OVERVIEW

Capital
- Payments
- Receipts

Revenue
- Payments
- Receipts

3.1 INTRODUCTION

Accounting aims in ascertaining and presenting the results of the business for an accounting period. For ascertaining the periodical business results, the nature of transactions should be analyzed whether they are of capital or revenue nature. Revenue Expense relates to the operations of the business of an accounting period or to the revenue earned during the period or the items of expenditure, benefits of which do not extend beyond that period. Capital Expenditure, on the other hand, generates enduring benefits and helps in revenue generation over more than one accounting period. Revenue Expenses must be associated with a physical activity of the entity. Therefore, whereas production and sales generate revenue in the earning process, use of goods and services in support of those functions causes expenses to occur.

Expenses are recognised in the Profit & Loss Account through matching principal which tells us when and how much of the expenses to be charged against revenue. A part of the expenditure can be capitalised only when these can be traced directly to definable streams of future benefits.

The distinction of transaction into revenue and capital is done for the purpose of placing them in Profit and Loss account or in the Balance Sheet. For example: revenue expenditures are shown in the profit and loss account as their benefits are for one accounting period i.e., in which they are incurred while capital expenditures are placed on the asset side of the balance sheet as they will generate benefits for more than one accounting period and will be transferred to profit and loss account of the year on the basis of utilisation of that benefit in particular accounting year. Hence, both capital and revenue expenditures are ultimately transferred to profit and loss account.

Revenue expenditures are transferred to profit and loss account in the year of spending while capital expenditures are transferred to profit and loss account of the year in which their benefits are utilised. Therefore, we can conclude that it is the time factor, which is the main determinant for transferring the expenditure to profit and loss account. Also, expenses are recognized in profit and loss account through matching concept which tells us when and how much of the expenses to be charged against revenue. However, distinction between capital and revenue creates a considerable difficulty. In many cases borderline between the two is very thin.

3.2 CONSIDERATIONS IN DETERMINING CAPITAL AND REVENUE EXPENDITURES

The basic considerations in distinction between capital and revenue expenditures are:

(a) **Nature of business:** For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. Therefore, the nature of business is a very important criteria in separating an expenditure between capital and revenue.

(b) **Recurring nature of expenditure:** If the frequency of an expense is quite often in an accounting year then it is said to be an expenditure of revenue nature while non-recurring expenditure is infrequent in nature and do not occur often in an accounting year. Monthly salary or rent is the example of revenue expenditure as they are incurred every month while purchase of assets is not the transaction done regularly therefore, classified as capital expenditure unless materiality criteria defines it as revenue expenditure.

(c) Purpose of expenses: Expenses for repairs of machine may be incurred in course of normal maintenance of the asset. Such expenses are revenue in nature. On the other hand, expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature. However, determination of the cost of maintenance and ordinary repairs which should be expensed, as opposed to a cost which ought to be capitalised, is not always simple.

(d) Effect on revenue generating capacity of business: The expenses which help to generate income/ revenue in the current period are revenue in nature and should be matched against the revenue earned in the current period. On the other hand, if expenditure helps to generate revenue over more than one accounting period, it is generally called capital expenditure.

When expenditure on improvements and repair of a fixed asset is done, it has to be charged to Profit and Loss Account if the expected future benefits from fixed assets do not change, and it will be included in book value of fixed asset, where the expected future benefits from assets increase.

(e) Materiality of the amount involved: Relative proportion of the amount involved is another important consideration in distinction between revenue and capital.

3.3 CAPITAL EXPENDITURES AND REVENUE EXPENDITURES

As we have already discussed, capital expenditure contributes to the revenue earning capacity of a business over more than one accounting period whereas revenue expense is incurred to generate revenue for a particular accounting period. The revenue expenses either occur in direct relation with the revenue or in relation with accounting periods, for example cost of goods sold, salaries, rent, etc. Cost of goods sold is directly related to sales revenue whereas rent is related to the particular accounting period. Capital expenditure may represent acquisition of any tangible or intangible fixed assets for enduring future benefits. Therefore, the benefits arising out of capital expenditure last for more than one accounting period whereas those arising out of revenue expenses expire in the same accounting period.

3.3.1 Key differences between Capital and Revenue Expenditures

Key Differences	Capital Expenditure	Revenue Expenditure
Period of benefit	Any expenditure incurred to provide a benefit over a long-term period is capital expenditure.	Any expenditure incurred to provide a benefit during the current period is revenue expenditure.

Enhancement vs Maintenance	Capital expenditure is incurred for the purpose of increasing the capacity of the business. Alternatively, it also includes an expenditure to reduce the costs of the business.	Revenue expenditure is incurred to maintain the earning capacity of the business.
Examples	Purchase of machine, car, furniture, etc.	Repairs and maintenance, salary of accounting staff, etc.

ILLUSTRATION 1

State with reasons whether the following statements are 'True' or 'False'.

(1) *Overhaul expenses of second-hand machinery purchased are Revenue Expenditure.*

(2) *Money spent to reduce working expenses is Revenue Expenditure.*

(3) *Legal fees to acquire property is Capital Expenditure.*

(4) *Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is Capital Expenditure.*

(5) *Amount spent for replacement of worn out part of machine is Capital Expenditure.*

(6) *Expense incurred on the repairs and white washing for the first time on purchase of an old building are Revenue Expenses.*

(7) *Expenses in connection with obtaining a license for running the cinema is Capital Expenditure.*

(8) *Amount spent for the construction of temporary huts, which were necessary for construction of the Cinema House and were demolished when the cinema house was ready, is Capital Expenditure.*

SOLUTION

(1) **False:** Overhaul expenses are incurred to put second-hand machinery in working condition to derive endurable long-term advantage. So it should be capitalised.

(2) **False:** It may be reasonably presumed that money spent for reducing revenue expenditure would have generated long-term benefits to the entity. So this is capital expenditure.

(3) **True:** Legal fee paid to acquire any property is part of the cost of that property. It is incurred to possess the ownership right of the property and hence a capital expenditure.

(4) **False:** Legal expenses incurred to defend a suit claiming that the firm's factory site belongs to the plaintiff is maintenance expenditure of the asset. By this expense, neither any endurable benefit can be obtained in future in addition to that what is presently available nor the capacity of the asset will be increased. Maintenance expenditure in relation to an asset is revenue expenditure.

(5) **False:** Amount spent for replacement of any worn out part of a machine is revenue expense since it is part of its maintenance cost.

(6) **False:** Repairing and white washing expenses for the first time of an old building are incurred to put the building in usable condition. These are the part of the cost of building. Accordingly, these are capital expenditure.

(7) **True:** The Cinema Hall could not be started without license. Expenditure incurred to obtain the license is pre-operative expense which is capitalised. Such expenses are amortised over a period of time.

(8) **True:** Cost of temporary huts constructed which were necessary for the construction of the cinema house is part of the construction cost of the cinema house. Therefore such costs are to be capitalised.

ILLUSTRATION 2

State with reasons whether the following are Capital or Revenue Expenditure:

(1) *Expenses incurred in connection with obtaining a license for starting the factory for ₹10,000.*

(2) *₹1,000 paid for removal of Inventory to a new site.*

(3) *Rings and Pistons of an engine were changed at a cost of ₹5,000 to get fuel efficiency.*

(4) *Money paid to Mahanagar Telephone Nigam Ltd. (MTNL) ₹8,000 for installing telephone in the office.*

(5) *A factory shed was constructed at a cost of ₹1,00,000. A sum of ₹5,000 had been incurred in the construction of temporary huts for storing building material.*

SOLUTION

(1) Money paid ₹ 10,000 for obtaining license to start a factory is a capital expenditure. This is an item of expenditure incurred to acquire the right to carry on business.

(2) ₹ 1,000 paid for removal of Inventory to a new site is revenue expenditure. This is neither bringing enduring benefit nor enhancing the value of the asset.

(3) ₹ 5,000 spent in changing Rings and Pistons of an engine to get fuel efficiency is capital expenditure. This is an expenditure on improvement of a fixed asset. It results in increasing profit-earning capacity of the business by cost reduction.

(4) Money deposited with MTNL for installation of telephone in office is not expenditure. This is treated as an asset and the same is adjusted over a period of time against actual telephone bills.

(5) Cost of construction of building including cost of temporary huts is capital expenditure. Building is fixed asset which will generate enduring benefit to the business over more than one accounting period. Construction of temporary huts is incidental to the main construction. Such cost is also capitalised with the cost of building.

ILLUSTRATION 3

Best Tech Solutions buys and sells computers as a part of its business. It purchased 20 computers for resale to its customers. Cost of each computer is ₹ 20,000. It also purchased a computer costing ₹ 24,000 for its accountant to be able to maintain the accounting records and printing of invoices. Suggest whether above transactions qualify as capital expenditure or revenue expenditure transactions?

SOLUTION

Best Tech Solutions is in the business of buying and selling of computers. Any computers purchased for resale to its customers will qualify as revenue expenditure. Hence, a purchase of 20,000 x 20 = ₹ 4,00,000 will be a part of revenue expenditure.

At the same time, the computer purchased for maintaining the records and invoicing is to be able to operate the business for a longer period of time. Therefore, the purchase of ₹ 24,000 qualifies as a capital expenditure. This amount will be a part of assets in the Balance Sheet.

3.4 CAPITAL RECEIPTS AND REVENUE RECEIPTS

Just as a clear distinction between Capital and Revenue expenditure is necessary, in the same manner capital receipts must be distinguished from revenue receipts.

Receipts which are obtained in course of normal business activities are revenue receipts (e.g., receipts from sale of goods or services, interest income etc.). On the other hand, receipts which are not revenue in nature are capital receipts (e.g., receipts from sale of fixed assets or investments, secured or unsecured loans, owners' contributions etc.). Revenue and capital receipts are recognised on accrual basis as soon as the right of receipt is established. Revenue receipts should not be equated with the actual cash receipts. Revenue receipts are credited to the Profit and Loss Account.

On the other hand, Capital receipts are not directly credited to Profit and Loss Account. For example, when a fixed asset is sold for ₹ 92,000 (cost ₹ 90,000), the capital receipts ₹ 92,000 is not credited to Profit and Loss Account. Profit or Loss on sale of fixed assets is calculated and credited to Profit and Loss Account as follows:

Sale Proceeds	₹ 92,000
Cost	(₹ 90,000)
Profit	₹ 2,000

ILLUSTRATION 4

State with reasons whether the below items relating to the business of AB td are capital or revenue receipts?

(a) A machine with a book value of ₹ 10 lakh is sold for ₹ 12 lakh.

(b) Premium amounting to ₹ 1 Lakh received on issue of shares

(c) An amount of ₹ 20,000 received from goods sold in cash.

(d) An amount of ₹ 5 lac received on the maturity of fixed deposit from bank. Also, an interest of ₹ 40,000 was received in addition to the maturity amount of the fixed deposits.

SOLUTION

(a) The amount of ₹ 12 lac is a capital receipt. There is a profit on sale of the machine to the extent of ₹ 2 lac (12 – 10)

(b) Premium received on issue of shares is an example of capital receipt.

(c) Amount received from cash sale is a revenue receipt.

(d) Amount received on the maturity of fixed deposit is the recovery of the deposit amount, and is a capital receipt. Interest income is an example of revenue receipt.

ILLUSTRATION 5

Good Pictures Ltd., constructs a cinema house and incurs the following expenditure during the first year ending 31st March, 2022.

(1) Second-hand furniture worth ₹ 9,000 was purchased; repainting of the furniture costs ₹ 1,000. The furniture was installed by own workmen, wages for this being ₹200.

(2) Expenses in connection with obtaining a license for running the cinema worth ₹ 20,000. During the course of the year the cinema company was fined ₹ 1,000, for contravening rules. Renewal fee ₹2,000 for next year also paid.

(3) Fire insurance, ₹ 1,000 was paid on 1st October, 2021 for one year.

(4) Temporary huts were constructed costing ₹ 1,200. They were necessary for the construction of the cinema. They were demolished when the cinema was ready.

Point out how you would classify the above items.

SOLUTION

(1) The total cost of the furniture should be treated as ₹ 10,200 i.e., all the amounts mentioned should be capitalised since without such expenditure the furniture would not be available for use. If ₹ 1,000 and ₹ 200 have been respectively debited to the Repairs Account and the Wages Account, these accounts will be credited to the Furniture Account.

(2) License for running the cinema house is necessary, hence its cost should be capitalised. But the fine of ₹ 1,000 is revenue expenditure. The renewal fee for the next year is also revenue expenditure but pertains to the next year; hence, it is a prepaid expense.

(3) Half of the insurance premium pertains to the year beginning on 1st April, 2021. Hence such amount should be treated as prepaid expense. The remaining amount is revenue expense for the current year.

(4) Since the temporary huts were necessary for the construction, their cost should be added to the cost of the cinema hall and thus capitalised.

ILLUSTRATION 6

State with reasons, how you would classify the following items of expenditure:

(1) Overhauling expenses of ₹25,000 for the engine of a motor car to get better fuel efficiency.

(2) Inauguration expenses of ₹25 lacs incurred on the opening of a new manufacturing unit in an existing business.

(3) Compensation of ₹2.5 crores paid to workers, who opted for voluntary retirement.

SOLUTION

(1) Overhauling expenses are incurred for the engine of a motor car to derive better fuel efficiency. These expenses will reduce the running cost in future and thus the benefit is in form of endurable long-term advantage. So this expenditure should be capitalised.

(2) Inauguration expenses incurred on the opening of a new unit may help to explore more customers This expenditure is in the nature of revenue expenditure, as the expenditure may not generate any enduring benefit to the business over more than one accounting period.

(3) The amount paid to workers on voluntary retirement is in the nature of revenue expenditure. Since the magnitude of the amount of expenditure is very significant, it may be better to defer it over future years.

ILLUSTRATION 7

Classify the following expenditures and receipts as capital or revenue:

(i) ₹ 10,000 spent as travelling expenses of the directors on trips abroad for purchase of capital assets.

(ii) Amount received from Trade receivables during the year.

(iii) Amount spent on demolition of building to construct a bigger building on the same site.

(iv) Insurance claim received on account of a machinery damaged by fire.

SOLUTION

(i) Capital expenditure.

(ii) Revenue receipt.

(iii) Capital expenditure.

(iv) Capital receipt.

ILLUSTRATION 8

Are the following expenditures capital in nature?

(i) M/s ABC & Co. run a restaurant. They renovate some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 10 to 13. The total expenditure was ₹20,000.

(ii) M/s New Delhi Financing Co. sold certain goods on installment payment basis. Five customers did not pay installments. To recover such outstanding installments, the firm spent ₹10,000 on account of legal expenses.

(iii) M/s Ballav & Co. of Delhi purchased a machinery from M/s Shah & Co. of Ahmedabad. M/s Ballav & Co. spent ₹40,000 for transportation of such machinery. The year ending is 31st Dec, 2022.

SOLUTION

(i) Renovation of cabins increased the number of cabins. This has an effect on the future revenue generating capability of the business. Thus, the renovation expense is capital expenditure in nature.

(ii) Expense incurred to recover installments due from customer do not increase the revenue generating capability in future. It is a normal recurring expense of the business. Thus, the legal expenses incurred in this case is revenue expenditure in nature.

(iii) Expenses incurred on account of transportation of fixed asset is capital expenditure in nature.

SUMMARY

- Revenue expenditures are shown in the profit and loss account while capital expenditures are placed on the asset side of the balance sheet since they generate benefits for more than are accounting period.
- Prepaid expenses are future expenses that have been paid in advance. These are shown in the balance sheet as an asset.
- Receipts obtained should be classified between revenue receipts and capital receipts.

TEST YOUR KNOWLEDGE

True and False

1. *The nature of business is not an important criteria in separating an expenditure between capital and revenue.*
2. *Expenditure incurred for major repair of the asset so as to increase its productive capacity is Revenue in nature.*
3. *Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is Capital Expenditure.*
4. *Amount spent for replacement of worn-out part of machine is Capital Expenditure.*
5. *Legal fees to acquire property is Capital Expenditure.*
6. *Amount spent for the construction of temporary huts, which were necessary for construction of the cinema house and were demolished when the cinema house was ready, is Capital Expenditure.*

Multiple Choice Questions

1. *Money spent ₹ 10,000 as traveling expenses of the directors on trips abroad for purchase of capital assets is*

   (a) Capital expenditures

   (b) Revenue expenditures

   (c) Prepaid revenue expenditures

2. *Amount of ₹5,000 spent as lawyers' fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is*

   (a) *Capital expenditures*

   (b) *Revenue expenditures*

   (c) *Prepaid revenue expenditures*

3. *Entrance fee of ₹2,000 received by Ram and Shyam Social Club is*

   (a) *Capital receipt*

   (b) *Revenue receipt*

   (c) *Capital expenditures*

4. *Subsidy of ₹ 40,000 received from the government for working capital by a manufacturing concern is*

   (a) *Capital receipt*

   (b) *Revenue receipt*

   (c) *Capital expenditures*

5. *Insurance claim received on account of*

   (a) *Capital receipt*

   (b) *Revenue receipt*

   (c) *Capital expenditures*

6. *Interest on investments received from*

   (a) *Capital receipt*

   (b) *Revenue receipt*

   (c) *Capital expenditures*

7. *Amount received from IDBI as a medium term loan for augmenting working capital is*

   (a) *Capital expenditures*

   (b) *Revenue expenditures*

   (c) *Capital receipt*

8. *Revenue from sale of products, ordinarily, is reported as part of the earning in the period in which*

   (a) *The sale is made.*

   (b) *The cash is collected.*

   (c) *The products are manufactured.*

9. *If repair cost is ₹25,000, whitewash expenses are ₹5,000, (both these expenses relate to presently used building) cost of extension of building is ₹ 2,50,000 and cost of improvement in electrical wiring system is ₹19,000; the amount to be expensed is*

   (a) ₹2,99,000.

   (b) ₹44,000.

   (c) ₹30,000.

Theoretical Questions

1. *What are the basic considerations in distinguishing between capital and revenue expenditures?*

2. *Define revenue receipts and give examples. How are these receipts treated?*

ANSWERS/HINTS

True and False

1. False: The nature of business is a very important criteria in separating an expenditure between capital and revenue. For example- For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. .

2. False: Expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature.

3. False: Legal expenses incurred to defend a suit claiming that the firm's factory site belongs to the plaintiff is maintenance expenditure of the asset. By this expense, neither any endurable benefit can be obtained in future in addition to that what is presently available nor the capacity of the asset will be increased. Maintenance expenditure in relation to an asset is revenue expenditure.

4. False: Amount spent for replacement of any worn out part of a machine is revenue expense since it is part of its maintenance cost.

5. True: Legal fee paid to acquire any property is a part of cost of that property. It is incurred to possess the ownership right of the property and hence a capital expenditure.

6. True: Since temporary huts were necessary for the construction, their cost should be added to the cost of the cinema hall and thus capitalised.

Multiple Choice Questions

1.	**(a)**	2.	**(b)**	3.	**(a)**	4.	**(b)**	5.	**(a)**	6.	**(b)**
7.	**(c)**	8.	**(a)**	9.	**(c)**						

Theoretical Questions

1. The basic considerations in distinction between capital and revenue expenditures are:

(a) Nature of business.

(b) Recurring nature of expenditure.

(c) Purpose of expenses.

(d) Effect on revenue generating capacity of business.

(e) Materiality of the amount involved.

2. Receipts which are obtained in course of normal business activities are revenue receipts (e.g,. receipts from sale of goods or services, interest income etc.).

Revenue receipts should not be equated with the actual cash receipts. Revenue receipts are credited to the Profit and Loss Account.

UNIT – 4 CONTINGENT ASSETS AND CONTINGENT LIABILITES

LEARNING OUTCOMES

After studying this Unit, you will be able to:

- Understand the meaning of the terms 'Contingent Assets' and 'Contingent Liabilities'.
- Distinguish 'Contingent Liabilities' with 'Liabilities' and 'Provisions'

UNIT OVERVIEW

Contingent Asset	A possible asset arises from past events and their existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events.
Contingent Liability	A possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

4.1 CONTINGENT ASSET

A contingent asset may be defined as a possible asset that arises from past events and whose existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. It usually arises from unplanned or unexpected events that give rise to the possibility of an inflow of economic benefits to the business entity. For example, a claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent asset.

As per the concept of prudence as well as the present accounting standards, an enterprise should not recognise a contingent asset. These assets are uncertain and may arise from a claim which an enterprise pursues through a legal proceeding. There is uncertainty in realisation of claim. It is possible that recognition of contingent assets may result in recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset no longer remains as contingent asset.

A contingent asset need not be disclosed in the financial statements. A contingent asset is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise), if an inflow of economic benefits is probable. Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

4.2 CONTINGENT LIABILITIES

The term 'Contingent liability' can be defined as

"(a) a ***possible obligation*** that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a ***present obligation*** that arises from past events but is not recognised because:

  (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

  (ii) a reliable estimate of the amount of the obligation cannot be made."

For example- Mr. X sells a machine to Mr. Y. Any damages incurred by Mr. Y while using the machine need to be compensated by Mr. X. A few days later from the date of sale of machine, Mr. X received a notice from Mr. Y who is claiming damages of ₹ 20 lac. The notice mentioned that a worker met with an accident during the use of the machine and is required to be compensated.

The receipt of this notice does not suggest that Mr. X is liable to pay the amount, although this needs to be investigated and confirmed, as whether the damage arose due to any defect in the machine or it is due to negligence while operating the machine. Although, the receipt of the notice results into an event which requires recognition of a contingent liability since **there is a possible obligation,** and that can only be confirmed in future.

Taking another example let us assume Mr. AB sells cars to its customers. One of the cars caught fire due to malfunctioning of a faulty part during the test drive by one of the customers. The customer has filed a court case seeking a claim of ₹ 50 lac due to the incidence.

While Mr. AB acknowledges that there is a **present obligation**, it is not certain that whether he is expected to pay for any damages. The final outcome will only be known during the court proceedings.

A contingent liability is a possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events [part (a) of the definition]. A contingent liability may also be a present obligation that arises from past events [(part (b) of the definition)].

An enterprise should not recognise a contingent liability in balance sheet, however it is required to be disclosed in the notes to accounts, unless possibility of outflow of a resource embodying economic benefits is remote. These liabilities are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable.

If it becomes probable that an outflow or future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in financial statements of the period in which the change in probability occurs except in the extremely rare circumstances where no reliable estimate can be made.

4.3 DISTINCTION BETWEEN CONTINGENT LIABILITIES AND LIABILITIES

The distinction between a liability and a contingent liability is generally based on the judgement of the management. A liability is defined as the present financial obligation of an enterprise, which arises from past events. The settlement of a liability results in an outflow from the enterprises of resources embodying economic benefits. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

Examples of contingent liabilities are claims against the enterprise not acknowledged as debts, guarantees given in respect of third parties, liability in respect of bills discounted and statutory liabilities under dispute etc. In addition to present obligations that are recognized as liabilities in the balance sheet, enterprises are required to disclose contingent liability in their balance sheets by way of notes.

4.4 DISTINCTION BETWEEN CONTINGENT LIABILITIES AND PROVISIONS

Provision means "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy".

It is important to know the difference between provisions and contingent liabilities. The distinction between both of them can be explained as follows:

	Provision	**Contingent liability**
(1)	Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation.	A Contingent liability is a possible obligation that may or may not crystallise depending on the occurrence or non-occurrence of one or more uncertain future events.
(2)	A provision meets the recognition criteria.	A contingent liability fails to meet the same.
(3)	Provision is recognised when (a) an enterprise has a present obligation arising from past events; an outflow of resources embodying economic benefits is probable, and (b) a reliable estimate can be made of the amount of the obligation.	Contingent liability includes present obligations that do not meet the recognition criteria because either it is not probable that settlement of those obligations will require outflow of economic benefits, or the amount cannot be reliably estimated.
(4)	If the management estimates that it is probable that the settlement of an obligation will result in outflow of economic benefits, it recognises a provision in the balance sheet.	If the management estimates, that it is less likely that any economic benefit will outflow the firm to settle the obligation, it discloses the obligation as a contingent liability.

Let us take an example to understand the distinction between provisions and contingent liabilities. The Central Excise Officer imposes a penalty on Alpha Ltd. for violation of a provision in the Central Excise Act. The company goes on an appeal. If the management of the company estimates that it is probable that the company will have to pay the penalty, it recognises a provision for the liability. On the other hand, if the management anticipates that the judgement of the appellate authority will be in its favour and it is less likely that the company will have to pay the penalty, it will disclose the obligation as a contingent liability instead of recognising a provision for the same.

SUMMARY

- A contingent asset may be defined as a possible asset that arises from past events and whose existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.
- A contingent liability is a possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.
- A liability is the present financial obligation of an enterprise, which arises from past events whereas contingent liability is a possible obligation arising from past events.
- Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation whereas Contingent liability is a possible obligation that may or may not crystallise depending on the occurrence or non-occurrence of one or more uncertain future events.

TEST YOUR KNOWLEDGE

True and False

1. *A contingent liability need not be disclosed in the financial statements.*
2. *A Provision fails to meet the recognition criteria.*
3. *A claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent liability.*
4. *When it is probable that the firm will need to pay off the obligation, this gives rise to Contingent liability.*
5. *Present financial obligation of an enterprise, which arises from past event is termed as contingent liability.*

Multiple Choice Questions

1. *Contingent asset usually arises from unplanned or unexpected events that give rise to*

    (a) The possibility of an inflow of economic benefits to the business entity.

    (b) The possibility of an outflow of economic benefits to the business entity.

    (c) Either (a) or (b).

2. *If an inflow of economic benefits is probable then a contingent asset is disclosed*

   (a) *In the financial statements.*

   (b) *In the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise).*

   (c) *In the cash flow statement.*

3 *In the case of_, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.*

   (a) *Liability*

   (b) *Provision*

   (c) *Contingent liabilities*

4. *Present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation is termed as______.*

   (a) *Provision.*

   (b) *Liability.*

   (c) *Contingent liability.*

5. *In the financial statements, contingent liability is*

   (a) *Recognised.*

   (b) *Not recognised.*

   (c) *Adjusted.*

Theoretical Questions

Differentiate between:

(i) *Provision and Contingent Liability.*

(ii) *Liability and Contingent liability.*

ANSWERS/HINTS

True and False

1. False: A Contingent liability is required to be disclosed unless possibility of outflow of a resource embodying economic benefits is remote.

2. False: A contingent liability fails to meet the recognition criteria.

3. False: A claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent asset

4. False: When it is probable that the firm will need to pay off the obligation, this gives rise to provision.

5. False: Present Financial obligation of an enterprise, which arises from past events is termed as liability,

Multiple Choice Questions

1.	**(a)**	2.	**(b)**	3.	**(c)**	4.	**(a)**	5.	**(b)**		

Theoretical Questions

1. Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation. On the other hand, a Contingent liability is a possible obligation that may or may not crystallize depending on the occurrence or non-occurrence of one or more uncertain future events.

2. A liability is defined as the present financial obligation of an enterprise, which arises from past events. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

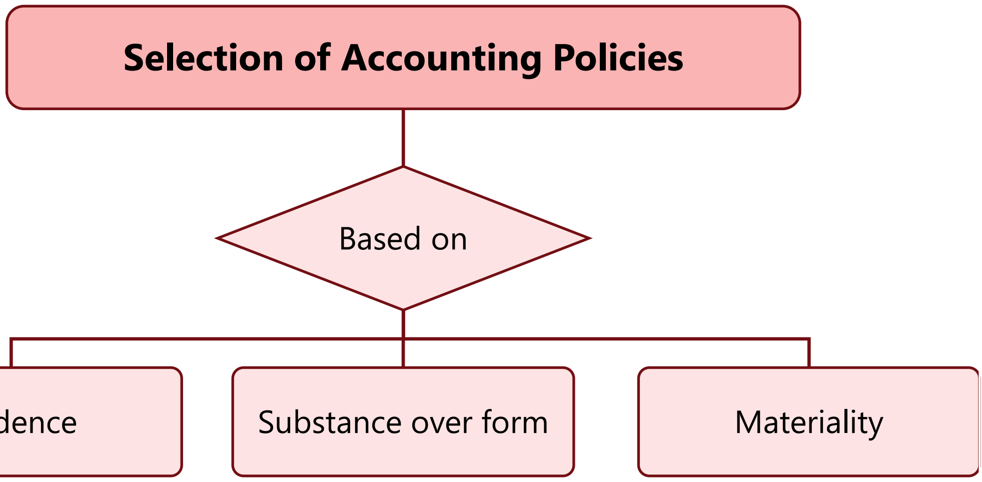
UNIT – 5 ACCOUNTING POLICIES

LEARNING OUTCOMES

After studying this Unit, you will be able to:

- Understand the meaning of 'Accounting Policies'.
- Familiarize with the situations under which selection from different accounting policies is required.
- Grasp the conditions where change in accounting policy can be made and the consequences arising from such change.

UNIT OVERVIEW



5.1 MEANING OF ACCOUNTING POLICIES

Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions that have already been explained in Unit 2 of Chapter 1. There is no single list of accounting policies, which are applicable to all enterprises in all circumstances. Enterprises operate in diverse and complex environmental situations and so they have to adopt various policies. The choice of specific accounting policy appropriate to the specific circumstances in which the enterprise is operating, calls for considerate judgement by the management. ICAI has been trying to reduce the number of acceptable accounting policies through Guidance Notes and Accounting Standards in its combined efforts with the government, other regulatory agencies and progressive managements. Already it has achieved some progress in this respect.

The areas wherein different accounting policies are frequently encountered can be given as follows:

(1) Valuation of Inventories;

(2) Valuation of Investments.

This list should not be taken as exhaustive but is only illustrative. As the course will progress, students will see the intricacies of the various accounting policies.

Suppose an enterprise holds some investments in the form of shares of a company at the end of an accounting period. For valuation of shares, the enterprise may adopt FIFO, average method etc. The method selected by that enterprise for valuation is called an accounting policy.

5.2 SELECTION OF ACCOUNTING POLICIES

Choice of accounting policy is an important policy decision which affects the performance measurement as well as financial position of the business entity. Selection of inappropriate accounting policy may lead to understatement or overstatement of performance and financial position. Thus, accounting policy should be selected with due care after considering its effect on the financial performance of the business enterprise from the angle of various users of accounts.

It is believed that no unified and exhaustive list of accounting policies can be suggested which has universal application. Three major characteristics which should be considered for the purpose of selection and application of accounting policies. viz., Prudence, Substance over form, and Materiality. The financial statements should be prepared on the basis of such accounting policies, which exhibit true and fair view of state of affairs of Balance Sheet and the Profit & Loss Account.

Examples wherein selection from a set of accounting policies is made, can be given as follows:–

1. Inventories are valued at cost except for finished goods and by-products. Finished goods are valued at lower of cost or market value and by-products are valued at net realizable value.
2. Investments (long term) are valued at their acquisition cost. Provision for permanent diminution in value has been made wherever necessary.

Sometimes a wrong or inappropriate treatment is adopted for items in Balance Sheet, or Profit & Loss Account, or other statement. Disclosure of the treatment adopted is necessary in any case, but disclosure cannot rectify a wrong or inappropriate treatment.

5.3 CHANGE IN ACCOUNTING POLICIES

A change in accounting policies should be made in the following conditions:

(a) It is required by some statute or for compliance with an Accounting Standard

(b) Change would result in more appropriate presentation of financial statement

Change in accounting policy may have a material effect on the items of financial statements. For example, if cost formula used for inventory valuation is changed from weighted average to FIFO, or if interest is capitalized which was earlier not in practice, or if proportionate amount of interest is changed to inventory which was earlier not the practice, all these may increase or decrease the net profit. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts. Therefore, it is necessary to quantify the effect of change on financial statement items like assets, liabilities, profit/loss.

For example, Omega Enterprises revised its accounting policy relating to valuation of inventories to include applicable production overheads. It intends to do as it believes that such change would result in a more appropriate presentation of its financial statements.

SUMMARY

♦ Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions.

♦ Three major characteristics which should be considered for the purpose of selection and application of accounting policies. viz., Prudence, Substance over form, and Materiality.

- A change in accounting policies should be made in the following conditions:
  - (a) It is required by some statute or for compliance with an Accounting Standard.
  - (b) Change would result in more appropriate presentation of financial statement.

TEST YOUR KNOWLEDGE

True and False

1. *There is a single list of accounting policies, which are applicable to all enterprises in all circumstances.*
2. *Selection of accounting policy doesn't impact financial performance and financial position of the business*
3. *A change in accounting policies should be made as and when business like to show result as per their choice.*
4. *Choosing FIFO or weighted average method for inventory valuation is selection of accounting policy.*
5. *Selection of an inappropriate accounting policy decision will overstate the performance and financial position of a business entity every time.*

Multiple Choice Questions

1. *A change in accounting policy is justified*
   - *(a) To comply with accounting standard and law.*
   - *(b) To ensure more appropriate presentation of the financial statement of the enterprise.*
   - *(c) Both (a) and (b).*
2. *Accounting policy for inventories of Xeta Enterprises states that inventories are valued at the lower of cost determined on weighted average basis or net realizable value. Which accounting principle is followed in adopting the above policy?*
   - *(a) Materiality.*
   - *(b) Prudence.*
   - *(c) Substance over form.*

3. *The areas wherein different accounting policies can be adopted are*

   (a) *Providing depreciation.*

   (b) *Valuation of inventories.*

   (c) *Both the option.*

4. *Selection of an inappropriate accounting policy decision may*

   (a) *Overstate the performance and financial position of a business entity.*

   (b) *Understate/overstate the performance and financial position of a business entity.*

   (c) *Overstate the performance of a business entity.*

5. *Accounting policies refer to specific accounting*

   (a) *Principles.*

   (b) *Methods of applying those principles.*

   (c) *Both (a) and (b).*

Theoretical Questions

1. *Define Accounting Policies in brief. Identify few areas wherein different accounting policies are frequently encountered.*

2. *"Change in accounting policy may have a material effect on the items of financial statements." Explain the statement with the help of an example.*

ANSWERS/HINTS

True and False

1. False: There cannot be single list of accounting policies, which are applicable to all enterprises in all circumstances. There would always be different policies chosen by different industries under different circumstances.

2. False: Accounting policy has big impact on value of items goes under financial statements, hence it impacts financial performance and financial position of the business.

3. False: A change in accounting policies should be made in the following conditions:

   (a) It is required by some statute or for compliance with an Accounting Standard.

   (b) Change would result in more appropriate presentation of financial statement.

4. True: An enterprise may adopt FIFO or weighted average method for inventory valuation and the method selected for valuation is called an accounting policy.

5. False: It could understate/overstate the performance and financial position of a business entity.

Multiple Choice Questions

1.	**(c)**	2.	**(b)**	3.	**(b)**	4.	**(b)**	5.	**(c)**		
7.	**(c)**	8.	**(a)**	9	**(c)**						

Theoretical Questions

1. Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. For details, refer para 5.1.

2. Change in accounting policy may have a material effect on the items of financial statements. For example, if cost formula used for inventory valuation is changed from weighted average to FIFO. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts.

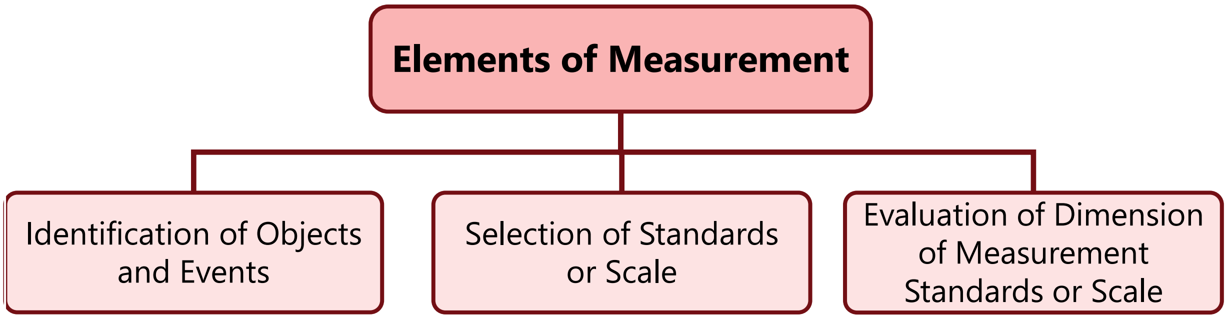
UNIT – 6 ACCOUNTING AS A MEASUREMENT DISCIPLINE – VALUATION PRINCIPLES, ACCOUNTING ESTIMATES

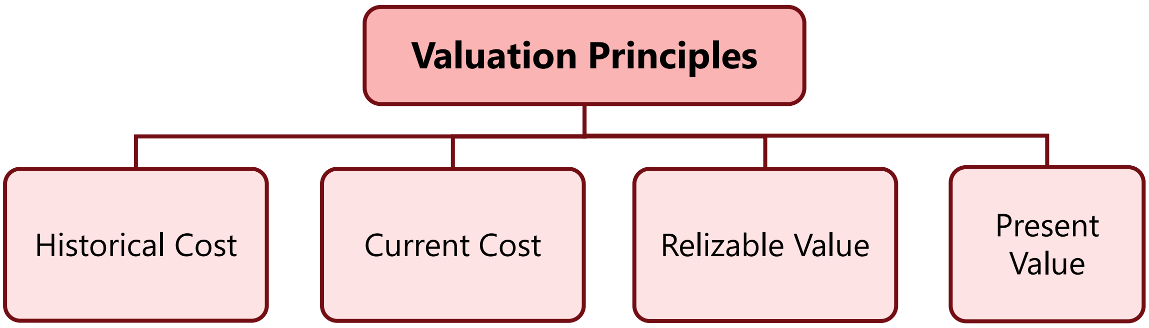
LEARNING OUTCOMES

After studying this Unit, you will be able to:

- Understand the meaning of measurement and its basic elements.
- Know how far accounting is a measurement discipline if considered from the standpoint of the basic elements of measurement.
- Distinguish measurement from valuation.
- Learn the different measurement bases namely historical cost, realizable value and present value.
- Understand the measurement bases which can give objective and valuation to transactions and events.
- Understand that the traditional accounting system mostly uses historical cost as measurement base, although in some cases other measurement bases are also used.

UNIT OVERVIEW





6.1 MEANING OF MEASUREMENT

Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money. Any measurement discipline deals with three basic elements of measurement viz., identification of objects and events to be measured, selection of standard or scale to be used, and evaluation of dimension of measurement standards or scale.

Prof. R. J. Chambers defined 'measurement' as "assignment of numbers to objects and events according to rules specifying the property to be measured, the scale to be used and the dimension of the unit". (R.J. Chambers, Accounting Evaluation and Economic Behaviour, Prentice Hall, Englewood Cliffs, N.J. 1966, P.10).

Kohler defined measurement as the assignment of a system of ordinal or cardinal numbers to the results of a scheme of inquiry or apparatus of observations in accordance with logical or mathematical rules – [A Dictionary of Accountant].

Ordinal numbers, or ordinals, are numbers used to denote the position in an ordered sequence: first, second, third, fourth, etc., whereas a cardinal number says 'how many there are': one, two, three, four, etc.

Chambers' definition has been widely used to judge how far accounting can be treated as a measurement discipline.

According to this definition, the three elements of measurement are:

(1) Identification of objects and events to be measured;

(2) Selection of standard or scale to be used;

(3) Evaluation of dimension of measurement standard or scale.

6.2 OBJECTS OR EVENTS TO BE MEASURED

We have earlier defined Accounting as the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the users of the information. So accounting essentially includes measurement of 'information'.

Decision makers need past, present and future information. For external users, generally the past information is communicated.

There is no uniform set of events and transactions in accounting which are required for decision making. For example, in cash management, various cash receipts and expenses are the necessary objects and events. Obviously, the decision makers need past cash receipts and expenses data along with projected receipts and expenses. For giving loan to a business one needs information regarding the repayment ability (popularly called debt servicing) of principal and interest. This also includes past information, current state of affairs as well as future projections. It may be mentioned that past and present objects and events can be measured with some degree of accuracy but future events and objects are only predicted, not measured. Prediction is an essential part of accounting information. Decision makers have to take decisions about the unseen future for which they need suitable information.

6.3 STANDARD OR SCALE OF MEASUREMENT

In accounting, money is the scale of measurement (see money measurement concept), although now-a- days quantitative information is also communicated along with monetary information.

Money as a measurement scale has no universal denomination. It takes the shape of currency ruling in a country. For example, in India the scale of measurement is Rupee, in the U.K. Pound-Sterling (£), in Germany Deutschmark (DM), in the United States Dollar ($) and so on. Also there is no constant exchange relationship among the currencies.

If one businessman in India took loan $5,000 from a businessman of the U.S.A., he would enter the transaction in his books in terms of ₹ Suppose at the time of loan agreement exchange rate was US $ = ₹ 50. Then loan amounted to ₹ 2,50,000. Afterwards the exchange rate has been changed to $ 1 = ₹ 55. At the changed exchange rate the loan amount becomes₹ 2,75,000. So money as a unit of measurement lacks universal applicability across the boundary of a country unless a common currency is in vogue. Since the rate of exchange fluctuates between two currencies over the time, money as a measurement scale also becomes volatile.

6.4 DIMENSION OF MEASUREMENT SCALE

An ideal measurement scale should be stable over time. For example, if one buys 1 kg. cabbage today, the quantity he receives will be the same if he will buy 1 kg. cabbage one year later. Similarly, length of 1 metre cloth will not change if it is bought a few days later. That is to say a measurement scale should be stable in dimension. Money as a scale of measurement is not stable. There occurs continuous change in the input output prices. The same quantity of money may not have the ability to buy same quantity of identical goods at different dates. Thus information of one year measured in money terms may not be comparable with that of another year. Suppose production and sales of a company in two different years are as follows:

Year 1		Year 2	
Qty.	**₹**	**Qty.**	**₹**
5,000 pcs	5,00,000	4,500 pcs	5,40,000

Looking at the monetary figures one may be glad for 8% sales growth. In fact there was 10% production and sales decline. The growth envisaged through monetary figures is only due to price change. Let us suppose further that the cost of production for the above mentioned two years is as follows:

Year 1		Year 2	
Qty.	**₹**	Qty.	₹
5,000 pcs	4,00,000	4,500 pcs	4,50,000

Take Gross profit = Sales – Cost of Production. Then in the first year profit was ₹ 1,00,000 while in the second year the profit was ₹ 90,000. There was 10% decline in gross profit.

So, money as a unit of measurement is not stable in the dimension.

Thus, Accounting measures information mostly in money terms which is not a stable scale having universal applicability and also not stable in dimension for comparison over the time. So it is not an exact measurement discipline.

6.5 ACCOUNTING AS A MEASUREMENT DISCIPLINE

How do you measure a transaction or an event? Unless the measurement base is settled we cannot progress to the record keeping function of book-keeping. It has been explained that accounting is meant for generating information suitable for users' judgments and decisions. But generation of such information is preceded by recording, classifying and summarising data. By that process it measures performance of the business entity by way of profit or loss and shows its financial position. Thus, measurement is an important part of accounting discipline. But a set of theorems governs the whole measurement sub- system. These theorems should be carefully understood to know how the cogs of the 'accounting-wheel' work. Now-a-days accounting profession earmarked three theorems namely going concern, consistency and accrual as fundamental accounting assumptions, i.e., these assumptions are taken for granted. Also while measuring, classifying, summarising and also presenting, various policies are adopted. Recording, classifying summarising and communication of information are also important part of accounting, which do not fall within the purview of measurement discipline. Therefore, we cannot simply say that accounting is a measurement discipline.

But in accounting money is the unit of measurement. So, let us take one thing for granted that all transactions and events are to be recorded in terms of money only. Quantitative information is also required in many cases but such information is only supplementary to monetary information.

6.6 VALUATION PRINCIPLES

There are four generally accepted measurement bases or valuation principles. These are:

(i) Historical Cost;

(ii) Current Cost;

(iii) Realizable Value;

(iv) Present Value.

Let us discuss these principles in detail.

(i) *Historical Cost:* It means acquisition price. For example, the businessman paid ₹ 7,00,000 to purchase the machine and spend ₹1,00,000 on its installation, its acquisition price including installation charges is ₹ 8,00,000. The historical cost of machine would be ₹8,00,000.

According to this base, assets are recorded at an amount of cash or cash equivalent paid at the time of acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation. In some circumstances a liability is recorded at the amount of cash or cash equivalent expected to be paid to satisfy it in the normal course of business.

When a businessman, takes ₹ 5,00,000 loan from a bank @ 10% interest p.a., it is to be recorded at the amount of proceeds received in exchange for the obligation. Here the obligation is the repayment of loan as well as payment of interest at an agreed rate i.e. 10%. Proceeds received are ₹ 5,00,000 - it is historical cost of the transactions.

Take another case regarding payment of income tax liability. You know every individual has to pay income tax on his income if it exceeds certain minimum limit. But the income tax liability is not settled immediately when one earns his income. The income tax authority settles it some time later, which is technically called assessment year. Then how does he record this liability? As per historical cost base it is to be recorded at an amount expected to be paid to discharge the liability.

Companies usually apply historical cost method in case of long-term assets like machinery, furniture, licenses etc.

(ii) *Current Cost:* Take that Mr. X purchased a machine on 1st January, 2011 at ₹ 7,00,000. As per historical cost base he has to record it at ₹ 7,00,000 i.e. the acquisition price. As on 1.1.2022, Mr. X found that it would cost ₹ 25,00,000 to purchase that machine. Take also that Mr. X took loan from a bank as on 1.1.2011 ₹ 5,00,000 @ 18% p.a. repayable at the end of 15th year together with interest. As on 1.1.2022 the bank announces 1% prepayment penalty on the loan amount if it is paid within 15 days starting from that day. As per historical cost the liability is recorded at ₹ 5,00,000 at the amount or proceeds received in exchange for obligation and asset is recorded at ₹ 7,00,000.

Current cost gives an alternative measurement base. Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

So as per current cost base, the machine value is ₹ 25,00,000 while the value of bank loan is ₹ 5,05,000.

(iii) *Realisable Value:* Suppose Mr. X found that he can get ₹ 20,00,000 if he would sell the machine purchased, on 1.1.2011 paying ₹ 7,00,000 and which would cost ₹ 25,00,000 in case he would buy it currently. Take also that Mr. X found that he had no money to pay off the bank loan of ₹ 5,00,000 currently.

As per realisable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal. Haphazard disposal may yield something less. Liabilities are carried at their settlement values; i.e. the undiscounted amount of cash or cash equivalents expressed to be paid to satisfy the liabilities in the normal course of business.

So, the machine should be recorded at ₹ 20,00,000 the realisable value in an orderly sale while the bank loan should be recorded at ₹ 5,00,000 the settlement value in the normal course of business.

Realisable value concept is commonly applied in case of inventories. Inventories are measured at the lower of cost and net realisable value.

(iv) *Present Value:* Suppose we are talking as on 1.1.2022 - take it as time for reference. Now think the machine purchased by Mr. X can work for another 10 years and is supposed to generate cash @ ₹ 1,00,000 p.a. Also take that bank loan of ₹ 5,00,000 taken by Mr. X is to be repaid as on 31.12.2028. Annual interest is ₹ 90,000.

As per present value, an asset is carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The concept of Present Value is common in case of accounting for investments and loans.

The term 'discount', 'cash inflow' and 'cash outflow' need a little elaboration. ₹ 100 in hand as on 1.1.2022 is not equivalent to ₹ 100 in hand as on 31.12.2022. There is a time gap of one year. If Mr. X had ₹ 100 as on 1.1.2022 he could use it at that time. If he received it only on 31.12.2022, he had to sacrifice his use for a year. The value of this sacrifice is called 'time value of money'. Mr. X would sacrifice i.e. he would agree to take money on 31.12.2022 if he had been compensated for the sacrifice. So a rational man will never exchange ₹ 100 as on 1.1.2022 with ₹ 100 to be received on 31.12.2022. Then ₹ 100 of 1.1.2022 is not equivalent to ₹ 100 of 31.12.2022. To make the money receivable at a future date equal with the money of the present date it is to be devalued. Such devaluation is called discounting of future money.

Perhaps you know the compound interest rule: A = P (1+ i)n

A = Amount

P = Principal

i = interest / 100

n = Time

This equation gives the relationship between present money, principal and the future money amount. If A, i and n are given, to find out P, the equation is to be changed slightly.

$$P = \frac{A}{(1+I)^n}$$

Using the equation one can find out the present value if he knows the values of A, i and n.

Suppose i = 20%, now what is the present value of ₹ 1,00,000 to be received as on 31.12.2022 (Take 1.1.2022 as the time of reference).

$$P = \frac{1,00,000}{(1+20)^1} = ₹\ 83,333$$

Similarly,

Time of Receipt	Money Value ₹	Present Value ₹
31.12.2023	1,00,000	69,444
31.12.2024	1,00,000	57,870
31.12.2025	1,00,000	48,225
31.12.2026	1,00,000	40,188
31.12.2027	1,00,000	33,490
31.12.2028	1,00,000	27,908
31.12.2029	1,00,000	23,257
31.12.2030	1,00,000	19,381
31.12.2031	1,00,000	16,150

Total of all these present values is ₹ 4,19,246. Since the machine purchased by Mr. X will produce cash equivalent to ₹ 4,19,246 in terms of present value, it is to be valued at such amount as per present value measurement basis.

Here, Mr. X will receive ₹ 1,00,000 at different points of time-these are cash inflows. In the other example, he has to pay interest and principal of bank loan-these are cash outflows.

Perhaps you also know the annuity rule:

Present value of an Annuity or Re. A for n periods is

A = Annuity

i = interest

t = time 1, 2, 3, ...n.

$$\frac{A}{i}\left[1-\frac{1}{(1+i)^n}\right]$$

Applying this rule one can derive the present value of ₹ 1,00,000 for 10 years @ 20% p.a.

$$\frac{1,00,000}{0.20}\left[1-\frac{1}{(1+0.20)^{10}}\right] = ₹\ 4,19,246$$

Similarly, the present value of bank loan is

$$\frac{90,000}{0.20}\left[1-\frac{1}{(1+0.20)^{5}}\right]+\frac{5,00,000}{(1+0.20)^{5}}$$

= ₹ 2,69,155 + ₹ 2,00,939= ₹ 4,70,094

Thus, we get the four measurements as on 1.1.2022:

	Historical cost ₹	Current cost ₹	Realisable value ₹	Present value ₹
Asset: Machine	7,00,000	25,00,000	20,00,000	4,19,246
Liability: Bank Loan	5,00,000	5,05,000	5,00,000	4,70,094

The accounting system which we shall discuss in the remaining chapters is also called historical cost accounting. However, this need not mean that one shall follow only historical cost basis of accounting. In the later stages of the CA course, we shall see that the accounting system uses all types of measurement bases although under the traditional system most of the transactions and events are measured in terms of historical cost.

6.7 MEASUREMENT AND VALUATION

Value relates to the benefits to be derived from objects, abilities or ideas. To the economist, value is the utility (i.e.; satisfaction) of an economic resource to the person contemplating or enjoying its use. In accounting, to mean value of an object, abilities or ideas, a monetary surrogate is used. That is to say, value is measured in terms of money. Suppose, an individual purchased a car paying ₹ 2,50,000. Its value lies in the satisfaction to be derived by that individual using the car in future. Economists often use ordinal scale to indicate the level of satisfaction. But accountants use only cardinal scales. If the value of car is taken as ₹ 2,50,000 it is only one type of value called acquisition cost or historical cost. So value is indicated by measurement. In accounting the value is always measured in terms of money.

6.8 ACCOUNTING ESTIMATES

Earlier in this unit we have learned how to measure a transaction, which had already taken place and for which either some value/money has been paid or some valuation principles are to be adopted for their measurement. But there are certain items, which have not occurred therefore cannot be measured using valuation principles still they are necessary to record in the books of account, for example, provision for doubtful debts. For such items, we need some value. In such a situation reasonable estimates based on the existing situation and past experiences are made.

The measurement of certain assets and liabilities is based on estimates of uncertain future events. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. Therefore, the management makes various estimates and assumptions of assets, liabilities, incomes and expenses as on the date of preparation of financial statements. Such estimates are made in connection with the computation of depreciation, amortisation and impairment losses as well as, accruals, provisions and employee benefit obligations. Also estimates may be required in determining the bad debts, useful life and residual value of an item of plant and machinery and inventory obsolescence. The process of estimation involves judgements based on the latest information available.

An estimate may require revision if changes occur regarding circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. Change in accounting estimate means difference arises between certain parameters estimated earlier and re-estimated during the current period or actual result achieved during the current period.

Few examples of situations wherein accounting estimates are needed can be given as follows:

1. A company incurs expenditure of ₹ 10,00,000 on development of patent. Now the company has to estimate that for how many years the patent would benefit the company. This estimation should be based on the latest information and logical judgement.

2. A company dealing in long-term construction contracts, uses percentage of completion method for recognizing the revenue at the end of the accounting year. Under this method the company has to make adequate provisions for unseen contingencies, which can take place while executing the remaining portion of the contract. Since provisioning for unseen contingencies requires estimation, there may be excess or short provisioning, which is to be adjusted in the period when it is recognised.

3. A company has to provide for taxes which is also based on estimation as there can be some interpretational differences on account of which tax authorities may either accept the expenditure or refuse it. This will ultimately lead to different tax liability.

4. Company XY Ltd purchases a machine for ₹ 10 lac in 2021. The procurement head suggested that the machine is expected to offer benefits up to next 10 years. After 3 years of its use, the machine has become obsolete as new technologies are now available providing better productivity than the existing machine. Hence, it is now expected that the machine can only offer benefits for further 3 years. This is a change in estimate in the useful life of the machine.

SUMMARY

♦ Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money.

♦ There are three elements of measurement:

(i) Identification of objects and events to be measured;

(ii) Selection of standard or scale to be used;

(iii) Evaluation of dimension of measurement standard or scale.

♦ There are four generally accepted measurement bases or valuation principles. These are:

(i) Historical Cost;

(ii) Current Cost;

(ii) Realizable Value;

(iv) Present Value.

TEST YOUR KNOWLEDGE

True and False

1. *There are four generally accepted measurement bases.*
   - (i) *Historical Cost;*
   - (ii) *Current Cost;*
   - (iii) *Realizable Value;*
   - (iv) *Future Value.*
2. *Historical Cost means price paid at time acquisition.*
3. *As per future value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal.*
4. *At Present value, liabilities are carried at the value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.*
5. *ABC purchased a machinery amounting ₹10,00,000 on 1st April, 2001. On 31st March, 2022, similar machinery could be purchased for ₹20,00,000. Historical cost of machine is 20,00,000*
6. *ABC purchased a machinery amounting ₹10,00,000 on 1st April, 2001. On 31st March, 2022, similar machinery could be purchased for ₹20,00,000. Current cost of machine is ₹ 20,00,000*
7. *Change in accounting estimate has to be given retrospective effect.*

Multiple Choice Questions

1. (i) *Measurement discipline deals with*
   - (a) *Identification of objects and events.*
   - (b) *Selection of scale.*
   - (c) *Both (a) and (b)*

   (ii) *All of the following are valuation principles except*
   - (a) *Historical cost.*
   - (b) *Present value.*
   - (c) *Future value.*

(iii) Book value of machinery on 31st March, 2022 ₹ 10,00,000

Market value as on 31st March, 2022 if sold ₹ 11,00,000

As on 31st March, 2022, if the company values the machinery at ₹11,00,000, which of the following valuation principle is being followed?

(a) Historical Cost.

(b) Present Value.

(c) Realisable Value.

2. Mohan purchased a machinery amounting ₹10,00,000 on 1st April, 2001. On 31st March, 2022, similar machinery could be purchased for ₹20,00,000 but the realizable value of the machinery (purchased on 1.4.2001) was estimated at ₹ 15,00,000. The present discounted value of the future net cash inflows that the machinery was expected to generate in the normal course of business, was calculated as ₹12,00,000.

(i) The current cost of the machinery is

(a) ₹10,00,000.

(b) ₹20,00,000.

(c) ₹ 15,00,000.

(ii) The present value of machinery is

(a) ₹10,00,000.

(b) ₹20,00,000.

(c) ₹ 12,00,000.

(iii) The historical cost of machinery is

(a) ₹10,00,000.

(b) ₹20,00,000.

(c) ₹ 15,00,000.

(iv) The realizable value of machinery is

(a) ₹10,00,000.

(b) ₹20,00,000.

(c) ₹ 15,00,000.

Theoretical Questions

1. Define Measurement in brief. Explain the significant elements of measurement.

2. Describe in brief, the alternative measurement bases, for determining the value at which an element can be recognized in the balance sheet or statement of profit and loss.

ANSWER/HINTS

True and False

1. False: There are four generally accepted measurement bases .

(i) Historical Cost;

(ii) Current Cost;

(iv) Realizable Value;

(iv) Present Value.

2. True: Historical cost means the acquisition price.

3. False: At Realisable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal.

4. False: Liabilities are carried at the present discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

5. False: Historical cost is ₹10,00,000.

6. True: Since similar machine is purchased at 20,00,000, the current cost of machine is ₹ 20,00,000.

7. False: Change in accounting estimate has not to be given retrospective effect.

Multiple Choice Questions

1. (i)	**(c)**	(ii)	**(c)**	(iii)	**(c)**	2.(i)	**(b)**	(ii)	**(c)**	(iii)	**(a)**
(iv)	**(c)**										

Theoretical Questions

1. Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money. Three elements of measurement are: (1) Identification of objects and events to be measured; (2) Selection of standard or scale to be used; (3) Evaluation of dimension of measurement standard or scale.

2. Alternative measurement bases are: (i) Historical Cost; (ii) Current cost (iii) Realisable (Settlement) Value and (iv) Present Value. Refer para 6.6 for details.

UNIT – 7 ACCOUNTING STANDARDS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the significance of issuance of Accounting Standards.
- Grasp the objectives, benefits and limitations of Accounting Standards.
- Learn the process of formulation of Accounting Standards by the Council of the Institute of Chartered Accountants of India.
- Familiarize with the list of applicable Accounting Standards in India.

UNIT OVERVIEW

Accounting Standards deal with the issues of

- Recognition of events and transactions
- Measurement of transactions and events
- Presentation of transactions and events
- Disclosure requirements

Formulation of Accounting Standards

Identification of area

↓

Constitution of study group

↓

Preparation of draft and its circulation

↓

Ascertainment of views of different bodies on draft

↓

Finalisation of exposure draft (E.D)

↓

Comments received on exposure draft (E.D)

↓

Modification of the draft

↓

Issue of AS

7.1 INTRODUCTION OF ACCOUNTING STANDARDS

Accounting as a 'language of business' communicates the financial results of an enterprise to various stakeholders by means of financial statements. If the financial accounting process is not properly regulated, there is possibility of financial statements being misleading, tendentious and providing a distorted picture of the business, rather than the true. To ensure transparency, consistency, comparability, adequacy and reliability of financial reporting, it is essential to standardize the accounting principles and policies. Accounting Standards (ASs) provide framework and standard accounting policies for treatment of transactions and events so that the financial statements of different enterprises become comparable.

Accounting standards are written policy documents issued by the expert accounting body or by the government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions and events in the financial statements. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in the company's economic performance. The accounting standards deal with the issues of -

(i) recognition of events and transactions in the financial statements;

(ii) measurement of these transactions and events;

(iii) presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader; and

(iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into what these financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decisions.

7.2 OBJECTIVES OF ACCOUNTING STANDARDS

The whole idea of accounting standards is centered around harmonisation of accounting policies and practices followed by different business entities so that the diverse accounting practices adopted for various aspects of accounting can be standardised. Accounting Standards standardise diverse accounting policies with a view to:

(i) eliminate the non-comparability of financial statements and thereby improving the reliability of financial statements; and

(ii) provide a set of standard accounting policies, valuation norms and disclosure requirements.

Accounting standards reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby ensuring comparability of financial statements of different enterprises.

7.3 BENEFITS AND LIMITATIONS OF ACCOUNTING STANDARDS

Accounting standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. By setting the accounting standards, the accountant has following benefits:

(i) Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.

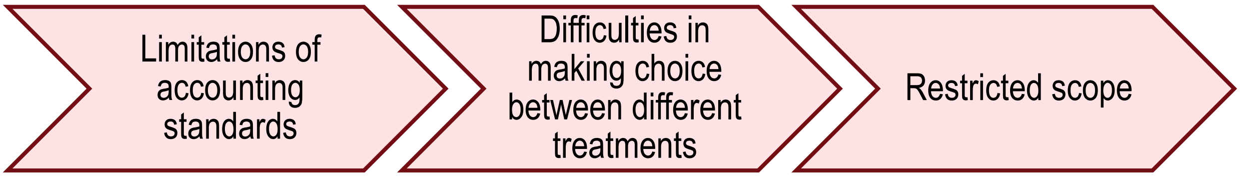
(ii) There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.

(iii) The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.

However, there are some limitations of accounting standards:

(i) ***Difficulties in making choice between different treatments:*** Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.

(ii) ***Restricted scope:*** Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.



7.4 PROCESS OF FORMULATION OF ACCOUNTING STANDARDS IN INDIA

The Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) in 1977. The ICAI has taken significant initiatives in the setting and issuing procedure of Accounting Standards to ensure that the standard-setting process is fully consultative and transparent. The ASB considers International Financial Reporting Standards (IFRSs) while framing Indian Accounting Standards (ASs) in India and try to integrate them, in the light of the applicable laws, customs, usages and business environment in the country. The composition of ASB includes, representatives of industries (namely, ASSOCHAM, CII, FICCI), regulators, academicians, government departments etc. Although ASB is a body constituted by the Council of the ICAI, it (ASB) is independent in the formulation of accounting standards and Council of the ICAI is not empowered to make any modifications in the draft accounting standards formulated by ASB without consulting with the ASB.

The standard-setting procedure of Accounting Standards Board (ASB) can be briefly outlined as follows:

- Identification of broad areas by ASB for formulation of AS.
- Constitution of study groups by ASB to consider specific projects and to prepare preliminary drafts of the proposed accounting standards. The draft normally includes objective and scope of the standard, definitions of the terms used in the standard, recognition and measurement principles wherever applicable and presentation and disclosure requirements.

- Consideration of the preliminary draft prepared by the study group of ASB and revision, if any, of the draft on the basis of deliberations.
- Circulation of draft of accounting standard (after revision by ASB) to the Council members of the ICAI and specified outside bodies such as Department of Company Affairs (DCA), Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), Central Board of Direct Taxes (CBDT), Standing Conference of Public Enterprises (SCOPE), etc. for comments.
- Meeting with the representatives of the specified outside bodies to ascertain their views on the draft of the proposed accounting standard.
- Finalisation of the exposure draft of the proposed accounting standard and its issuance inviting public comments.
- Consideration of comments received on the exposure draft and finalisation of the draft accounting standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance.
- Consideration of the final draft of the proposed standard and by the Council of the ICAI, and if found necessary, modification of the draft in consultation with the ASB is done.
- The accounting standard on the relevant subject (for non-corporate entities) is then issued by the ICAI. For corporate entities the accounting standards are issued by The Central Government of India.

7.5 LIST OF ACCOUNTING STANDARDS IN INDIA

The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

Following is the list of applicable Accounting Standards:

List* of Accounting Standards

Sl. No.	Number of the Accounting Standard (AS)	Title of the Accounting Standard
1.	AS 1	Disclosure of Accounting Policies
2.	AS 2 (Revised)	Valuation of Inventories
3.	AS 3 (Revised)	Cash Flow Statements

4.	AS 4 (Revised)	Contingencies and Events Occurring after the Balance Sheet Date
5.	AS 5 (Revised)	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
6.	AS 7 (Revised)	Accounting for Construction Contracts
7.	AS 9	Revenue Recognition
8.	AS 10	Property, Plant and Equipment
9.	AS 11 (Revised)	The Effects of Changes in Foreign Exchange Rates
10.	AS 12	Accounting for Government Grants
11.	AS 13	Accounting for Investments
12.	AS 14	Accounting for Amalgamations
13.	AS 15 (Revised)	Employee Benefits
14.	AS 16	Borrowing Costs
15.	AS 17	Segment Reporting
16.	AS 18	Related Party Disclosures
17.	AS 19	Leases
18.	AS 20	Earnings Per Share
19.	AS 21	Consolidated Financial Statements
20.	AS 22	Accounting for Taxes on Income
21.	AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
22.	AS 24	Discontinuing Operations
23.	AS 25	Interim Financial Reporting
24.	AS 26	Intangible Assets
25.	AS 27	Financial Reporting of Interests in Joint Ventures
26.	AS 28	Impairment of Assets
27.	AS 29	Provisions, Contingent Liabilities & Contingent Assets

**** Note: The list of accounting standards given above does not form part of syllabus. It has been given here for the knowledge of students only.***

SUMMARY

- Accounting Standards (ASs) provide framework and standard accounting policies for treatment of transactions and events so that the financial statements of different enterprises become comparable. Accounting Standards standardise diverse accounting policies with a view to:
  (i) eliminate the non-comparability of financial statements
  (ii) provide a set of standard accounting policies, valuation norms and disclosure requirements
- By setting the accounting standards, the accountant has following benefits:
  (i) Comparability of financial statements
  (ii) Requirements of additional disclosures
- Following are the limitations of accounting standards
  (i) Difficulties in making choice between different treatments.
  (ii) Accounting standards cannot override the statute

TEST YOUR KNOWLEDGE

True and False

1. *Accounting standards are written policy documents issued by the expert accounting body or by the government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions and events in the financial statements.*
2. *Accounting standards can override the statute.*
3. *Difficulties in making choice between different treatments is one of the benefits of accounting standards.*
4. *Requirements for additional disclosures is limitation of accounting standards.*
5. *ASB stands for Accounting standardisation benchmarking.*
6. *There are no limitation to accounting standards.*

Multiple Choice Questions

1. *Accounting Standards for Non-Corporate entities in India are issued by*

   (a) *Central Govt.*

   (b) *State Govt.*

   (c) *Institute of Chartered Accountants of India.*

2. *Accounting Standards*

   (a) *Harmonise accounting policies.*

   (b) *Eliminate the non-comparability of financial statements.*

   (c) *Both the above.*

3. *It is essential to standardize the accounting principles and policies in order to ensure*

   (a) *Transparency.*

   (b) *Consistency.*

   (c) *Both the above.*

Theoretical Questions

1. *Explain the objective of "Accounting Standards" in brief.*
2. *State the advantages of setting Accounting Standards.*

ANSWERS/HINTS

True and False

1. True: Accounting standards are documents covering recognition, measurement, presentation and disclosure of accounting transactions and events in the financial statements.

2. False: Accounting standards can never override the statute. The standards are required to be framed within the ambit of prevailing statutes.

3. False: Difficulties in making choice between different treatments is one of the limitation of accounting standard.

4. False: Benefits of accounting standards are:

- Standardisation of alternative accounting treatments

- Comparability of financial statements
- Requirements for additional disclosures.

5. False: ASB stands for Accounting Standard Board.

6. False: limitations of accounting standards

- Difficulties in making choice between different treatments
- Restricted scope

Multiple Choice Questions

1.	**(c)**	2.	**(c)**	3.	**(c)**						

Theoretical Questions

1. Accounting Standards are selected set of accounting policies or broad guidelines regarding the principles and methods to be chosen out of several alternatives. The main objective of Accounting Standards is to establish standards which have to be complied with, to ensure that financial statements are prepared in accordance with generally accepted accounting principles. Accounting Standards seek to suggest rules and criteria of accounting measurements. These standards harmonize the diverse accounting policies and practices at present in use in India.

2. The main advantage of setting accounting standards is that the adoption and application of accounting standards ensure uniformity, comparability and qualitative improvement in the preparation and presentation of financial statements. The other advantages are: Reduction in variations; Disclosures beyond that required by law and Facilitates comparison.

NOTES

CHAPTER 2

ACCOUNTING PROCESS

UNIT -1 BASIC ACCOUNTING PROCEDURES – JOURNAL ENTRIES

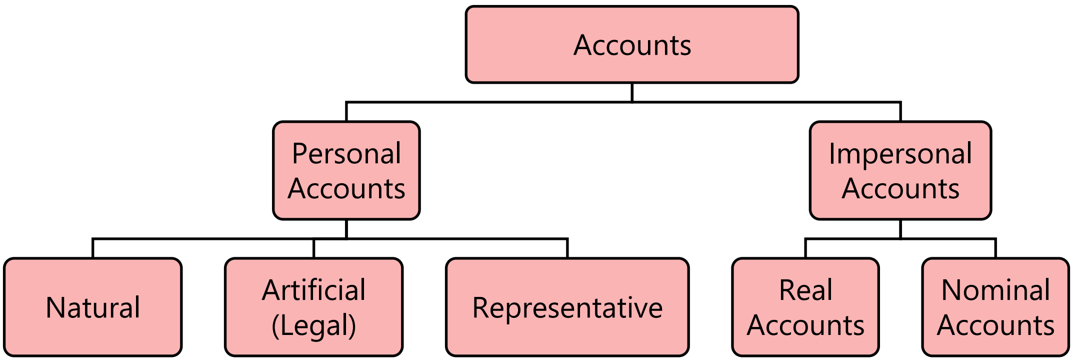
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand meaning and significance of Double Entry System.
- Familiarize with the term 'account' and understand the classification of accounts into personal, real and nominal.
- Note the utility of such classification and sub-classifications.
- Understand how debits and credits are determined from transactions and events.
- Observe the points to be taken care of while recording a transaction in the journal.

UNIT OVERVIEW

Source Documents	•All documents in records which contain financial records and act as evidence of transactions.
Books of original entry and Ledger Accounts	•Purchase day book, Cash book, Sales day book and Purchases return book •Accounts where information relating to a particular asset/liability, capital, income and expenses are recorded.
Trial Balance	•It contains the totals from various ledger accounts and act as preliminary check on accounts before producing financial statements.



1.1 DOUBLE ENTRY SYSTEM

Double entry system of accounting is more than 500 years old. "Luca Pacioli" an Italian friar & mathematician published Summa de Arithmetica, Geometria, Proportioni, et Proportionalita ("Everything about Arithemetic Geometry and proportions"). The first book that described a double entry accounting system. Double entry system of book-keeping has emerged in the process of evolution of various accounting techniques. It is the only scientific system of accounting. According to it, every transaction has two-fold aspects–debit and credit and both the aspects are to be recorded in the books of accounts. Therefore, in every transaction at least two accounts are effected.

For example, on purchase of furniture either the cash balance will be reduced or a liability to the supplier will arise and new asset furniture is acquired. This has been made clear already, the Double Entry System records both the aspects. It may be defined as the system which recognises and records both the aspects of transactions. This system has proved to be systematic and has been found of great use for recording the financial transactions for all kind of entities requiring use of money.

1.2 ADVANTAGES OF DOUBLE ENTRY SYSTEM

This system affords the under mentioned advantages:

(i) By the use of this system the accuracy of the accounting work can be established, through the device of the trial balance.

(ii) The profit earned or loss incurred during a period can be ascertained together with details.

(iii) The financial position of the entity or the institution concerned can be ascertained at the end of each period, through preparation of the financial statements.

(iv) The system permits accounts to be kept in as much details as necessary and, therefore provides significant information for the purpose of control and reporting.

(v) Result of one year may be compared with those of previous years and reasons for the change may be ascertained.

In view of the above, the advantages of double entry system has been used extensively in all countries.

1.3 ACCOUNT

We have seen how the accounting equation becomes true in all cases. A person starts his business with say, ₹ 10,00,000 as capital with corresponding balance of cash ₹ 10,00,000. For example, transactions entered into by the entity will alter the cash balance in two ways, one will increase the cash balance and other will reduce it. Payment for goods purchased, salaries paid and rent expense paid, etc., will reduce the cash balance whereas sales of goods for cash and collection from customers will increase it.

We can change the cash balance with every transaction but this will be cumbersome. Instead it would be better if all the transactions that lead to an increase are recorded in one column and those that reduce the cash balance in another column; then the net result can be ascertained. If we add all increases to the opening balance of cash and then deduct the total of all decreases, we shall know the closing balance. In this manner, significant information will be available relating to cash.

The two columns which we referred above are put usually in the form of an account, called the ‘T’ form. This is illustrated below by taking imaginary figures:

CASH

Particular		Increase (Receipt) ₹	Particular		Decrease (Payment) ₹
Opening Balance	(1)	10,00,000		(7)	1,00,000
	(2)	2,50,000		(8)	3,00,000
	(3)	2,00,000		(9)	2,00,000
	(4)	5,00,000		(10)	5,00,000
	(5)	1,35,000			
	(6)	4,00,000		(11)	12,00,000
			New or Closing Balance		1,85,000
		24,85,000			24,85,000

Since, each T-account shows only amounts and not transaction descriptions, we record each transaction in some way, such as by numbering used in this illustration. However, one can use date also for this purpose.

What we have done is to record the increase of cash on the left hand side and the decrease on the right hand side; the closing balance has been ascertained by deducting the total of payments, ₹ 23,00,000 from the total of the left - hand side. Such a treatment of receipts and payments of cash is very convenient.

Here we talked about only one account namely cash, now let us see how to make T-accounts when assets as well as liabilities are effected from a particular transaction.

Now, let us take some more examples:-

Transaction 1:

Initial investment by owners ₹ 25,00,000 in cash.

This will effect two accounts namely cash and capital. The asset cash increases and the stock holders' equity paid up capital also increases.

CASH

	Increase		Decrease
(1)	25,00,000		

CAPITAL

	Decrease		Increase
		(1)	25,00,000

Transaction 2:

Paid cash to the creditors ₹ 14,00,000

This will effect cash account which will decrease and creditors account which is a liability will also decrease.

CASH

	Increase		Decrease
		(2)	14,00,000

CREDITORS

	Decrease		Increase
(2)	14,00,000		

The proper form of an account is as follows:

Account

Date	Particulars	Amount	Date	Particulars	Amount
		₹			

The columns are self-explanatory.

1.4 DEBIT AND CREDIT

We have seen that in T-accounts increase and decrease entries are made on the left and right side of the accounts for assets respectively and vice-versa for liabilities. But, formally accountants use the term Debit (Dr.) to denote an entry on the left side of any account and Credit (Cr.) to denote an entry on the right side of any account.

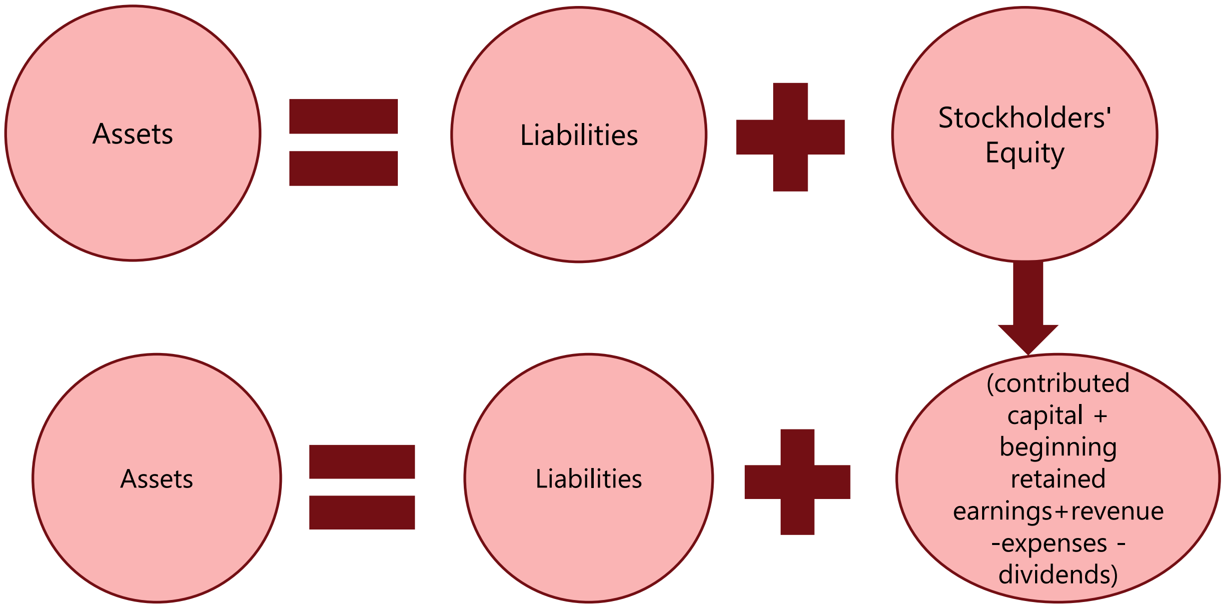
We know that by deducting the total of liabilities from the total of assets the amount of capital is ascertained, as is indicated by the accounting equation.

Assets = Liabilities + Capital

or

Assets − Liabilities = Capital

To understand the equation better, let us expand it:-



Here,

Contributed capital = the original capital introduced by the owner.

Beginning retained earnings = previous earnings not distributed to the shareholders.

Revenue = generated from the ongoing activities of the business

Expenses = cost incurred for the operations of the company.

Dividends = earnings distributed to the shareholders of the company

We have also seen that if there is any change on one side of the equation, it is bound to be similar change on the other side of the equation or amongst items covered by it or an opposite change on the same side of the equation. This is illustrated below:

Transactions	**Total Assets ₹**	**= Liabilities ₹**	**+ Owner's Capital ₹**
(1) Started business with cash ₹ 10,00,000	10,00,000		10,00,000
(2) Borrowed ₹ 5,00,000	+ 5,00,000	+ 5,00,000	
(3) Withdrew cash from business ₹ 2,00,000	- 2,00,000		- 2,00,000
(4) Loan repaid to the extent of ₹ 1,00,000	- 1,00,000	- 1,00,000	
(5) Bought furniture worth ₹ 3,00,000 with	+3,00,000		
Cash	- 3,00,000		
Balance	**12,00,000**	**= 4,00,000**	**+ 8,00,000**

As has been seen previously, what has been given above is suitable only if the number of transactions is small. But if the number is large, a different procedure of putting increases and decreases in different columns will be useful and this will also yield significant information. The transactions given above are being shown below according to this method.

Total Assets		= Liabilities		+ Owner's Capital	
Increase ₹	**Decrease** ₹	**Decrease** ₹	**Increase** ₹	**Decrease** ₹	**Increase** ₹
(1) 10,00,000					10,00,000
(2) 5,00,000			5,00,000		
(3)	2,00,000			2,00,000	
(4)	1,00,000	1,00,000			
Total 15,00,000	**3,00,000**	**1,00,000**	**5,00,000**	**2,00,000**	**10,00,000**
Balance 12,00,000			**4,00,000**		**+ 8,00,000**

It is a tradition that:

(i) increases in assets are recorded on the left-hand side and decreases in them on the right-hand side; and

(ii) in the case of liabilities and capital, increases are recorded on the right-hand side and decreases on the left-hand side.

When two sides are put together in T form, the left-hand side is called the 'debit side' and the right hand side is 'credit side'. When in an account a record is made on the debit or left-hand side, one says that one has debited that account; similarly to record an amount on the credit or right-hand side, it is said the account has been credited.

From the above, the following rules can be obtained:

(i) When there is an increase in the amount of an asset, its account is debited; the account will be credited if there is a reduction in the amount of the asset concerned: Suppose a firm purchases furniture for ₹ 8,00,000, the furniture account will be debited by ₹ 8,00,000 since the asset has increased by this amount. Suppose later the firm sells furniture to the extent of ₹ 3,00,000 the reduction will be recorded by crediting the furniture account by ₹ 3,00,000.

FURNITURE

	Increase		Decrease
(1) To Cash	8,00,000	(2) By Cash	3,00,000
		Balance	5,00,000

(ii) If the amount of a liability increases, the increase will be entered on the credit side of the liability account, i.e. the account will be credited: similarly, a liability account will be debited if there is a reduction in the amount of the liability. Suppose a firm borrows ₹ 5,00,000 from Mohan; Mohan's account will be credited since ₹ 5,00,000 is now owing to him. If, later, the loan is repaid, Mohan's account will be debited since the liability no longer exists.

MOHAN

	Decrease		Increase
(2) To Cash	5,00,000	(1) By Cash	5,00,000

(iii) An increase in the owner's capital is recorded by crediting the capital account: Suppose the proprietor introduces additional capital, the capital account will be credited. If the owner withdraws some money, i.e., makes a drawing, the capital account will be debited.

(iv) Profit leads to an increase in the capital and a loss to reduction: According to the rule mentioned in (iii) above, profit & incomes may be directly credited to the capital account and losses & expenses may be similarly debited.

However, it is more useful to record all incomes, gains, expenses and losses separately. By doing so, very useful information will be available regarding the factors which have contributed to the year's profits and losses. Later the net result of all these is ascertained and adjusted in the capital account.

(v) Expenses are debited and Incomes are credited: Since incomes and gains increase capital, the rule is to credit all gains and incomes in the accounts concerned and since expenses and losses decrease capital, the rule is to debit all expenses and losses. Of course, if there is a reduction in any income or gain, the account concerned will be debited; similarly, for any reduction in an expenses or loss the concerned account will be credited.

The rules given above are summarised below:

- Increases in assets are debits; decreases are credits;
- Increases in liabilities are credits; decreases are debits;
- Increases in owner's capital are credits; decreases are debits;
- Increases in expenses are debits; decreases are credits; and
- Increases in revenue or incomes are credits; decreases are debits.

The terms debit and credit should not be taken to mean, respectively, favourable and unfavourable things. They merely describe the two sides of accounts.

Whether an entry is to the debit or credit side of an asset depends on the type of account and the transactions

Debit	**Credit**
Increase in Purchases	Increase in Sales
Increase in Expenses	Increase in revenue and Incomes
Increase in Assets	Increase in Liabilities and Owners' Capital

In the same way, decrease in purchases, expenses and assets are credits and decrease in sales, income, liabilities and owners' capital are debit.

ILLUSTRATION 1

Following are the transactions entered into by R after he started his business. Show how various accounts will be affected by these transactions:

2022 April		***(₹ in 000)***
1.	*R started business with*	*5,000*
2.	*He purchased furniture for*	*1,200*
3.	*Paid salary to his clerk*	*1,100*
4.	*Paid rent*	*1,150*
5.	*Received interest*	*2,000*

SOLUTION

2022 April	Explanation	Accounts Involved	Nature of Accounts	How affected	Debit (₹ in 000)	Credit (₹ in 000)
1.	₹ 5,000 cash invested in business	Bank and R's Capital	Asset Capital	Increased Increased	5,000	 5,000
2.	Purchased furniture for ₹ 1,200	Furniture and Bank	Asset Asset	Increased Decreased	1,200	 1,200
3.	Paid ₹ 1,100 to employee for salary	Salary & Bank	Expense Asset	Increased Decreased	1,100	 1,100
4.	Paid Rent ₹ 1,150	Rent & Bank	Expense Asset	Increased Decreased	1,150	 1,150
5.	Received interest ₹ 2,000	Cash & Interest	Asset Income	Increased Increased	2,000	 2,000

1.5 TRANSACTIONS

In the system of book-keeping, students can notice that transactions are recorded in the books of accounts. A transaction is a type of event, which is generally external in nature and can be determined in terms of money. In an accounting period, every business has huge number of transactions which are analysed in financial terms and then recorded individually, followed by classification and summarisation process, to know their impact on the financial statements. A transaction is a two-way process in which value is transferred from one party to another. In it either a party receives a value in terms of goods etc. and passes the value in terms of money or vice versa. Therefore, one can easily make out that in a transaction, a party receives as well as passes the value to other party. For recording transaction, it is very important that they are supported by a substantial document like purchase invoices, bills, pay-slips, cash-memos, passbook etc.

Transactions analysed in terms of money and supported by proper documents are recorded in the books of accounts under double entry system. To analyse the dual aspect of each transaction, two approaches can be followed:

(1) Accounting Equation Approach.

(2) Traditional Approach.

1.6 ACCOUNTING EQUATION APPROACH

The relationship of assets with that of liabilities and owners' equity in the equation form is known as 'Accounting Equation'. Basic accounting equation comes into picture when sum total of capital and liabilities equalises assets, where assets are what the business owns and capital and liabilities are what the business owes. Under double entry system, every business transaction has two-fold effect on the business enterprise where each transaction affects changes in assets, liabilities or capital in such a way that an accounting equation is completed and equated. This accounting equation holds good at all points of time and for any number of transactions and events except when there are errors in accounting process.

Let us suppose that an individual started business by contributing ₹ 50,00,000 and taking loan of ₹10,00,000 from a bank to be repayable, after 5 years. He purchased furniture costing ₹ 10,00,000, and merchandise worth ₹ 50,00,000. For purchasing the merchandise he paid ₹ 40,00,000 to the suppliers and agreed to pay balance after 3 months.

The contribution by the owner is termed as capital; the loans are termed as liabilities. Whenever the loan is repayable in the short-run, say within one year, it is called short-term loan or liability. On the other hand, if the loan is repayable atleast after one year, it would be termed as long term loan or liability.

Some other short-term liabilities relating to credit purchase of merchandise are popularly called as trade payables, and for other purchases and services received on credit as expense payables. The short-term liabilities are also termed as current liabilities and long term liabilities are termed as non-current liabilities.

On the other hand, money raised has been invested in two types of assets–fixed assets and current assets. Furniture is a fixed asset, if it lasts long, say more than one year, and has utility to the business, while inventory and cash balance will not remain fixed for long as soon as the business starts to roll-these are current assets.

Often the owner's claim or fund in the business is called equity. Owner's claim implies capital invested plus any profit earned minus any loss incurred.

Now we have an equation:

Equity + Liabilities = Assets or, Equity + Long-Term Liabilities = Fixed Assets + Current Assets - Current Liabilities

Check : L.H.S.	**(₹ in '000)**
Equity	₹ 5,000
Long–term Liabilities	₹ 1,000
Current Liabilities	₹ 1,000
	₹ 7,000

Check : R. H. S.	(₹ in '000)
Assets	
Fixed Assets:	
Furniture	₹ 1,000
Current Assets:	
Inventory	₹ 5,000
Cash	₹ 1,000
	₹ 7,000

Cash = Capital + Loan - Furniture - Payment to Trade payables (₹' 000)

= ₹ 5,000 + ₹ 1,000 - ₹ 1,000 - ₹ 4,000 = ₹ 1,000

Let us use E_0, L_0 and A_0 to mean Equity, Liabilities and Assets respectively at t_0. Thus the basic accounting equation becomes

$E_0 + L_0 = A_0$

or $E_0 = A_0 - L_0$ ...(Eq. 1)

(₹' 000)

Now, let us suppose that at the end of period inventory valuing ₹ 2,500 is in hand, cash ₹ 2,000; trade payables ₹ 500; bank loan ₹ 1,000 (interest was properly paid); furniture ₹ 800 {₹ 200 is taken as loss of value due to use (also known as depreciation)}. So at t_1 -

Assets:	**(₹' 000)**
Fixed assets	
Furniture	₹ 800
Current assets	
Inventory	₹ 2,500
Cash	₹ 2,000
(A_1)	₹ 5,300
Liabilities:	
Long-term Liabilities	₹ 1,000
Current Liabilities	₹ 500
(L_1)	₹ 1,500
Equity ($A_1 - L_1$)	₹ 3,800

Equity = Assets - Liabilities

i.e., $E_1 = A_1 - L_1$

or $E_1 + L_1 = A_1$ ...(Eq. 2)

Let us compare E1 with E0. Equity is reduced by ₹ 12,00,000 (50,00,000 - 38,00,000). Reduction in equity is termed as loss incurred.

Since the business has incurred loss during the period, E_1 becomes less than E0.

$E_1 < E_0$ implies loss during t01

Similarly, $E_2 < E_1$ implies loss during t_{12} and so on.

On the other hand, $E_1 > E_0$ implies profit earned by business during t_{01}, $E_2 > E_1$ implies profit earned during $t_{2\&1}$ and so on.

So if En> En-1, in general terms, equity has increased, while En< En-1 implies that equity has decreased. Increase in equity is termed as profit while decrease in equity is termed as loss.

ILLUSTRATION 2

Develop the accounting equation from following information available at the beginning of accounting period:

Particulars	***(₹ in '000)***
Capital	*51,000*
Loan	*11,500*
Trade payables	*5,700*
Fixed Assets	*12,800*
Inventory	*22,600*
Trade receivables	*17,500*
Cash and Bank	*15,300*

At the end of the accounting period the balances appear as follows:

	₹
Capital	*?*
Loan	*11,500*
Trade payables	*5,800*
Fixed Assets	*12,720*

Inventory	*22,900*
Trade receivables	*17,500*
Cash at Bank	*15,600*

(a) *Reset the equation and find out profit.*

(b) *Prepare Balance Sheet at the end of the accounting period.*

SOLUTION

(All the figures in solution are in '000)

(a) Accounting equation is given by

Equity + Liabilities = Assets

Let us use E_0, L_0 and A_0 to mean equity, liabilities and assets respectively at the beginning of the accounting period.

E_0 = ₹ 51,000

L_0 = Loan + Trade payables

= ₹ 11,500 + ₹ 5,700 = ₹ 17,200

A_0 = Fixed Assets + Inventories + Trade receivables + Cash at Bank

= ₹ 12,800 + ₹ 22,600 + ₹ 17,500 + ₹ 15,300 = ₹ 68,200

So, at the beginning of accounting period

$E_0 + L_0 = A_0$

i.e., ₹ 51,000 + ₹ 17,200 = ₹ 68,200

Let us use E_1, L_1, A_1 to mean equity, liabilities and assets respectively at the end of the accounting period.

L_1 = Loan + Trade payables

= ₹ 11,500 + ₹ 5,800 = ₹ 17,300

A_1 = Fixed Assets + Inventories + Trade receivables + Cash at Bank

= ₹ 12,720 + ₹ 22,900 + ₹ 17,500 + ₹ 15,600 = ₹ 68,720

E_1 = $A_1 - L_1$ = ₹ 68,720 - ₹ 17,300 = ₹ 51,420

Profit = $E_1 - E_0$ = ₹ 51,420 - ₹ 51,000 = ₹ 420

(b) **Balance Sheet**

Liabilities	**₹**	**₹**	**Assets**	**₹**
Capital			Fixed Assets	12,720
Balance	51,000		Inventories	22,900
Add: Profit	420	51,420	Trade receivables	17,500
Loan		11,500	Cash at Bank	15,600
Trade payables		5,800		
		68,720		68,720

ILLUSTRATION 3

Mr. Dravid. has provided following details related to his financials. Find out the missing figures:

Particulars	***(₹ in'000)***
Profits earned during the year	*5,000*
Assets at the beginning of year	*A*
Liabilities at the beginning of year	*12,000*
Assets at the end of the year	*B*
Liabilities at the end of the year	*C*
Closing capital	*35,000*
Total liabilities including capital at the end of the year	*50,000*

SOLUTION

Computing opening capital: (All figure in ₹' 000)

Closing capital - profits earned during the year (35,000 - 5,000) = 30,000

We also know:

Assets = liabilities + capital

Therefore, opening assets (A) (12,000 + 30,000) = 42,000

Computation of liabilities at the end of the year:

Total liabilities including capital - closing capital (C) (50,000 – 35,000) = 15,000

Also assets at the end of the year (B)= closing capital + liabilities at the end of the year

= 35,000 + 15,000 = 50,000

1.7 TRADITIONAL APPROACH

Under traditional approach of recording transactions one should first understand the term debit and credit and their rules. The term debit and credit have already been explained in para 1.4 of this Unit.

Transactions in the journal are recorded on the basis of the rules of debit and credit only. For the purpose of recording, these transactions are classified in three groups:

(i) Personal transactions.

(ii) Transactions related to assets and properties.

(iii) Transactions related to expenses, losses, income and gains.

1.7.1 Classification of Accounts

(i) Personal Accounts: Personal accounts relate to persons, trade receivables or trade payables. Example would be the account of Ram & Co., a credit customer or the account of Jhaveri & Co., a supplier of goods. The capital account is the account of the proprietor and, therefore, it is also personal but adjustment on account of profits and losses are made in it. This account is further classified into three categories:

(a) Natural personal accounts: It relates to transactions of human beings like Ram, Rita, etc.

(b) Artificial (legal) personal accounts: For business purpose, business entities are treated to have separate entity. They are recognised as persons in the eye of law for dealing with other persons. For example: Government, Companies (private or limited), Clubs, Co-operative societies etc.

(c) Representative personal accounts: These are not in the name of any person or organisation but are represented as personal accounts. For example: outstanding liability account or prepaid account, capital account, drawings account.

(ii) Impersonal Accounts: Accounts which are not personal such as machinery account, cash account, rent account etc. These can be further sub-divided as follows:

(a) Real Accounts: Accounts which relate to assets of the firm but not debt. For example, accounts regarding land, building, investment, fixed deposits etc., are real accounts. Cash in hand and Cash at the bank accounts are also real.

(b) Nominal Accounts: Accounts which relate to expenses, losses, gains, revenue, etc. like salary account, interest paid account, commission received account. The net result of all the nominal accounts is reflected as profit or loss which is transferred to the capital account. Nominal accounts are, therefore, temporary.

1.7.2 Golden Rules of Accounting

All the above classified accounts have two rules each, one related to Debit and one related to Credit for recording the transactions which are termed as golden rules of accounting, as transactions are recorded on the basis of double entry system.

Types of Account	Account to be Debited	Account to be Credited
Personal Account	Receiver	Giver
Real Account	What comes in	What goes out
Nominal Account	Expense and losses	Income and gains

Example:-

From the following information, state the nature of account and state which account will be debited and which will be credited.

1. Started business with a capital of ₹ 50,00,000.
2. Wages and salaries paid ₹ 50,000
3. Rent received ₹ 2,00,000
4. Purchased goods on credit ₹ 9,00,000
5. Sold goods for ₹ 8,16,000 and received payment in cheque.

SOLUTION

Transaction	ACCOUNTS INVOLVED	NATURE	DEBIT OR CREDIT	Journal Entry
Started business with capital of ₹ 50,00,000	Bank account Capital account	Personal Personal	Debit (Receiver) Credit (giver)	Bank A/c Dr. To Capital A/c
Wages and salaries paid	Wages/salaries Bank	Nominal Personal	Debit (expense) Credit (giver)	Wages/ Salaries Dr. To Bank A/c
Rent received	Bank Rent	Personal Nominal	Debit (Receiver) Credit (income)	Bank A/c Dr. To Rent A/c
Purchases made on credit	Purchases Creditor	Nominal Personal	Debit (expense) Credit (giver)	Purchases A/c Dr. To Creditor A/c
Goods sold and payment received in cheque	Bank Sales	Personal Nominal	Debit (Receiver) Credit (gains)	Bank A/c Dr. To Sales A/c

1.8 MODERN CLASSIFICATION OF ACCOUNTS

Real, nominal and personal accounts is the traditional classification of accounts. Now, let us see the modern and more acceptable classification of accounts:-

Types of account	Normal balance of account	Account to be debited when there is:	Account to be credited when there is:
Asset account	Debit	Increase	Decrease
Liabilities account	Credit	Decrease	Increase
Capital account	Credit	Decrease	Increase
Revenue account	Credit	Decrease	Increase
Expenditure account	Debit	Increase	Decrease
Withdraw account	Debit	Increase	Decrease

Let us solve the same example with the modern approach now:-

Accounts involved	Nature	Debit/Credit	Reason
Cash	Asset	Debit	Increase
Capital	Liability	Credit	Increase
Wages/salaries paid	Expense	Debit	Increase
Cash	Asset	Credit	Decrease
Rent received	Revenue	Credit	Increase
Purchase	Expense	Debit	Increase
Creditor	Liability	Credit	Increase
Cash	Asset	Debit	Increase
Sales	Revenue	Credit	Increase

1.9 JOURNAL

Transactions are first entered in this book to show which accounts should be debited and which credited. Journal is also called subsidiary book. Recording of transactions in journal is termed as journalizing the entries. It is the book of original entry in which transactions are entered on a daily basis in a chronological order.

1.9.1 Journalising Process

All transactions may be first recorded in the journal as and when they occur; the record is chronological; otherwise it would be difficult to maintain the records in an orderly manner. Debits and credits are listed along with the appropriate explanations. There are basically two types of journals:-

1. General journal
2. Specialized journal

The latter is used when there are many repetitive transactions of the same nature. The form of the journal is given below:

JOURNAL

Date	**Particulars**	**Ledger Folio (L.F.)**	**Amount** Dr.	**Amount** Cr.
			₹	₹
(1)	(2)	(3)	(4)	(5)

The columns have been numbered only to make clear the following but otherwise they are not numbered. The following points should be noted:

(1) In the first column the date of the transaction is entered-the year is written at the top, then the month and in the narrow part of the column the particular date is entered.

(2) In the second column, the names of the accounts involved are written; first the account to be debited, with the word "Dr" written towards the end of the column. In the next line, after leaving a little space, the name of the account to be credited is written preceded by the word "To" (the modern practice shows inclination towards omitting "Dr." and "To"). Then in the next line the explanation for the entry together with necessary details is given-this is called narration.

(3) In the third column the number of the page in the ledger on which the account is written up is entered.

(4) In the fourth column the amounts to be debited to the various accounts concerned are entered.

(5) In the fifth column, the amount to be credited to various accounts is entered.

1.9.2 Points to be taken into account while recording a transaction in the Journal

1. Journal entries can be single entry (i.e. one debit and one credit) or compound entry (i.e. one debit and two or more credits or two or more debits and one credit or two or more debits and credits). In such cases, it is important to check that the total of both debits and credits are equal.

2. If journal entries are recorded in several pages then both the amount column of each page should be totalled and the balance should be written at the end of that page and also that the same total should be carried forward at the beginning of the next page.

An entry in the journal may appear as follows:

			₹	₹
May 5	Bank Account	Dr.	14,50,000	
	To Mohan			14,50,000
	(Being the amount received from Mohan in payment of the amount due from him)			

We will now consider some individual transactions.

(i) Mohan commences business with ₹ 50,00,000 in his bank account. This means that the firm has ₹ 50,00,000 in bank. According to the rules given above, the increase in an asset has to be debited. The firm also now owes ₹ 50,00,000 to the proprietor, Mohan as capital. The rule given above also shows that the increase in capital should be credited. Therefore, the journal entry will be:

Bank Account	Dr.	₹ 50,00,000	
To Capital Account			₹ 50,00,000
(Being capital introduced by Mohan)			

(ii) Out of the above, ₹ 25,000 is withdrawn from the bank. By this transaction the bank balance is reduced by ₹ 25,000 and another asset, cash account, comes into existence. Since increase in assets is debited and decrease is credited, the journal entry will be:

Cash Account	Dr.	₹ 25,000	
To Bank Account			₹ 25,000
(Being cash withdrawn in Bank)			

(iii) Furniture is purchased for ₹ 12,00,000. Applying the same reasoning as above the entry will be:

Furniture Account	Dr.	₹ 12,00,000	
To Bank Account			₹ 12,00,000
(Being Furniture purchased vide voucher No....)			

(iv) Purchased goods for ₹ 4,00,000. The student can see that the required entry is:

Purchases Account	Dr.	₹ 4,00,000	
To Bank Account			₹ 4,00,000
(Being goods purchased vide voucher No....)			

(v) Purchased goods for ₹ 10,00,000 on credit from M/s Ram Narain Bros. Purchase of merchandise is an expense item so it is to be debited. ₹ 10,00,000 is now owing to the supplier; his account should therefore be credited, since the amount of liabilities has increased. The entry will be:

Purchases Account	Dr.	₹ 10,00,000	
To M/s Ram Narain Bros.			₹ 10,00,000
(Being goods purchased on credit vide Bill No.....)			

(vi) Sold goods to M/s Ram & Co. for ₹ 6,00,000. Amount is received in cheque. The amount of bank increases and therefore, the bank amount should be debited; sale of merchandise is revenue item so it is to be credited. The entry will be:

Bank Account	Dr.	₹ 6,00,000	
To Sales Account			₹ 6,00,000
(Being goods sold vide sales invoice No....)			

(vii) Sold goods to Ramesh on credit for ₹ 13,00,000. The Inventories of goods has decreased and therefore, the goods account has to be credited. Ramesh now owes ₹ 13,00,000; that is an asset and therefore, Ramesh should be debited. The entry is:

Ramesh	Dr.	₹ 13,00,000	
To Sales Account			₹ 13,00,000
(Being goods sold vide Bill No....)			

(viii) Received cheque from Ramesh ₹ 13,00,000. The amount of bank increased therefore the bank account has to be debited. Ramesh's liability towards firm has decreased in fact in this case he no longer owes any amount to the firm now, i.e., this particular form of assets has disappeared; therefore, the account of Ramesh should be credited. The entry is:

Bank Account	Dr.	₹ 13,00,000	
To Ramesh			₹ 13,00,000
(Being amount received vide cheque No.......against sales invoice No....)			

(x) Paid rent ₹ 1,00,000. The bank balance has decreased and therefore, the bank account should be credited. No asset has come into existence because the payment is for services enjoyed and is an expense. Expenses are debited. Therefore, the entry should be:

Rent Account	Dr.	₹ 1,00,000	
To Bank Account			₹ 1,00,000
(Being rent paid for the month of ....)			

(xi) Paid ₹ 22,000 to the clerk as salary. Applying the reasons given in (x) above, the required entry is:

Salary Account	Dr.	₹ 22,000	
To Bank Account			₹ 22,000
(Being salary paid to Mr..... for the month of ....)			

(xii) Received ₹ 2,20,000 interest. The bank account should be debited since there is an increase in the bank balance. There is no increase in any liability; since the amount is not returnable to any one, the amount is an income, incomes are credited. The entry is:

Bank Account	Dr.	₹ 2,20,000	
To Interest Account			₹ 2,20,000
(Being interest received from.........for the period ....)			

When transactions of similar nature take place on the same date, they may be combined while they are journalised. For example, entries (x) and (xi) may be combined as follows:

Rent Account	Dr.	₹ 1,00,000	
Salary Account	Dr.	₹ 22,000	
To Bank Account (Being expenses done as per detail attached)			₹ 1,22,000

When journal entry for two or more transactions are combined, it is called composite journal entry. Usually, the transactions in a firm are so numerous that to record the transactions for a month will require many pages in the journal. At the bottom of one page the totals of the two columns are written together with the words "Carried forward" in the particulars column. The next page is started with the respective totals in the two columns with the words "Brought forward" in the particulars column.

ILLUSTRATION 4

Analyse transactions of M/s Sahil & Co. for the month of March, 2022 on the basis of double entry system by adopting the following approaches:

(A) Accounting Equation Approach.

(B) Traditional Approach.

Transactions for the month of March, 2022 were as follows (figures are in '000):

1. *Sahil introduced capital through bank of ₹ 4,000.*
2. *Cash withdrawn from the City Bank ₹ 200.*
3. *Loan of ₹ 500 taken from Mr. Y.*
4. *Salaries paid for the month of March, 2022, ₹ 300 and ₹ 100 is still payable for the month of March, 2022.*
5. *Furniture purchased ₹ 500.*

Required

What conclusions one can draw from the above analysis?

SOLUTION

(A) Analysis of Business Transaction: Accounting Equation Approach

The accounting equation is

Assets = Liabilities + Capital

(₹ in '000)

ASSETS						=	CAPITAL	+	LIABILITIES
	CASH	+	BANK	+	FURNITURE	=	CAPITAL	+	LIABILITIES
(a)	-	+	4,000	+	-	=	4,000	+	-
(b)	+200	+	-200	+	-	=	-	+	-
(c)	-	+	500	+	-	=	-	+	500
(d)	-	+	-300	+	-	=	-400	+	100
(e)	-	+	-500	+	500	=	-	+	-
Balance	**200**	**+**	**3,500**	**+**	**500**	**=**	**3,600**	**+**	**600**
			4,200				**4,200**		

(B) Analysis of Business Transactions: Traditional Approach

Transaction	**Analysis**	**Account Affected and Nature of Account**	**Rule**	**Entry**
Introduction of ₹ 4,000 through bank by the proprietor	Bank has received the money; Owner has given Bank balance	Bank–Personal Capital–Personal	Debit the receiver Credit the giver	Debit Bank Credit Capital
Cash Withdrawn from Bank ₹ 200	Cash comes into business; Bank gives out cash	Cash–Real Bank–Personal	Debit what comes in Credit the giver	Debit Cash Credit Bank
Loan from Y ₹ 500	Bank receives the amount : Y pays through bank	Bank–Personal Y's Loan–Personal	Debit the receiver Credit the giver	Debit Bank Credit Y's Loan
Salary paid ₹ 300 and still payable ₹ 100	Cost of services used ₹ 400; Bank gives out ₹300; Still payable or outstanding for services received ₹ 100	Salary Nominal Bank–Personal Salary Outstanding-Personal	Debit all expenses Credit the giver Credit the giver	Debit Salary (₹ 400) Credit Bank (₹ 300) Credit Salary outstanding (₹ 100)

Furniture purchased ₹ 500	Furniture is purchased; Bank gives out money	Furniture Real Bank–Personal	Debit what comes in Credit the giver	Debit Furniture Credit Bank

Conclusion:

It is evident from above analysis that procedure for analysis of transactions, classification of accounts and rules for recording business transactions under accounting equation approach and traditional approach are different. But the accounts affected and entries entered/passed remains the same under both approaches. Thus, the recording of transactions in affected accounts on the basis of double entry system is independent of the method of analysis followed by a business enterprise. In other words, accounts to be debited and credited to record the dual aspect remains the same under both the approaches.

ILLUSTRATION 5

Journalise the following transactions. Also state the nature of each account involved in the Journal entry.

Following figures are given in ('00)

1. *December 1, 2022, Ajit started business with capital ₹ 4,00,000*
2. *December 3, he withdrew cash for business from the Bank ₹ 2,000.*
3. *December 5, he purchased goods by making payment through bank ₹ 15,000.*
4. *December 8, he sold goods for ₹ 16,000 and received payment through bank.*
5. *December 10, he purchased furniture and paid by cheque ₹ 2,500.*
6. *December 12, he sold goods to Arvind ₹ 2,400.*
7. *December 14, he purchased goods from Amrit ₹ 10,000.*
8. *December 15, he returned goods to Amrit ₹ 500.*
9. *December 16, he received from Arvind ₹ 2,300 in full settlement.*
10. *December 18, he withdrew goods for personal use ₹ 1,000.*
11. *December 20, he withdrew cash from business for personal use ₹ 2,000.*
12. *December 24, he paid telephone charges ₹ 110.*
13. *December 26, amount paid to Amrit in full settlement ₹ 9,450.*
14. *December 31, paid for stationery ₹ 200, rent ₹5,000 and salaries to staff ₹ 2,000 from bank.*

15. *December 31, goods distributed by way of free samples ₹ 2,000.*

SOLUTION

JOURNAL **(₹ in '00)**

Sl. No	Date	Particulars		Nature of Account	L.F.	Dr. Debit (₹)	Cr. Credit (₹)
1.	Dec. 1	Bank Account	Dr.	Personal A/c		4,00,000	
		To Capital Account		Personal A/c			4,00,000
		(Being commencement of business with capital)					
2.	Dec. 3	Cash Account	Dr.	Real A/c		2,000	
		To Bank Account		Personal A/c			2,000
		(Being cash withdrawn from the Bank)					
3.	Dec. 5	Purchases Account	Dr.	Nominal A/c		15,000	
		To Bank Account		Personal A/c			15,000
		(Being purchase of goods for cash)					
4.	Dec. 8	Bank Account	Dr.	Personal A/c		16,000	
		To Sales Account		Nominal A/c			16,000
		(Being goods sold for cash)					
5.	Dec. 10	Furniture Account	Dr.	Real A/c		2,500	
		To Bank Account		Personal A/c			2,500
		(Being purchase of furniture, paid by cheque)					
6.	Dec. 12	Arvind	Dr.	Personal A/c		2,400	
		To Sales Account		Nominal A/c			2,400
		(Being sale of goods on credit)					

7.	Dec. 14	Purchases Account	Dr.	Nominal A/c		10,000	
		To Amrit		Personal A/c			10,000
		(Being purchase of goods from Amrit)					
8.	Dec. 15	Amrit	Dr.	Personal A/c		500	
		To Purchases Returns Account		Nominal A/c			500
		(Being goods returned to Amrit)					
9.	Dec. 16	Bank Account	Dr.	Personal A/c		2,300	
		Discount Account	Dr.	Nominal A/c		100	
		To Arvind		Personal A/c			2,400
		(Being amount received from Arvind in full settlement and allowed him ₹ 100 as discount)					
10.	Dec. 18	Drawings Account	Dr.	Personal A/c		1,000	
		To Purchases Account		Nominal A/c			1,000
		(Being withdrawal of goods for personal use)					
11.	Dec. 20	Drawings Account	Dr.	Personal A/c		2,000	
		To Cash Account		Real A/c			2,000
		(Being cash withdrawal from the business for personal use)					
12.	Dec. 24	Telephone Expenses Account	Dr.	Nominal A/c		110	
		To Bank Account		Personal A/c			110
		(Being telephone expenses paid)					

13.	Dec 26	Amrit	Dr.	Personal A/c		9,500	
		To Bank Account		Personal A/c			9,450
		To Discount Account		Nominal A/c			50
		(Being cash paid to Amrit and he allowed ₹ 50 as discount)					
14.	Dec. 31	Stationery Expenses	Dr.	Nominal A/c		200	
		Rent Account	Dr.	Nominal A/c		5,000	
		Salaries Account	Dr.	Nominal A/c		2,000	
		To Bank Account		Personal A/c			7,200
		(Being expenses paid)					
15.	Dec. 31	Advertisement Expenses Account	Dr.	Nominal A/c		2,000	
		To Purchases Account		Real A/c			2,000
		(Being distribution of goods by way of free samples)					

ILLUSTRATION 6

Show the classification of the following Accounts under traditional and accounting equation approach:

(a) Building; (b) Purchases; (c) Sales; (d) Bank Fixed Deposit; (e) Rent; (f) Rent Outstanding; (g) Cash; (h) Adjusted Purchases; (i) Closing Inventory; (j) Investments; (k) Trade receivables; (l) Sales Tax Payable, (m) Discount Allowed; (n) Bad Debts; (o) Capital; (p) Drawings; (q) Interest Receivable account; (r) Rent received in advance account; (s) Prepaid salary account; (t) Bad debts recovered account; (u) Depreciation account, (v) Personal income-tax account.

SOLUTION

Nature of Account

Sl. No.	Title of Account	Traditional Approach	Accounting Equation Approach
(a)	Building	Real	Asset
(b)	Purchases	Nominal	Expense
(c)	Sales	Nominal	Revenue

(d)	Bank Fixed Deposit	Personal	Asset
(e)	Rent	Nominal	Expense
(f)	Rent Outstanding	Personal	Liability
(g)	Cash	Real	Asset
(h)	Adjusted Purchases	Nominal	Expense
(i)	Closing Inventory	Real	Asset
(j)	Investment	Real	Asset
(k)	Trade receivables	Personal	Asset
(l)	Sales Tax Payable	Personal	Liability
(m)	Discount Allowed	Nominal	Expense
(n)	Bad Debts	Nominal	Expense
(o)	Capital	Personal	Capital
(p)	Drawings	Personal	Capital - Drawings
(q)	Interest receivable	Personal	Asset
(r)	Rent received in advance	Personal	Liability
(s)	Prepaid salary	Personal	Asset
(t)	Bad debts recovered	Nominal	Gain
(u)	Depreciation	Nominal	Expense
(v)	Personal Income Tax	Personal (Drawing)	Capital - Drawings

ILLUSTRATION 7

Transactions of Ramesh for April are given below. Journalise them.

2022			₹
April	*1*	*Ramesh started business with*	*10,00,000*
"	*3*	*Bought goods for cash*	*50,000*
"	*5*	*Drew cash from bank*	*10,000*
"	*13*	*Sold to Krishna- goods on credit*	*1,50,000*
"	*20*	*Bought from Shyam goods on credit*	*2,25,000*
"	*24*	*Received from Krishna*	*1,45,000*
"		*Allowed him discount*	*5,000*

"	*28*	*Paid Shyam cash*	*2,15,000*
"		*Discount allowed*	*10,000*
"	*30*	*Cash sales for the month*	*8,00,000*
		Paid Rent	*50,000*
		Paid Salary	*1,00,000*

SOLUTION

JOURNAL

Date 2022	Particulars		L.F.*	Amount (Dr.)	Amount (Cr.)
April 1	Bank Account	Dr.	1	10,00,000	
	To Capital Account		4		10,00,000
	(Being the amount invested by Ramesh in the business as capital)				
" 3	Purchases Account	Dr.	7	50,000	
	To Bank Account		1		50,000
	(Being goods purchased for cash)				
" 5	Cash Account	Dr.	5	10,000	
	To Bank Account		1		10,000
	(Being cash withdrawn from bank)				
" 13	Krishna	Dr.	9	1,50,000	
	To Sales Account		11		1,50,000
	(Being goods sold to Krishna on credit)				
" 20	Purchases Account	Dr.	7	2,25,000	
	To Shyam		10		2,25,000
	(Being goods bought from Shyam on credit)				
" 24	Bank Account	Dr.	1	1,45,000	
	Discount Account	Dr.	12	5,000	
	To Krishna		9		1,50,000
	(Being cash received from Krishna and discount allowed to him)				

" 28	Shyam	Dr.	10	2,25,000	
	To Bank Account		1		2,15,000
	To Discount Account		12		10,000
	(Being cash paid to Shyam and discount allowed by him)				
" 30	Bank Account	Dr.	1	8,00,000	
	To Sales Account		11		8,00,000
	(Being sales for the month of April 2022)				
" 30	Rent Account	Dr.	15	50,000	
	Salaries Account	Dr.	14	1,00,000	
	To Bank Account		1		1,50,000
	(Being the amount paid for rent and salary)				
	Total			27,60,000	27,60,000

***Ledger Folio imaginary**

1.10 ADVANTAGES OF JOURNAL

In journal, transactions recorded on the basis of double entry system, fetch the following advantages:

1. As transactions are recorded in chronological order, one can get complete information about the business transactions on timely basis.
2. Entries recorded in the journal are supported by a note termed as narration, which is a precise explanation of the transaction for the proper understanding of the entry. One can know about the transactions through these narrations.
3. Journal forms the basis for posting the entries in the ledger and reduces the chances of error.

1.11 ACCOUNTING FOR GST

1.11.1 Introduction to GST

Goods and Services Tax (GST) is a comprehensive Indirect Tax* which has subsumed multiple Indirect Taxes in India such as State Value added Tax (VAT) which was levied on sale of goods, Excise Duty, which was levied on manufacture or production of goods, Service Tax which was levied on provision of services etc. GST is a single tax on the supply of goods and services, right from the manufacturer to consumer.

* An indirect tax is a tax whose incidence is borne by the consumers who ultimately consume the product or service. The immediate liability to pay the tax may fall upon another person such as a manufacturer or provider of service or seller of goods, but the same is collected from the person purchasing the goods (recipient of goods or services).

Pre-GST scenario:

Prior to introduction of GST, the following duties were levied:

(a) On manufacture of goods: Excise Duty (levied by Central Government)

(b) On sale of goods within the State: State Value Added Tax (VAT)

(c) On sale of goods outside the State: Central Sales Tax (levied by Central Government)

(d) On provision of services provided: Service Tax (levied by Central Government)

Since the taxes were levied by different authorities (central and state authorities), it was not possible to take the benefit of credit of taxes paid at different stages. For instance, when a trader received goods (say costing ₹ 1,00,000) from the manufacturer, excise duty (say @ 18% = ₹ 18,000) was levied on the goods sold by the manufacturer. When such trader would sell the goods to the customer, he would charge VAT (assume 18%). However, the trader could not avail the benefit of the credit of the excise duty of ₹ 18,000 paid in respect of the goods purchased from the manufacturer. Accordingly, the 'cost' of the goods to the trader would be ₹ 1,00,000 + ₹ 18,000 = ₹ 1,18,000, on which the trader would add his profit margin and levy VAT while selling to the consumer. This created a scenario wherein a tax (in our example, VAT) was levied on the tax (in our example, excise duty) also, in addition to the tax levied on the goods. This cascading effect (tax-on-tax) increased the price of the product, and resulted in an unjust enrichment at the cost of the ultimate consumer.

Post-GST scenario:

On introduction of GST, the tax to be levied at all stages right from manufacture up to final consumption was a single tax- GST, with credit of taxes paid at previous stages available as setoff. Thus, in the example above, the GST (erstwhile excise duty) of ₹ 18,000 paid by the trader could be availed as a credit (an asset), for set off against the tax charged by the trader (a liability for the trader, which would be received from the consumer). Hence, the cost of the goods to the trader would be ₹ 1,00,000 only, as ₹ 18,000 can be set off against the GST charged by the trader to the consumer. The tax levied by the manufacturer to the trader becomes 'input tax' for the trader, since the goods are purchased by him (it is his input). The tax levied by the manufacturer to the trader, or the trader to the consumer is known as 'output tax' (since it is output for both the manufacturer and trader) both for the manufacturer and trader. The 'input tax' cannot be added to the cost of the goods or services procured, as it will be adjusted against the 'output tax' liability. In a nutshell, since the input tax is availed as a credit, only the value addition (i.e., the profit margin levied by the trader to the consumer in our example) will be taxed, with the burden of tax being borne by the final consumer.

1.11.2 Salient features of GST

- GST is levied on supply i.e., manufacture or sale of goods and provision of services. In other words, supply is taxable event which own its occurrence creates or attracts the liability to pay tax.
- Under GST, tax in levied only the value added at each stage of the supply chain.
- GST is a destination-based consumption tax, i.e. the tax is levied at the place where the goods or services are consumed, rather than the place where they are produced.
- There is no **tax on tax** or cascading of taxes under GST system.
- Under GST, there is a harmonization of laws, procedures and rates of tax across the country.

1.11.3 Types of Taxes under GST

Before going through the types of taxes under GST, it is important to understand the concept of intra-State supply and inter-State supply under GST which determines the type of tax to be charged by the supplier.

The Concept of intra-state supply and inter-state supply depends upon on the location of the supplier and place of supply (place of supply is the place where goods/services are consumed.

As a general rule, where the location of the supplier and the place of supply of goods or services are in the same State/Union territory, it is treated as **intra-State supply** of goods or services respectively.

Similarly, where the location of the supplier and the place of supply of goods or services are in (i) two different States or (ii) two different Union Territories or (iii) a State and a Union territory, it is treated as **inter-State supply** of goods or services respectively.

GST has a dual aspect with the Centre and States simultaneously levying on a common tax base. There are three main components of GST which are:

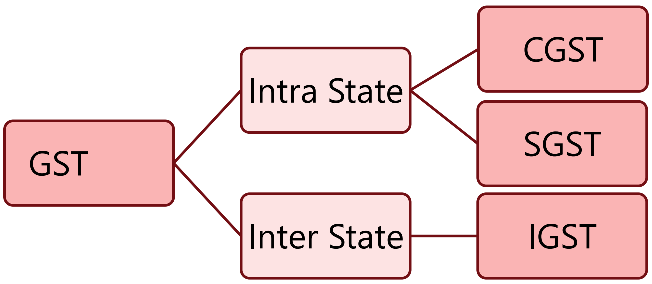
(i) **Central Goods and Service Tax (CGST)** is levied and collected by the Centre on the **"Intra -State"** supply of goods and services.

(ii) **State Goods and Services Tax (SGST)** is levied and collected by the State Governments (including Union Territories with legislature, for example Delhi, Pondicherry, Jammu and Kashmir) on "**Intra state"** supply of goods and services

(iii) **Union Territory Goods and Service Tax (UTGST)** is levied and collected by Union Territories without Legislatures [i.e. Andaman and Nicobar Islands, Lakshadweep, Ladakh, Dadra and Nagar Haveli & Daman and Diu and Chandigarh] on "intra-state" supply of goods and services.

(iv) **Integrated Goods and services tax (IGST):** It is the GST levied on the "**inter state**" supply of goods and services and is collected by the Centre. IGST is equivalent to the sum total of CGST and SGST.

GST is a "Consumption Based Tax" i.e. the tax is received by the State in which the goods or services are consumed and not by the state in which the goods and services are manufactured.



1.11.4 Input and Output GST

The tax paid by the recipient on procurement of goods /services is called **Input tax**. An entity at each stage is permitted to avail credit of GST paid on the purchase of goods and /or availment of services and can set off this credit against the GST payable on the goods and/or services supplied by him. Thus, the final consumer bears the GST charged in the supply chain, with set-off benefits at all the previous stages. Hence, the tax will be levied only on the value added, which results in avoiding double taxation. For example, if tax payable by a manufacturer on the output, i.e. final product is ₹750 and he has already paid tax on ₹500 on input, i.e. purchases, then he can claim 'Input Credit' of ₹500 and he needs to deposit only ₹250 in cash.

Output tax means the GST charged on supply of goods or services made by a supplier.

Input tax means the credit of Input tax already paid.

Utilisation of Input Tax Credit under GST

Tax credit of CGST, SGST and IGST can be utilized in the following manner:

- Utilization of IGST Credit: IGST credit has to be first utilized against IGST liability and if any balance is still available, the same can be utilized against CGST or/and SGST in any order and in any proportion.
- Utilization of CGST Credit: CGST credit has to be first utilized against CGST liability and if any balance is available, same can be utilized against IGST. However, CGST credit cannot be utilized against SGST.
- Utilization of SGST Credit: SGST credit has to be first utilized against SGST liability and if any balance is available, same can be utilized against IGST. However, SGST credit cannot be utilized against CGST.

	Input GST (credit can be availed, hence asset)	**Output GST (charged to the consumer, payable by the supplier, hence liability)**
Nature	At the time of purchases of goods (including fixed assets) or services, input GST A/c (CGST and SGST or IGST) is debited.	At the time of sale of goods/assets or supply of services, Output GST A/c (CGST and SGST or IGST) is credited.
Intra-state transaction	CGST paid is debited to "Input CGST Account" and SGST paid is debited to Input SGST".	CGST charged is credited to "Output CGST Account" and SGST charged is credited to "Output SGST Account "
Inter-state transaction	IGST paid is debited to "Input IGST Account".	IGST charged is credited to "Output IGST Account"
Reversal of GST	Input GST paid at the time of purchase are reversed in the following situations: (i) Purchases Return (ii) Drawings (iii) Goods distributed as free samples (iv) Goods distributed as gift (if the same does not qualify as "supply under GST").	Output GST charged is reversed when the goods are returned by the purchaser.

	(v) Goods lost in fire or theft. (vi) Input tax credit of supplies which are not allowed to be availed by recipient.	
Utilization of Input tax credit	Input GST A/c is credited when tax is paid by utilizing input tax.	

Double entry book-keeping with GST

The Double entry book-keeping records need to show the GST values separately so that the purchases, expenses and sales are posted net i.e. without the addition of GST.

Journal entry in case of Sales of Goods or services

Account Receivable/Debtors A/c	Dr.	Gross Amount (including GST)	
To Sales A/c			Net Amount (excluding GST)
To Output GST			Amount of GST

Journal entry in case of Purchase of Goods or services

Purchases A/c	Dr.	Net Amount (excluding GST)	
Input GST A/c	Dr.	Amount of GST	
To Account Payable/Creditors			Gross Amount (including GST)

Journal entry in case of Utilization of Input Tax Credit towards payment of Output Tax

Output CGST A/c	Dr.	Amount of GST liability	
Output SGST A/c	Dr.	Amount of GST liability	
Output IGST A/c	Dr.	Amount of GST liability	
To Input CGST A/c			Amount of output GST liability paid utilizing Input CGST
To Input SGST A/c			Amount of output GST liability paid utilizing Input SGST
To Input IGST A/c			Amount of output GST liability paid utilizing Input IGST

ILLUSTRATION 8

Journalise the following transactions in the books of Mr. Rohit:

(i) Purchased goods from Sahil for ₹ 50,000 plus CGST and SGST @ 9% each.

(ii) Purchased goods from Sam for ₹ 40,000 at a trade discount of 10% plus CGST and SGST @ 9% each. ₹ 20,000 was paid immediately and balance payable after 3 months.

(iii) Goods costing ₹ 20,000 withdrawn for personal use. Such goods were purchased by paying CGST and SGST @ 9% each.

(iv) Paid rent to Gagandeep for ₹ 20,000 plus CGST and SGST @ 6% each.

(v) Goods costing ₹ 5,000 (before trade discount of 10%) returned to Sam. Such goods were purchased by paying CGST and SGST @ 9% each.

(vi) Purchased furniture for ₹ 44,800 including IGST @ 12%.

(vii) Purchased machinery from M/s Symphony industries for ₹ 1,40,000 plus CGST and SGST @ 9% each. Paid ₹ 1,00,000 immediately and balance to be paid after two months.

SOLUTION

In the books of Mr. Rohit

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
(i)	Purchases A/c	Dr.		50,000	
	Input CGST A/c (50,000 x 9%)	Dr.		4,500	
	Input SGST A/c (50,000 x 9%)	Dr.		4,500	
	To Sahil's A/c				59,000
	(Being goods purchased from Sahil, CGST and SGST paid @ 9% each)				
(ii)	Purchases A/c (40,000 x 90%)	Dr.		36,000	
	Input CGST A/c (36,000 x 9%)	Dr.		3,240	
	Input SGST A/c (36,000 x 9%)	Dr.		3,240	
	To Sam's A/c				22,480
	To Bank A/c				20,000
	(Being goods purchased from Sam, CGST and SGST payable @ 9% each)				
(iii)	Drawings A/c*	Dr.		23,600	
	To Purchase A/c				20,000

	To Input CGST A/c (20,000 x 9%)			1,800
	To Input SGST A/c (20,000 x 9%)			1,800
	(Being goods withdrawn for personal use and input GST and input SGST debited at the time of purchase reversed)			
(iv)	Rent A/c Dr.		30,000	
	Input CGST A/c (30,000 x 6%) Dr.		1,800	
	Input SGST A/c (30,000 x 6%) Dr.		1,800	
	To Gagandeep A/c			33,600
	(Being rent paid to Gagandeep)			
(v)	Sam's A/c Dr.		5,310	
	To Purchases Return A/c **			4,500
	(5,000 – 10% trade Discount)			
	To Input CGST A/c (4,500 x 9%)			405
	To Input SGST A/c (4,500 x 9%)			405
	(Being goods returned to Sam and input IGST debited at the time of purchases reversed)			
(vi)	Furniture A/c (WN 1) Dr.		40,000	
	Input IGST A/c Dr.		4,800	
	To Bank A/c			44,800
	(Being furniture purchased paid IGST @ 12%)			
(vii)	Machinery A/c Dr.		1,40,000	
	Input CGST A/c (1,40,000 x 9%) Dr.		12,600	
	Input SGST A/c (1,40,000 x 9%) Dr.		12,600	
	To Bank A/c			1,00,000
	To Symphony Industries			65,200
	(Being machinery purchased and paid ₹ 1,00,000 immediately, CGST and SGST @ 9% each)			

* The input tax availed earlier is reversed, because these goods are 'consumed' by Mr. Rohit himself. Since he cannot 'sell' goods to himself and charged output tax, the input tax thereon is reversed, since in this case Mr. Rohit himself is the ultimate consumer of those goods.

** Since goods are returned to the supplier, the input tax credit availed earlier on those goods is to be reversed, since these goods are no longer available to be sold.

Working Note.

1. Furniture purchased is including IGST @ 12%. So, value of furniture excluding IGST = ₹ 44,800 × 100/112 = ₹ 40,000. IGST = ₹ 40,000 × 12% = ₹ 4,800.

ILLUSTRATION 9

Journalise the following transactions in the books of Ms. Nidhi traders

July, 2022

3 Sold Goods for ₹ 50,000, charged CGST and SGST @ 6% each.

4 Sold goods to Surjeet for ₹ 28,000 including CGST and SGST @ 6% each.

5 Received ₹ 25,200 from Surjeet in full settlement of his account of ₹ 28,000.

6 Sold goods to Kapil for ₹ 30,000 charged IGST @ 12%. Received ₹ 12,000 immediately and balance to be received after one month.

10 Kapil was allowed rebate of ₹ 5,000 as goods supplied to him were defective. These goods were sold by charging IGST @ 12%.

12 Sold goods to Manpreet for ₹ 1,00,000 at trade discount of 20% and charged IGST @ 12%

13 Goods of list price ₹ 20,000 returned by Manpreet.

17 Received commission of ₹ 15,000, charged CGST and SGST @ 6% each.

SOLUTION

In the Books of Ms. Nidhi
Journal

Date July, 2022	Particulars	L.F.	Dr. (₹)	Cr. (₹)
3	Bank A/c Dr.		56,000	
	To Sales A/c			50,000
	To Output CGST A/c			3,000
	To Output SGST A/c			3,000
	(Being goods sold for cash, charged CGST and SGST @ 6% each)			
4	Surjeet's A/c Dr.		28,000	
	To Sales A/c			25,000

	To Output CGST A/c To Output SGST A/c (Being goods sold to Surjeet, charged CGST and SGST @ 6% each)(refer W.N.)			1,500 1,500
5	Bank A/c Dr. Discount Allowed A/c Dr. To Surjeet A/c (Being amount received from Surjeet in full settlement of ₹ 14,000 after allowing him discount of ₹ 1,400)		25,200 2,800	 28,000
6	Bank A/c Dr. Kapil's A/c Dr. To Sales A/c To Output IGST A/c (Being goods sold to Kapil, charged IGST @ 12% and received ₹ 12,000 in cash and balance receivable after one month)		12,000 21,600	 30,000 3,600
10	Rebate A/c * Dr. Output IGST A/c Dr. To Kapil's A/c (Being rebate allowed on goods sold to Kapil, Output IGST charged at the time of sales, now reversed)		5,000 600	 5,600
12	Manpreet's A/c Dr. To Sales A/c (1,00,000 x 80%) To Output IGST A/c (80,000 x 12%) (Being goods sold to Manpreet at trade discount of 20% and charged IGST @ 12%)		89,600	 80,000 9,600
13	Sales Return A/c Dr. Output IGST A/c Dr. To Manpreet A/c (Being goods returned by Manpreet and Output IGST charged at the time of sales now reversed)		16,000 1,920	 17,920

17	Cash A/c Dr.		16,800	
	To Commission A/c			15,000
	To Output CGST A/c (15,000 x 6%)			900
	To Output SGST A/c (15,000 x 6%)			900
	(Being commission received charged CGST and SGST @ 6% each)			

*Since rebate is on account of defective goods which cannot be sold/utilized further by Kapil, the output GST charged thereon is also reversed. This treatment is like that of Sales Return. If rebate was on account of other reasons (such as prompt payment), Output IGST would not be reversed.

Working Note:

Goods sold to Surjeet is including CGST and SGST @ 6% each. So, sales excluding CGST and SGST = ₹ 28,000 × 100/112 = ₹ 25,000. CGST and SGST = ₹ 25,000 × 6% = ₹ 1,500 each.

ILLUSTRATION 10

Record the following transactions in a Journal, assuming CGST and SGST@ 6% each.

(i) *Sold goods to Mukesh at the list price of ₹ 50,000 less 20% trade discount.*

(ii) *Sold goods to Mukesh at the list price of ₹ 1,00,000 less 20% trade discount and 5% cash discount.*

(iii) *Sold goods to Mukesh at the list price of ₹ 1,50,000 less 20% trade discount and 5% cash discount. Out of the amount due 60% is received out of which three-fourth is received by cheque.*

SOLUTION

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
(i)	Mukesh A/c Dr.		44,800	
	To Sales A/c			40,000
	To Output CGST A/c			2,400
	To Output SGST A/c			2,400
	(Being goods sold to Mukesh at a trade discount of 20% charged CGST and SGST @ 6% each)			

(ii)	Discount Allowed A/c Dr.		4,000	
	Bank A/c		85,600	
	To Sales A/c			80,000
	To Output SGST A/c			4,800
	To Output SGST A/c			4,800
	(Being goods sold to Mukesh at a trade discount of 20% and 5% cash discount, charged CGST and SGST @ 6% each)*			
(iii)	Discount Allowed A/c (1,20,000 x 5%) Dr.		6,000	
	Bank A/c Dr.		57,780	
	Cash A/c Dr.		19,260	
	Mukesh's A/c (refer W. N.) Dr.		51,360	
	To Sales A/c (1,50,000 x 80%)			1,20,000
	To Output CGST A/c (1,20,000 x 6%)			7,200
	To Output SGST A/c (1,20,000 x 6%)			7,200
	(Being goods sold to Mukesh at a trade discount of 20% and 5% cash discount and received 60%, charged CGST and SGST @ 6% each)			

Note : After allowing cash discount of ₹ 4,000 (₹ 80,000 × 5%), the balance of ₹ 85,600 is received. Since discount is on account of prompt payment, output CGST and SGST is computed on value determine after deducting trade discount.

Working Note : After allowing cash discount of ₹ 6,000 on ₹ 1,20,000, 60% of the balance amount i.e. ₹ 1,28,400 (₹ 1,20,000 + 12% GST ₹ 14,400 – discount ₹ 6,000) is paid in cash and by cheque.

Hence, the amount paid in cash and cheque = ₹ 1,28,400 × 60% = 77,040.

Amount paid by cheque = ₹ 77,040 × 3/4 = ₹ 57,780

Amount paid in cash = ₹ 77,040 x ¼ = 19,260

Mukesh's A/c = (₹ 1,20,000 + ₹ 14,400 – ₹ 6,000 – ₹ 57,780 – ₹ 19,260) = ₹ 51,360

SUMMARY

- The accounting process starts with the recording of transactions in the form of journal entries.
- The recording is based on double entry system. This book or register called journal is the book of first or original entry.
- Next step is to post the entries in the ledger which is covered in the next unit.

TEST YOUR KNOWLEDGE

True and False

1. *In accounting equation approach, equity + Long-term liabilities = fixed asset + current assets – current liabilities.*
2. *In the traditional approach a debtor becomes receiver.*
3. *The rule of nominal account states that all expenses & losses are recorded on credit side.*
4. *Journal proper is also called a subsidiary book.*
5. *Capital account has a debit balance.*
6. *Purchase account is a nominal account.*
7. *All the personal & real account are recorded in P&L A/c.*
8. *Asset side of balance sheet contains all the personal & nominal accounts.*
9. *Capital account is a personal account.*
10. *Journal is also known as the book of original entry.*

Multiple Choice Question

1. *The rent paid to landlord is credited to*

    (a) *Landlord's account.*

    (b) *Rent account.*

    (c) *Cash account.*

2. *In case of a debt becoming bad, the amount should be credited to*

    (a) *Trade receivables account.*

    (b) *Bad debts account.*

    (c) *Cash account.*

3. *A Ltd. has a ₹ 35,000 account receivable from Mohan. On January, 22, Mohan makes a partial payment of ₹ 21,000 to A Ltd. The journal entry made on January, 22 by A Ltd. to record this transaction includes:*

   (a) *A credit to the cash received account of ₹ 21,000.*

   (b) *A credit to the Accounts receivable account of ₹ 21,000.*

   (c) *A debit to the cash account of ₹ 14,000.*

4. *Which financial statement represents the accounting equation -*

   Assets = Liabilities + Owner's equity:

   (a) *Income Statement*

   (b) *Statement of Cash flows*

   (c) *Balance Sheet.*

5. *Which account is the odd one out?*

   (a) *Office furniture & Equipment.*

   (b) *Freehold land and Buildings.*

   (c) *Inventory of materials.*

6. *The debts written off as bad, if recovered subsequently are*

   (a) *Credited to Bad Debts Recovered Account*

   (b) *Credited to Trade Receivables Account.*

   (c) *Debited to Profit and Loss Account.*

7. *In Double Entry System of Book-keeping every business transaction affects:*

   (a) *Two accounts*

   (b) *Two sides of the same account.*

   (c) *The same account on two different dates.*

8. *A sale of goods to Ram for cash should be debited to:*

   (a) *Ram*

   (b) *Cash*

   (c) *Sales*

Theory Questions

1. *Write short note on classification of accounts.*
2. *Distinguish between Real account and nominal account.*

Practical Questions

1. *Show the classification of the following Accounts under traditional and accounting equation approach:*

a	Rent outstanding	g	Capital
b	Closing Inventory	h	Sales Tax Payable
c	Sales	i	Trade receivables
d	Bank Fixed Deposit	j	Depreciation
e	Cash	k	Drawings
f	Bad Debts		

2. *Pass Journal Entries for the following transactions in the books of Gamma Bros.*

   (i) *Employees had taken inventory worth ₹ 1,00,000 (Cost price ₹ 75,000) on the eve of Deepawali and the same was deducted from their salaries in the subsequent month.*

   (ii) *Wages paid for erection of Machinery ₹ 18,000.*

   (iii) *Income tax liability of proprietor ₹ 17000 was paid out of petty cash.*

   (iv) *Purchase of goods from Naveen of the list price of ₹ 2,00,000. He allowed 10% trade discount, ₹ 5,000 cash discount was also allowed for quick payment.*

3. *Calculate the missing amount for the following.*

	Assets	Liabilities	Capital
(a)	15,00,000	2,50,000	?
(b)	?	1,50,000	75,000
(c)	14,50,000	?	13,75,000
(d)	57,00,000	- 2,80,000	?

4. *Show the effect of increase = (+), decrease = (-) and no change=(0) on the assets of the following transactions:*

   a. *Purchased office furniture, payment to be made next month.*

b. *Collected cash for repair services*

c. *Goods sold on credit.*

d. *Withdrawal of cash by the owner for personal use.*

e. *Hired an employee as sales manager of the north wing.*

f. *Returned goods worth ₹ 50,000.*

g. *One of our debtor agreed to pay his dues to Mr. C who is a creditor of the company with the same amount being due to him.*

h. *Entered into an agreement with Mehta & Co. to purchase all raw materials from their company from next year.*

Also give reasons for your answers.

5. *Following is the information provided by Mr. Gopi pertaining to year ended 31st March 2022. Find the unknowns, showing computation to support your answer:*

Particulars	**₹**	***Particulars***	**₹**
Machinery	*12,00,000*	*Trade Receivables*	*B*
Accounts Payable	*1,00,000*	*Loans*	*C*
Inventory	*60,000*	*Closing Capital*	*D*
Total Liabilities including capital	*14,15,000*	*Opening Capital*	*10,00,000*
Cash	*A*	*Loss incurred during the year*	*35,000*
Bank	*80,000*	*Capital Introduced during the year*	*1,00,000*

Additional Information: During the year sales of ₹ 15,55,000 was made of which ₹ 15,00,000 have been received.

ANSWERS/HINTS

True and False

1. True: As per the modern accounting equation approach- it is the basic formula in the accounting process

2. False: In the traditional approach a debtor becomes giver.

3. False: The rule of nominal account states that all expenses & losses are recorded on debit side.

4. True: It is one of the book where in the transactions not entered in the other books are entered in this book.

5. False: Capital account has a credit balance.

6. True: As it is considered as an expense.

7. False: All the personal & real account are recorded in balance sheet.

8. False: Asset side of balance sheet contains all the personal & real accounts.

9. True: As it is in the name of the proprietor who is bringing in the capital to the business.

10. True: As the transactions are entered first in this book as a first hand record.

Multiple Choice Questions

1.	(c)	**2.**	(a)	**3.**	(b)	**4.**	(c)	**5.**	(c)	**6.**	(a)
7.	(a)	**8.**	(b)								

Theoretical Questions

1. **a.** Accounts are broadly classified into assets, liabilities and capital. The basic accounting equation specifies broad categories, which are as follows:

(i) **Assets:** These are resources controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise, namely cash, stock of goods, land, buildings, machinery etc.

(ii) **Liabilities:** These are financial obligations of an enterprise other than owner's equity namely long term loans, creditors, outstanding expenses etc.

(iii) **Capital:** It generally refer to the amounts invested in an enterprise by its owner(s), the accretion to it or a reduction in it. Since capital is affected by expenses and incomes of revenue nature, there are two more categories of accounts, namely expenses and incomes. The difference between incomes and expenses are taken into capital account.

- **Expenses:** These represents those accounts which show the amount spent or even lost in carrying on operations.

- **Incomes:** These represent those accounts which show the revenue amounts earned by the enterprise.

However, traditionally accounts are classified as follows:

(i) **Personal Accounts:** These accounts relate to persons, institutions, debtors or creditors.

(ii) **Impersonal Accounts:** These represent accounts which are not personal. These can be further sub-divided as follows:

- Real Accounts: These accounts relate to assets of the firm but not debt e.g. accounts relating to land, buildings, cash in hand etc.
- Nominal accounts: These accounts relate to expenses, losses, gains, revenues etc.

2. A real account is an account relating to properties and assets, other than personal accounts of the firm. Examples are land, buildings, machinery, cash, investments etc. Nominal accounts relate to expenses or losses, incomes and gains. Examples are: wages, salaries, rent, depreciation etc. The net result of all the nominal accounts is reflected as profit or loss which is transferred to the capital account. Nominal accounts are therefore, temporary. The real accounts are shown in the balance sheet along with personal accounts.

Practical Problems

1. **Nature of Account**

Sl. No.	Title of Account	Traditional Approach	Accounting Equation Approach
a	Rent Outstanding	Personal	Liability
b	Closing Inventory	Real	Asset
c	Sales	Nominal	Revenue
d	Bank Fixed Deposit	Personal	Asset
e	Cash	Real	Asset
f	Bad Debts	Nominal	Expense
g	Capital	Personal	Capital
h	Sales Tax Payable	Personal	Liability
i	Trade receivables	Personal	Asset
j	Depreciation	Nominal	Expense
k	Drawings	Personal	Capital -Drawings

2. **Journal Entries in the books of Gamma Bros.**

	Particulars		Dr. Amount ₹	Cr. Amount ₹
(i)	Salaries A/c	Dr.	75,000	
	To Purchase A/c			75,000
	(Being entry made for inventory taken by employees)			
(ii)	Machinery A/c	Dr.	18,000	
	To Bank A/c			18,000
	(Being wages paid for erection of machinery)			
(iii)	Drawings A/c	Dr.	17,000	
	To Petty Cash A/c			17,000
	(Being the income tax of proprietor paid out of business money)			
(iv)	Purchase A/c	Dr.	1,80,000	
	To Naveen A/c			1,80,000
	(Being goods purchased from Naveen)			
	Naveen A/c	Dr.	1,80,000	
	To Bank			1,75,000
	To Discount Received A/c			5,000
	(Being amount paid for the goods purchased from Naveen for ₹ 2,00,000. 10% trade discount and cash discount of ₹ 5,000 allowed by him)			

Note:

i. Here wages paid on erection of machinery have been capitalised therefore machinery account has been debited directly instead of wages being recorded as an expenditure.

ii. The students may also note that trade discount is allowed on the list price of goods. It is deducted to compute the invoice amount of the goods to be recorded in the books. Cash discount is a discount allowed in case of early payments to the seller. The entry is made in the books of accounts for cash discount.

3. (a) 12,50,000

(b) 2,25,000

(c) 75,000

(d) 59,80,000

These have been solved using the Accounting Equation:

Assets = Capital + Liabilities

4.

S. No.	**Increase (+) / Decrease (-) / No Change (0) in Assets**	**Reasons**
(a)	+	Furniture has been purchased making it an increase in assets and also it being purchased on credit it increases liability and there is no outflow of assets like cash or bank.
(b)	+	Cash has flowed in for services provided making it an increase in assets.
(c)	+	For goods sold, it is a decrease in inventory (assets) but correspondingly there is an increase in debtors. However, there will be a net increase in assets because goods sold on profit. Though if goods are sold at cost; it will result in no change whereas if sold at below cost; it will result in decrease in assets.
(d)	-	Here cash has been withdrawn from business resulting in decrease in assets and capital.
(e)	0	Only hiring of employee has been done resulting in no change in assets.
(f)	-	Outflow of goods has resulted in decrease in assets while money owed to creditors reduce on the liability side.
(g)	-	Both assets and liabilities reduced by same amounts meaning a decrease in assets.
(h)	0	Only a purchase agreement has been entered into with no transaction taking place yet.

5. Trade Receivable Balance (B) = Sales- Amount received during the year

= ₹ (15,55,000 – 15,00,000)

= ₹ 55,000.

Since, we know Assets = Capital + Liabilities

Therefore, balance of assets is also ₹ 14,15,000

So, total assets:

Particulars	**₹**
Total Assets	14,15,000
Less: Machinery	(12,00,000)
Less: Inventory	(60,000)
Less: Bank	(80,000)
Less: Receivables	(55,000)
Cash (A)	20,000

Computation of Closing Capital (D):

Particulars	**₹**
Opening Capital	10,00,000
Add: Introduced during the year	1,00,000
Less: Loss incurred during the year	(35,000)
Closing Capital	10,65,000

So, Loan amount (C) = Total Liabilities and capital - Closing Capital - Trade Payables

= ₹ (14,15,000 - 10,65,000 - 1,00,000)= ₹ 2,50,000

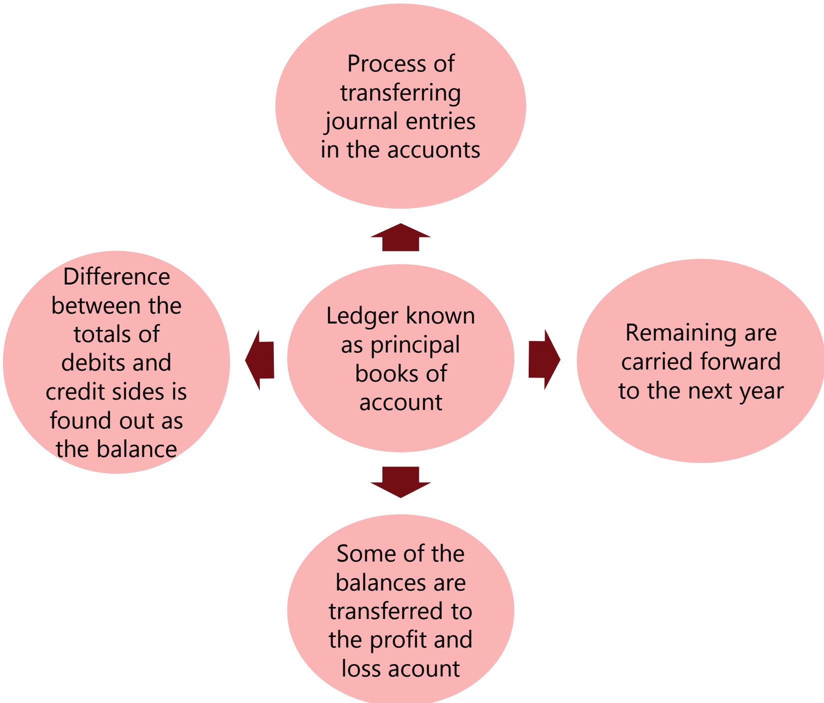
UNIT 2 : LEDGERS

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the concept of Ledgers.
- Learn the technique of ledger posting and how to balance an account.
- Learn the technique of opening accounts each year taking closing balances of the previous year. Note also the use of term 'balance c/d' and 'balance b/d'

UNIT OVERVIEW



2.1 INTRODUCTION

After recording the original transactions in the journal, recorded entries are classified and grouped into by preparation of accounts. The book which contains all set of accounts (viz. personal, real and nominal accounts), is known as Ledger. It is known as principal books of account in which account-wise balance of each account is determined.

2.2 SPECIMEN OF LEDGER ACCOUNTS

A ledger account has two sides-debit (left side of the account) and credit (right side of the account). Each of the debit and credit side has four columns. (i) Date (ii) Particulars (iii) Journal folio i.e. page from where the entries are taken for posting and (iv) Amount.

Dr. Account Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)

2.3 POSTING

The process of transferring the debit and credit items from journal to classified accounts in the ledger is known as posting.

2.3.1 Rules regarding Posting of Entries in the Ledger

1. Separate account is opened in ledger book for each distinct account and entries from Journal are posted to respective account accordingly.
2. It is a practice to use words 'To' and 'By' while posting transactions in the ledger. The word 'To' is used in the particular column with the accounts written on the debit side while 'By' is used with the accounts written in the particular column of the credit side. These 'To' and 'By' do not have any meanings but are used to the account debited and credited.
3. The concerned account debited in the journal should also be debited in the ledger but reference should be of the respective credit account.

2.4 BALANCING AN ACCOUNT

At the end of each month or year or any particular reporting period, it may be necessary to ascertain the balance in an account. Suppose a person has bought goods worth ₹1,000 and has paid only ₹ 850; he owes ₹150 and that is the balance in his account. To ascertain the balance in any account, both the sides of the account is totalled and smaller amount is deducted from the bigger amount to ascertain the difference. If the credit side is bigger than the debit side, it is a credit balance and vice a versa. The credit balance is written on the debit side as, "To Balance c/d"; c/d means "carried down". By doing this, two sides will be equal. The totals are written on the two sides opposite one another.

Then the credit balance is written on the credit side as "By balance b/d (i.e., brought down)". This is the opening balance for the new period. The debit balance similarly is written on the credit side as "By Balance c/d", the totals then are written on the two sides as shown above and then the debit balance written on the debit side as, "To Balance b/d", as the opening balance of the new period.

It should be noted that nominal accounts are not balanced; the balance in the end are transferred to the profit and loss account. Only personal and real accounts balances are ultimately shown in the balance sheet at the end of the accounting period. The capital account is adjusted for profit or loss (i.e net of nominal accounts) at the end of accounting period.

ILLUSTRATION 1

Prepare the Stationery Account of a firm for the month of Jan. 2022 duly balanced off, from the following details:

2022		₹
Jan. 1	*Inventory of stationery*	*480*
Jan. 5	*Purchase of stationery by cheque*	*800*
Jan. 15	*Purchase of stationery on credit from Five Star Stationery Mart*	*1,280*

SOLUTION

Dr. **Stationery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.1.2022	To Balance b/d	480	31.1.2022	By Balance c/d	2,560
5.1.2022	To Bank A/c	800			
15.1.2022	To Five Star Stationery				

	Mart A/c		1,280				
			2,560				2,560
1.2.2022	To Balance b/d		2,560				

ILLUSTRATION 2

Prepare the ledger accounts on the basis of following transactions in the books of a trader.

Debit Balances on January 1, 2022:

Cash in Hand ₹ 8,000, Cash at Bank ₹ 25,000, inventory of Goods ₹ 20,000, Building ₹ 10,000. Trade receivables: Vijay ₹ 2,000 and Madhu ₹ 2,000.

Credit Balances on January 1, 2022:

Trade payables: Anand ₹ 5,000 and Kapil ₹7,000, Capital ₹ 55,000

Following were further transactions in the month of January, 2022:

Jan. 1 *Purchased goods worth ₹ 5,000 (payable at later date) for cash less 20% trade discount and 5% cash discount.*

Jan. 4 *Received ₹ 1,980 from Vijay and allowed him ₹ 20 as discount.*

Jan. 8 *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.*

Jan. 12 *Sold goods to Rahim on credit ₹600.*

Jan. 15 *Rahim became insolvent and could pay only 50 paise in a rupee.*

Jan. 18 *Sold goods to Ram for cash ₹1,000.*

SOLUTION

Dr. **Cash Account** Cr.

Date 2022	Particulars	J.F.	₹	Date 2022	Particulars	J.F.	₹
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. 31	By Balance c/d		7,180
Jan. 18	To Sales A/c		1,000				
			11,280				11,280
Feb. 1	To Balance b/d		7,180				

Dr. **Bank Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
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				

Dr. **Inventory Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
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. **Building Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
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				

Dr. **Vijay** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
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

Dr. **Madhu** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
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				

Dr. **Anand** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 31	To Balance c/d		5,000	Jan. 1	By Balance b/d		5,000
			5,000				5,000
				Feb. 1	By Balance b/d		5,000

Dr. **Kapil** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 31	To Balance c/d		7,000	Jan. 1	By Balance b/d		7,000
			7,000				7,000
				Feb. 1	By Balance b/d		7,000

Dr. **Capital Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
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. **Purchases Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 1	To Cash		3,800				
Jan. 1	To Cash Discount		200	Jan. 31	By Balance c/d		4,000
			4,000				4,000
Feb. 1	To Balance b/d		4,000				

Dr. **Discount Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 4	To Vijay		20	Jan. 1	By Purchases A/c		200
Jan.31	To Balance c/d		180				
			200				200
				Feb. 1	By Balance b/d		180

Dr. **Plant Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
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				

Dr. **Mukesh** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
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

Dr. **Sales Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 31	To Balance c/d		1,600	Jan. 12	By Rahim		600
				Jan. 18	By Cash A/c		1,000
			1,600				1,600
				Feb. 1	By Balance b/d		1,600

Dr. **Rahim** Cr.

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

Dr. **Bad Debts Account** Cr.

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

ILLUSTRATION 3

The following data is given by Mr. S, the owner, with a request to compile only the two personal accounts of Mr. H and Mr. R, in his ledger, for the month of April, 2022.

1	*Mr. S owes Mr. R ₹ 15,000; Mr. H owes Mr. S ₹ 20,000.*
4	*Mr. R sold goods worth ₹ 60,000 @ 10% trade discount to Mr. S.*
5	*Mr. S sold to Mr. H goods prices at ₹ 30,000.*

17 *Record a purchase of ₹25,000 net from R, which were sold to H at a profit of ₹15,000.*

18 *Mr. S rejected 10% of Mr. R's goods of 4th April.*

19 *Mr. S issued a cash memo for ₹10,000 to Mr. H who came personally for this consignment of goods, urgently needed by him.*

22 *Mr. H cleared half his total dues to Mr. S, enjoying a ½% cash discount (of the payment received, ₹20,000 was by cheque).*

26 *R's total dues (less ₹10,000 held back) were cleared by cheque, enjoying a cash discount of ₹1,000 on the payment made.*

29 *Close H's Account to record the fact that all but ₹5,000 was cleared by him, by a cheque, because he was declared bankrupt.*

30 *Balance R's Account.*

SOLUTION

In the books of Mr. S

Dr. **Mr. H Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2022	To Balance b/d	20,000	22.4.2022	By Bank A/c	20,000
5.4.2022	To Sales A/c	30,000	22.4.2022	By Cash A/c (Note 2)	24,775
17.4.2022	To Sales A/c	40,000	29.4.2022	By Discount Allowed A/c	225
			29.4.2022	By Bank A/c	40,000
			29.4.2022	By Bad Debts A/c	5,000
		90,000			90,000

Dr. **Mr. R Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
18.4.2022	To Purchase Returns A/c	5,400	1.4.2022	By Balance b/d	15,000
			4.4.2022	By Purchases A/c	54,000
26.4.2022	To Bank A/c	77,600	17.4.2022	By Purchases A/c	25,000
26.4.2022	To Discount Received A/c	1,000			
30.4.2022	To Balance c/d	10,000			
		94,000			94,000
			1.5.2022	By Balance b/d	10,000

Working Notes:

(1) Sale of ₹ 10,000 on 19th April is a cash sales, therefore, it will not be recorded in the Personal Account of Mr. H; and

(2) On 22nd April, Mr. H owes Mr. S ₹ 90,000, amount paid by Mr. H ½ of ₹ 90,000 less ½% discount i.e., ₹ 45,000– ₹ 225 = ₹ 44,775. Out of this amount, ₹ 20,000 paid by cheque and the balance of ₹ 24,775 in cash.

Note: The balance of all nominal accounts is transferred to Profit and Loss account at the time of preparation of financial statements as the nominal Accounts are in the nature of revenue/incomes/gains or expenses/losses. Thus, the net result of all nominal accounts is reflected in profit and loss Account for an accounting period which is transferred to Capital Account. The balance of all the accounts relating to assets and liabilities (personal and real) are reflected in the Balance Sheet at the end of accounting period.

SUMMARY

- Process of transferring journal entries in the accounts opened in Ledger is called posting.
- Ledger is known as principal books of accounts and it provides full information regarding all the financial transactions pertaining to any individual account.
- The difference between the totals of debits and credit sides is found out as the balance. Some of these balances (i.e nominal accounts) are transferred to the profit and loss account and some are carried forward to the next period/year i.e., shown in the balance sheet, depending upon the nature of the account.

TEST YOUR KNOWLEDGE

True and False

1. *A ledger is also known as the principal book of accounts.*
2. *Cash account has a debit balance.*
3. *Posting is the process of transferring the accounts from ledger to journal.*
4. *At the end of the accounting year, all the nominal accounts of the ledger book are balanced.*
5. *Ledger records the transactions in a chronological order.*

6. *If the total debit side is greater than the total of credit side, we get a credit balance as opening balance.*

7. *Ledger accounts of assets will always be debited when they are increased.*

Multiple Choice Questions

1. *The process of transferring the debit and credit items from a Journal to their respective accounts in the ledger is termed as*

   (a) Posting

   (b) Purchase

   (c) Balancing of an account

2. *The technique of finding the net balance of an account after considering the totals of both debits and credits appearing in the account is known as*

   (a) Posting

   (b) Purchase

   (c) Balancing of an account

3. *Journal and ledger records transactions in*

   (a) A chronological order and analytical order respectively.

   (b) An analytical order and chronological order respectively.

   (c) A chronological order only

4. *Ledger book is popularly known as*

   (a) Secondary book of accounts

   (b) Principal book of accounts

   (c) Subsidiary book of accounts

5. *At the end of the accounting year all the nominal accounts of the ledger book are*

   (a) Balanced but not transferred to profit and loss account

   (b) Not balanced and also the balance is not transferred to the profit and loss account

   (c) Not balanced and their balance is transferred to the profit and loss account.

Theory Questions

1 *What do you mean by principal books of accounts?*

2 *What are the rules of posting of journal entries into the Ledger?*

Practical Questions

1. *Journalize the following transactions, post them in the Ledger and balance the accounts on 31st December.*

   1. *X started business with a capital of ₹ 20,000*
   2. *He purchased goods from Y on credit ₹ 4,000*
   3. *He paid cash to Y ₹ 2,000*
   4. *He sold goods to Z ₹ 4,000*
   5. *He received cash from Z ₹ 6,000*
   6. *He further purchased goods from Y ₹ 4,000*
   7. *He paid cash to Y ₹ 2,000*
   8. *He further sold goods to Z ₹ 4,000*
   9 *He received cash form Z ₹ 2,000*

ANSWERS/HINTS

True and False

1. *True: Since it classifies all the amounts related to a particular account and then it is used as the base for preparing the Trial balance, a ledger is also known as principal books of accounts.*

2. *True: Being an asset under the modern equation approach, cash account has a debit balance.*

3. *False: Posting is the process of transferring the balances from journal to ledger.*

4. *False: At the end of the accounting year, all the nominal accounts of the ledger book are totaled and transferred to P&L A/c.*

5. *False: Ledger records the transactions in analytical order. But journal records the transactions in a chronological order.*

6. *False: If the total of debit side is greater than the total of credit side, we get a debit balance as the opening balance.*

7. *True: The increase to an asset shall be debited since the original balance is also debit.*

Multiple Choice Questions

1.	**(a)**	2.	**(c)**	3.	**(a)**	4.	**(b)**	5.	**(c)**		

Theoretical Questions

1. *Ledger is known as principal books of accounts and it provides full information regarding all the transactions pertaining to any individual account. Ledger contains all set of accounts (viz. personal, real and nominal accounts).*

2. *Rules regarding posting of entries in the ledger:*

a. *Separate account is opened in ledger book for each account and entries from the Journal are posted to respective accounts accordingly.*

b. *It is a practice to use words 'To' and 'By' while posting transactions in the ledger. The word 'To' is used in the particular column with the accounts written on the debit side while 'By' is used with the accounts written in the particular column of the credit side. These 'To' and 'By' do not have any meanings but are used to the account debited and credited.*

c. *The concerned account debited in the journal should also be debited in the ledger but reference should be of the respective credit account.*

Practical Questions

1. **Journal**

Particulars		L.F.	Debit ₹	Credit ₹
Cash A/c	Dr.		20,000	
To Capital A/c				20,000
(Being commencement of business)				
Purchase A/c	Dr.		4,000	
To Y				4,000
(Being purchase of goods on credit)				
Y	Dr.		2,000	
To Cash				2,000
(Being amount paid to Y)				

Z Dr. To Sales A/c (Being goods sold to Z)		4,000	4,000
Bank A/c Dr. To Z (Being amount received from Z)		6,000	6,000
Purchase A/c Dr. To Y (Being purchase of goods on credit from Y)		4,000	4,000
Y Dr. To Cash A/c (Being amount paid to Y)		2,000	2,000
Z Dr. To Sales A/c (Being goods sold to Z)		4,000	4,000
Cash A/c Dr. To Z (Being cash received from Z)		2,000	2,000
TOTAL		48,000	48,000

Dr. **Cash Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Capital A/c	20,000		By Y	2,000
	To Z	6,000		By Y	2,000
	To Z	2000		By Balance c/d	24,000
		28,000			28,000
Feb. 1	To Balance b/d	24,000			

Dr. **Capital Account** Cr.

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

Dr. **Purchase Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Y	4,000	Jan 31.	By Balance c/d	8,000
	To Y	4,000			
		8,000			8,000
Feb.1	To Balance b/d	8,000			

Dr. **Y's Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Cash	2,000		By Purchases	4,000
	To Cash	2,000		By Purchases	4,000
Jan. 31	To Balance c/d	4,000			
		8,000			8,000
				By Balance b/d	4,000

Dr. **Z's Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Sales	4,000		By Cash A/c	6,000
	To Sales	4,000		By Cash A/c	2,000
		8,000			8,000

Dr. **Sales Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	8,000		By Z	4,000
				By Z	4,000
		8,000			8,000
			Feb. 1	By Balance b/d	8,000

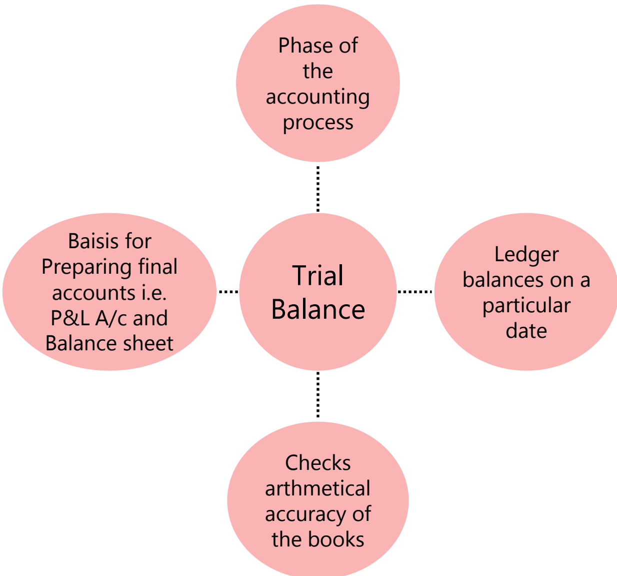
UNIT 3 : TRIAL BALANCE

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Learn the technique of taking balances from ledger accounts to prepare trial balance.
- Understand what is trial balance and what purposes it can serve..

UNIT OVERVIEW



Trial balance contains various ledger balances on a particular date. It forms the basis for preparing the financial statement i.e. profit and loss account and balance sheet. If it tallies, it means that the accounts are arithmetically accurate but certain errors may still remain undetected. Therefore, it is very important to carefully journalise and post the entries, following the rules of accounting.

3.1 INTRODUCTION

Preparation of trial balance is the third phase in the accounting process. After posting the accounts in the ledger, a statement is prepared to show separately the debit and credit balances. Such a statement is known as the trial balance. It may also be prepared by listing each and every account and entering in separate columns the totals of the debit and credit sides. Whichever way it is prepared, the totals of the two columns should agree. An agreement indicates arithmetic accuracy of the accounting work; if the two sides do not agree, then there is simply an arithmetic error(s).

This follows from the fact that under the Double Entry System, the amount written on the debit sides of various accounts is always equal to the amounts entered on the credit sides of other accounts and vice versa. Hence the totals of the debit sides must be equal to the totals of the credit sides. Also total of the debit balances will be equal to the total of the credit balances. Once this agreement is established, there is reasonable confidence that the accounting work is free from clerical errors, though it is not a proof of cent per cent accuracy, because some errors of principle and compensating errors may still remain. Generally, to check the arithmetic accuracy of accounts, trial balance is prepared at monthly intervals. But because double entry system is followed, one can prepare a trial balance any time. Though a trial balance can be prepared any time but it is preferable to prepare it at the end of the reporting period which may be month end/quarter end/year end to ensure the arithmetic accuracy of all the accounts before the preparation of the financial statements. It may be noted that trial balance is a statement and not an account.

3.2. OBJECTIVES OF PREPARING THE TRIAL BALANCE

The preparation of trial balance has the following objectives:

(i) Trial balance enables one to establish whether the posting and other accounting processes have been carried out without committing arithmetical errors. In other words, the trial balance helps to establish arithmetical accuracy of the books of accounts.

(ii) Financial statements are normally prepared on the basis of agreed trial balance; otherwise the financial statements will not give true and fair picture of the financial transactions.

(iii) The trial balance serves as a summary of what is contained in the ledger; the ledger may have to be seen only when details are required in respect of an account.

The form of the trial balance is simple as shown below:

Trial Balance

as at......................

S.No	Ledger Accounts	Dr. Amount	Cr. Amount
		(Total or Balance)	(Total or Balance)
		₹	₹

The under mentioned points may be noted:

(i) A trial balance is prepared as on a particular date which should be mentioned at the top.

(ii) In the second column the name of the account is written.

(iii) In the third column the total of the debit side of the account concerned or the debit balance, if any is entered.

(iv) In the fourth column, the total of the credit side or the credit balance is written.

(v) The third and fourth columns are totalled at the end.

3.3 LIMITATIONS OF TRIAL BALANCE

One should note that the agreement of Trial Balance is not a conclusive proof of accuracy. In other words, in spite of the agreement of the trial balance some errors may remain. These may be of the following types:

(i) Transaction has not been entered at all in the journal.

(ii) A wrong amount has been written in both columns of the journal.

(iii) A wrong account has been mentioned in the journal.

(iv) An entry has not at all been posted in the ledger.

(v) Entry is posted twice in the ledger.

Still, the preparation of the trial balance is very useful; without it, the preparation of financial statements, would be difficult.

3.4 METHODS OF PREPARATION OF TRIAL BALANCE

1. TOTAL METHOD

Under this method, every ledger account is totalled and that total amount (both of debit side and credit side) is transferred to trial balance. In this method, trial balance can be prepared as soon as ledger account is totalled. Time taken to balance the ledger accounts is saved under this method as balance can be found out in the trial balance itself. The difference of totals of each ledger account is the balance of that particular account. This method is not commonly used as for the preparation of the financial statements, only net balance of the ledger account is required. Therefore, the trial balance compiled under this method cannot be used directly for preparation of the financial statements.

ILLUSTRATION 1

Given below is a ledger extract relating to the business of X and Co. as on March, 31, 2022. You are required to prepare the Trial Balance by the Total Amount Method.

Dr. **Cash Account** Cr.

Particulars	₹	Particulars	₹
To Capital A/c	10,000	By Furniture A/c	3,000
To Ram's A/c	25,000	By Salaries A/c	2,500
To Cash Sales	500	By Shyam's A/c	21,000
		By Cash Purchases	1,000
		By Capital A/c	500
		By Balance c/d	7,500
	35,500		35,500

Dr. **Furniture Account** Cr.

Particulars	₹	Particulars	₹
To Cash A/c	3,000	By Balance c/d	3,000
	3,000		3,000

Dr. **Salaries Account** Cr.

Particulars	₹	Particulars	₹
To Cash A/c	2,500	By Balance c/d	2,500
	2,500		2,500

Dr. **Shyam's Account** Cr.

Particulars	₹	Particulars	₹
To Cash A/c	21,000	By Purchases A/c	25,000
To Purchase Returns A/c	500	(Credit Purchase)	
To Balance c/d	3,500		–
	25,000		25,000

Dr. **Purchases Account** Cr.

Particulars	₹	Particulars	₹
To Cash A/c (Cash Purchases)	1,000	By Balance c/d	26,000
To Sundries as per Purchases Book (Credit Purchases)	25,000		–
	26,000		26,000

Dr. **Purchases Returns Account** Cr.

Particulars	₹	Particulars	₹
To Balance c/d	500	By Sundries as per Purchases Return Book	500
	500		500

Dr. **Ram's Account** Cr.

Particulars	₹	Particulars	₹
To Sales A/c (Credit Sales)	30,000	By Sales Returns A/c	100
		By Cash A/c	25,000
		By Balance c/d	4,900
	30,000		30,000

Dr. **Sales Account** Cr.

Particulars	₹	Particulars	₹
To Balance c/d	30,500	By Cash A/c (Cash Sales)	500
		By Sundries as per Sales Book (Credit Sales)	30,000
	30,500		30,500

Dr. ***Sales Returns Account*** Cr.

Particulars	₹	***Particulars***	₹
To Sundries as per Sales Returns Book	*100*	*By Balance c/d*	*100*
	100		*100*

Dr. ***Capital Account*** Cr.

Particulars	₹	***Particulars***	₹
To Cash A/c	*500*	*By Cash A/c*	*10,000*
To Balance c/d	*9,500*		
	10,000		*10,000*

SOLUTION

Trial Balance of X and Co. as at 31.03.2022

Sl. No.	**Name of Account**	**Total Debit ₹**	**Total Credit ₹**
1.	Cash A/c	35,500	28,000
2.	Furniture A/c	3,000	
3.	Salaries A/c	2,500	
4.	Shyam's A/c	21,500	25,000
5.	Purchases A/c	26,000	
6.	Purchases Returns A/c		500
7.	Ram's A/c	30,000	25,100
8.	Sales A/c		30,500
9.	Sales Returns A/c	100	
10.	Capital A/c	500	10,000
		1,19,100	1,19,100

2. BALANCE METHOD

Under this method, every ledger account is balanced and those balances only are carried forward to the trial balance. This method is used commonly by the accountants and helps in the preparation of the financial statements. Financial statements are prepared on the basis of the balances of the ledger accounts.

ILLUSTRATION 2

Taking the same information as given in Illustration 1, prepare the Trial Balance by Balance Method.

SOLUTION

Trial Balance of X and Co. as at 31.03.2022

Sl. No.	Name of Account	Debit Balance ₹	Credit Balance ₹
1.	Cash A/c	7,500	
2.	Furniture A/c	3,000	
3.	Salaries A/c	2,500	
4.	Shyam's A/c		3,500
5.	Purchases A/c	26,000	
6.	Purchases Returns A/c		500
7.	Ram's A/c	4,900	
8.	Sales A/c		30,500
9.	Sales Returns A/c	100	
10.	Capital A/c		9,500
		44,000	44,000

3. TOTAL AND BALANCE METHOD

Under this method, the above two explained methods are combined. This has been explained with the help of the following example:

Trial Balance of X as at 31.03.2022

Sl. No.	Heads of Account	Debit Balance (₹)	Credit Balance (₹)	Debit Total (₹)	Credit Total (₹)
1.	Cash Account	7,500		35,500	28,000
2.	Furniture Account	3,000		3,000	
3.	Salaries Account	2,500		2,500	
4.	Shyam's Account		3,500	21,500	25,000

5.	Purchases Account	26,000		26,000	
6.	Purchase Returns Account		500		500
7.	Ram's Account	4,900		30,000	25,100
8.	Sales Account		30,500		30,500
9.	Sale Returns Account	100		100	
10.	Capital Account		9,500	500	10,000
	Total	44,000	44,000	1,19,100	1,19,100

3.5 ADJUSTED TRIAL BALANCE (THROUGH SUSPENSE ACCOUNT)

If the trial balance does not agree after transferring the balance of all ledger accounts including cash and bank balance and also errors are not located timely, then the trial balance is tallied by transferring the difference of debit and credit side to an account known as suspense account. This is a temporary account opened to proceed further and to prepare the financial statements timely.

3.6 RULES OF PREPARING THE TRIAL BALANCE

While preparing the trial balance from the given list of ledger balances, following rules should be taken into account:

1. The balances of all (i) assets accounts (ii) expenses accounts (iii) losses (iv) drawings are placed in the debit column of the trial balance.
2. The balances of all (i) liabilities accounts (ii) income accounts (iii) gains (iv) capital are placed in the credit column of the trial balance.

ILLUSTRATION 3

From the following ledger balances, prepare a trial balance of Anuradha Traders as on 31st March, 2022:

Account Head	₹
Capital	*1,00,000*
Sales	*1,66,000*
Purchases	*1,50,000*

Sales return	*1,000*
Discount allowed	*2,000*
Expenses	*10,000*
Trade receivables	*75,000*
Trade payables	*25,000*
Investments	*15,000*
Cash at bank and in hand	*37,000*
Interest received on investments	*1,500*
Insurance paid	*2,500*

SOLUTION

Trial Balance of Anuradha Traders as on 31.03.2022

Particulars	**Dr. balance ₹**	**Particulars**	**Cr. balance ₹**
Purchases	1,50,000	Capital	1,00,000
Sales return	1,000	Sales	1,66,000
Discount allowed	2,000	Trade payables	25,000
Expenses	10,000	Interest received on investments	1,500
Trade receivables	75,000		
Investments	15,000		
Cash at bank and in hand	37,000		
Insurance paid	2,500		
Total	2,92,500		2,92,500

ILLUSTRATION 4

One of your clients, Mr. Singhania has asked you to finalise his accounts for the year ended 31st March, 2022. Till date, he himself has recorded the transactions in books of accounts. As a basis for audit, Mr. Singhania furnished you with the following statement.

	Dr. Balance (₹)	Cr. Balance (₹)
Singhania's Capital		*1,556*
Singhania's Drawings	*564*	
Leasehold premises	*750*	
Sales		*2,750*
Dues from customers		*530*
Purchases	*1,259*	
Purchases return	*264*	
Loan from bank		*256*
Trade payables	*528*	
Trade expenses	*700*	
Cash at bank	*226*	
Bills payable	*100*	
Salaries and wages	*600*	
Inventories (1.4.2021)		*264*
Rent and rates	*463*	
Sales return		*98*
	5,454	*5,454*

The closing inventory on 31st March, 2022 was valued at ₹ 574. Mr. Singhania claims that he has recorded every transaction correctly as the trial balance is tallied. Check the accuracy of the above trial balance.

SOLUTION

Corrected Trial Balance of Mr. Singhania as on 31st March, 2022

Particulars	Dr. Amount ₹	Cr. Amount ₹
Singhania's Capital		1,556
Singhania's Drawings	564	
Leasehold premises	750	
Sales		2,750

Dues from customers (refer note 1 below)	530	
Purchases	1,259	
Purchases returns (refer note 2 below)		264
Loan from Bank		256
Trade payables (refer note 3 below)		528
Trade expenses	700	
Cash at Bank	226	
Bills payable (refer note 4 below)		100
Salaries and Wages	600	
Inventory (1.4.2021) (refer note 5 below)	264	
Rent and rates	463	
Sales return (refer note 6 below)	98	
	5,454	5,454

Notes:

1. Dues from customers is an asset, so its balance will be a debit balance.
2. Purchases return account always shows a credit balance because assets go out.
3. Balance in Trade payables is a liability, so its balance will be a credit balance.
4. Bills payable is a liability, so its balance will be a credit balance.
5. Inventory (opening) represents assets, so it will have a debit balance.
6. Sales return account always shows a debit balance because assets come.

ILLUSTRATION 5

The following trail balance as on 31st March, 2022 was drawn from the books of fintech traders:

	L.F.	***Dr. Balance (₹)***	***Cr. Balance (₹)***
Building		*60,000*	-
Machinery		*17,000*	-
Return Outward		*2,600*	-
Bad Debts		*2,800*	-
Cash		*400*	-

Discount Received		*3,000*	*-*
Bank Overdraft		*10,000*	*-*
Creditors		*50,000*	*-*
Purchases		*1,00,000*	*-*
Capital		*-*	*73,600*
Fixtures		*-*	*5,600*
Sales		*-*	*1,04,000*
Debtors		*--*	*60,000*
Interest Received		*-*	*2,600*
Input CGST A/c		*-*	*3,000*
Input SGST A/c		*-*	*3,000*
Input IGST A/c		*-*	*4,800*
Output CGST A/c		*5,400*	*-*
Output SGST A/c		*5,400*	*-*
Total		*2,56,600*	*2,56,600*

Even though the debit and credit sides agree, the trial Balance contains certain errors. Check the accuracy of trial balance.

SOLUTION

Corrected Trial Balance of Fintech traders as on 31st March, 2022

	L.F.	***Dr. Balance (₹)***	***Cr. Balance (₹)***
Building		60,000	-
Machinery		17,000	-
Return Outward		-	2,600
Bad Debts		2,800	-
Cash		400	-
Discount Received		-	3,000
Bank Overdraft		-	10,000
Creditors		-	50,000
Purchases		1,00,000	-
Capital		-	73,600

Fixtures		5,600	-
Sales		-	1,04,000
Debtors		60,000	-
Interest Received		-	2,600
Input CGST A/c		3,000	-
Input SGST A/c		3,000	-
Input IGST A/c		4,800	-
Output CGST A/c		-	5,400
Output SGST A/c		-	5,400
		2,56,600	2,56,600

SUMMARY

- Trial balance contains various ledger balances on a particular date.
- It forms the basis for preparing financial statement i.e. profit and loss account and balance sheet.
- If it tallies, it means that the accounts are arithmetically accurate but certain errors may still remain undetected.
- It is very important to carefully journalize and post the entries, following the rules of accounting.

TEST YOUR KNOWLEDGE

True and False

1. *Preparing trial balance is the third phase of accounting process.*
2. *Trial balance forms a base for the preparation of Financial statement.*
3. *Agreement of trial balance is a conclusive proof of accuracy.*
4. *A trial balance will tally in case of compensating errors.*
5. *A trial balance can find the missing entry from the journal.*
6. *Suspense account opened in a trial balance is a permanent account.*
7. *The balance of purchase returns account has a credit balance.*

Multiple Choice Questions

1. *A trial balance will not balance if _____________________________*

   (a) *Correct journal entry is posted twice.*

   (b) *The purchase on credit basis is debited to purchases and credited to cash.*

   (c) *₹500 cash payment to creditor is debited to Trade payables for ₹50 and credited to cash as ₹500.*

2. *₹ 1, 500 received from sub-tenant for rent and entered correctly in the cash book is posted to the debit of the rent account. In the trial balance _____________________________*

   (a) *The debit total will be greater by ₹3,000 than the credit total.*

   (b) *The debit total will be greater by ₹1,500 than the credit total.*

   (c) *Subject to other entries being correct the total will agree.*

3. *After the preparation of ledgers, the next step is the preparation of _____________________________*

   (a) *Trading accounts*

   (b) *Trial balance*

   (c) *Profit and loss account*

4. *After preparing the trial balance the accountant finds that the total of debit side is short by ₹1,500. This difference will be _____________________________*

   (a) *Credited to suspense account*

   (b) *Debited to suspense account*

   (c) *Adjusted to any of the debit balance account*

5.

S.No.	***Account heads***	***Debit (₹)***	***Credit (₹)***
1.	*Sales*		*15,000*
2.	*Purchases*	*10,000*	
3.	*Miscellaneous expenses*	*2,500*	
4.	*Salaries*		*2,500*
	Total	*12,500*	*17,500*

The difference in trial balance is due to ____________________________

(a) Wrong placing of sales account

(b) Wrong placing of salaries account

(c) Wrong placing of miscellaneous expenses account

Theory Questions

1. *What is the trial balance? And how it is prepared?*
2. *Explain objectives of preparation of trial balance.*
3. *Even if the trial balance agrees, some errors may remain. Do you agree? Explain.*

Practical Question

1. *An inexperienced bookkeeper has drawn up a Trial Balance for the year ended 30th June, 2022.*

	Debit (₹)	Credit (₹)
Provision for Doubtful Debts	200	–
Bank Overdraft	1,654	–
Capital	–	4,591
Trade payables	–	1,637
Trade receivables	2,983	–
Discount Received	252	–
Discount Allowed	–	733
Drawings	1,200	–
Office Furniture	2,155	–
General Expenses	–	829
Purchases	10,923	–
Returns Inward	–	330
Rent & Rates	314	–
Salaries	2,520	–
Sales	–	16,882
Inventory	2,418	–
Provision for Depreciation on Furniture	364	–
Total	24,983	25,002

Required:

Draw up a 'Corrected' Trial Balance, debiting or crediting any residual errors to a Suspense Account.

ANSWERS/HINTS

True and False

1. *True: Preparing trial balance is the third phase of accounting process which forms the base for the preparation of the final accounts.*

2. *True: Based on trial balance only, we can prepare financial statement.*

3. *False: Agreement of trial balance gives only arithmetical accuracy, there can still be errors in preparing the trail balance.*

4. *True: Since compensating errors cancel out due to their compensating nature of the amounts, hence the Trial balance tallies.*

5. *False: A trial balance cannot find the missing entry from the journal.*

6. *False: Suspense account opened in a trial balance is a temporary account*

7. *True: As purchases is debited, any returns shall be credited (treated in opposite way).*

Multiple Choice Questions

1.	**(c)**	2.	**(a)**	3.	**(b)**	4.	**(b)**	5.	**(b)**		

Theoretical Questions

1. Preparation of trial balance is the third phase in the accounting process. After posting the accounts in the ledger, a statement is prepared to show separately the debit and credit balances. Such a statement is known as the trial balance.

Trial balance contains various ledger balances on a particular date. It forms the basis for preparing the financial statements i.e. profit and loss account and balance sheet. If is tallies, it means that the accounts are arithmetically accurate but certain errors may still remain undetected. Therefore, it is very important to carefully journalise and post the entries, following are rules of accounting.

2. The preparation of trial balance has the following objectives:

(i) Trial balance enables one to establish whether the posting and other accounting processes have been carried out without committing arithmetical errors. In other words, the trial balance helps to establish arithmetical accuracy of the books of accounts.

(ii) Financial statements are normally prepared on the basis of agreed trial balance.

(iii) The trial balance serves as a summary of what is contained in the ledgers.

3. In spite of the agreement of the trial balance some errors may remain. These may be of the following types:

(i) Transaction has not been entered at all in the journal.

(ii) A wrong amount has been written in both columns of the journal.

(iii) A wrong account has been mentioned in the journal.

(iv) An entry has not at all been posted in the ledger.

(v) Entry is posted twice in the ledger.

Practical Question

1. **Trial Balance as on 30th June, 2022**

Heads of Accounts	Debit ₹	Credit ₹
Provision for Doubtful Debts	–	200
Bank overdraft	–	1,654
Capital	–	4,591
Trade payables	–	1,637
Trade receivables	2,983	–
Discount Received	–	252
Discount allowed	733	–
Drawings	1,200	–
Office furniture	2,155	–
General Expenses	829	–
Purchases	10,923	–
Returns Inward	330	–
Rent & Rates	314	–
Salaries	2,520	–
Sales	–	16,882
Inventory	2,418	–
Provision for Depreciation on Furniture	–	364
Suspense Account (Balancing figure)	1,175	–
Total	25,580	25,580

UNIT – 4 SUBSIDIARY BOOKS

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the techniques of recording transactions in Purchase Book, Sales Book; Returns Inward Book and Returns Outward Book; Bills Receivable and Bills Payable Book.
- Learn the technique of posting from Subsidiary Books to Ledger.
- Understand that even if subsidiary books are maintained, journalisation is required for many other transactions and events.
- Learn the difference between the subsidiary books and principal books.

UNIT OVERVIEW

Principle books

- Ledger
- Cash books

Subsidiary books

- Purchases and Sales book, Purchase and Sales return books
- Bill payable and Bills receivable books
- Journal Proper

4.1 INTRODUCTION

In a business, most of the transactions generally relate to receipts and payments of cash, sale of goods and their purchase. It is convenient to keep a separate register for each such class of transactions one for receipts and payments of cash, one for purchase of goods and one for sale of goods. A register of this type is called a book of original entry or of prime entry. The transactions recorded in such books will not require journal entries. The system by which transactions of a class are first recorded in the specified book, specially meant for it and on the basis of which ledger accounts are then prepared is known as the Practical System of Book keeping or even the English System. It should be noted that in this system, there is no departure from the rules of the double entry system.

These books of original or prime entry are also called subsidiary books since ledger accounts are prepared on their basis without further processing of ledger posting. Normally, the following subsidiary books are used in a business:

(i) Cash Book to record receipts and payments of cash, including receipts into and payments out of the bank.

(ii) Purchases Book to record credit purchases of goods dealt in or of the materials and stores required in the factory.

(iii) Purchase Returns Book to record the returns of goods and materials previously purchased.

(iv) Sales Book to record the sales of the goods dealt in by the firm.

(v) Sale Returns Book to record the returns of goods made by the customers sold to them earlier.

(vi) Bills Receivable Book to record the receipts of promissory notes or hundies from various parties.

(vii) Bills Payable Book to record the issue of the promissory notes or hundies to other parties.

(viii) Journal (proper) to record the transactions which cannot be recorded in any of the seven books mentioned above.

It may be noted that in all the above cases the word "Journal" may be used for the word "book".

Advantages of Subsidiary Books

The use of subsidiary books affords the undermentioned advantages:

(i) **Division of work:** Since in the place of one journal there will be so many subsidiary books, the accounting work may be divided amongst a number of clerks.

(ii) **Specialization and efficiency:** When the same work is allotted to a particular person over a period of time, he acquires full knowledge of it and becomes efficient in handling it. Thus the accounting work will be done efficiently.

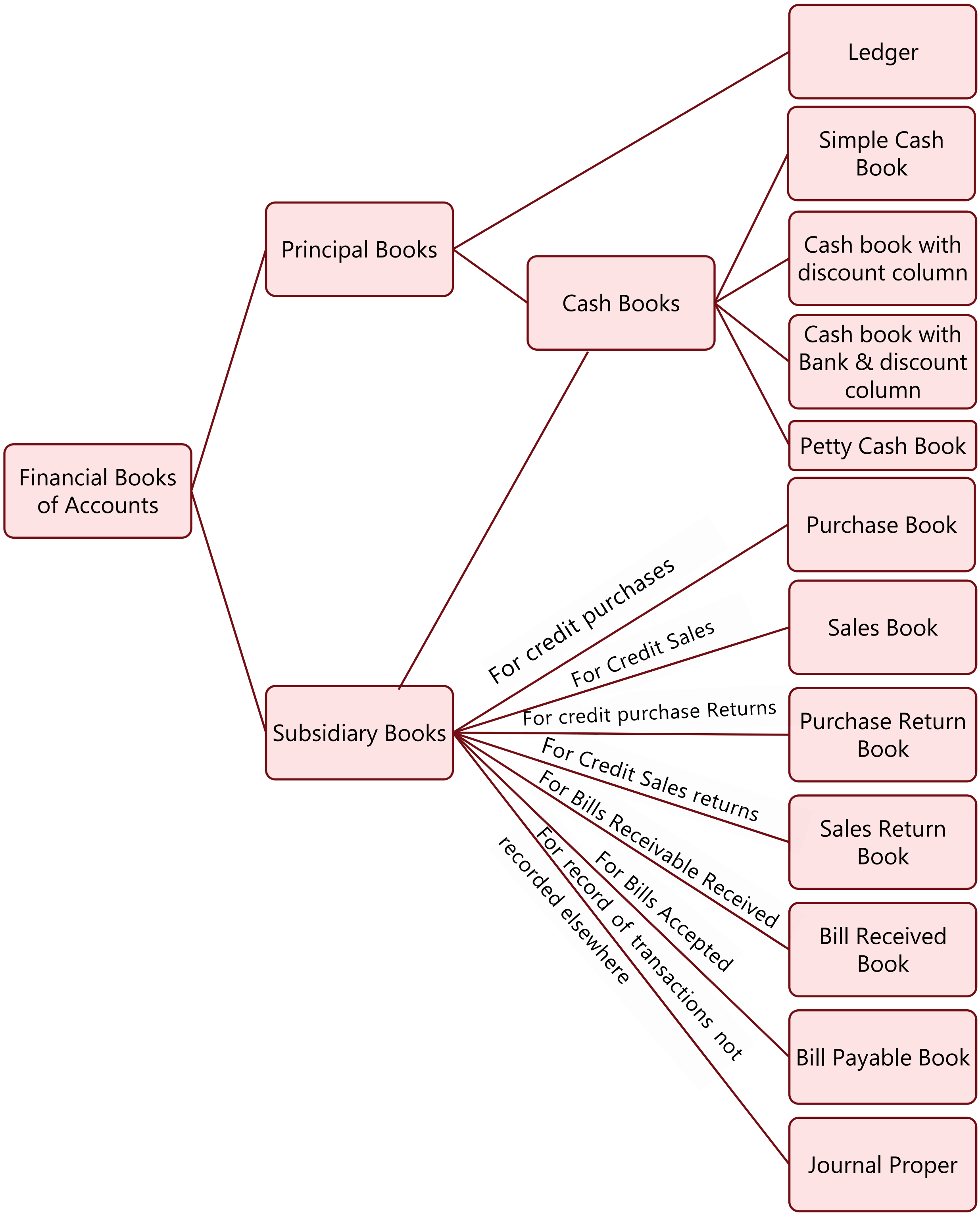
(iii) **Saving of the time:** Various accounting processes can be undertaken simultaneously because of the use of a number of books. This will lead to the work being completed quickly.

(iv) **Availability of information:** Since a separate register or book is kept for each class of transactions, the information relating to each class of transaction be available at one place.

(v) **Facility in checking:** When the trial balance does not agree, the location of the error or errors is facilitated by the existence of separate books. Even the commission of errors and frauds will be checked by the use of various subsidiary books.

4.2 DISTINCTION BETWEEN SUBSIDIARY BOOKS AND PRINCIPAL BOOKS

The books in which transactions are first recorded to enable further processing are called subsidiary books. The ledger and the cash book are the principle books since they furnish information for preparation of the trial balance and financial statements. The following chart will help you in understanding the difference between Subsidiary Books and Principal Books.


Financial Books of Accounts
Principal Books
Subsidiary Books
Ledger
Cash Books
Simple Cash Book
Cash book with discount column
Cash book with Bank & discount column
Petty Cash Book
For credit purchases
For Credit Sales
For credit purchase Returns
For Credit Sales returns
For Bills Receivable Received
For Bills Accepted
For record of transactions not recorded elsewhere
Purchase Book
Sales Book
Purchase Return Book
Sales Return Book
Bill Received Book
Bill Payable Book
Journal Proper

4.3 PURCHASES BOOK

To record the credit purchases of goods dealt in or materials used in the business, a separate register called the Purchases Book or the Purchases Journal, is usually maintained by firms. The format is given below:

Date	Particulars	Details ₹	Amount ₹

It should be remembered that:

(i) Cash purchases are not entered in this book since these will be entered in the cash book; and

(ii) Credit purchases of items other than goods or materials, such as office furniture or typewriters are journalised - they are not entered in the Purchases Book.

The particulars column is meant to record the name of the supplier and name of the articles purchased and the respective quantities. The amount in respect of each article is entered in the details column. After totalling the various amounts included in a single purchase, the amount for packing, or other charges is added and the amount for trade discount is deducted. The net amount is entered in the amount column. The total in the amount column shows the total purchase made in a period.

ILLUSTRATION 1

The Rough Book of M/s. Narain & Co. contains the following :

2022

Feb. *1.* *Purchased from Brown & Co. on credit :*

5 gross pencils @ ₹100 per gross,

1 gross register @ ₹ 240 per doz.

Less : Trade Discount @ 10%

2. *Purchased for cash from the Stationery Mart;*

10 gross exercise books @ ₹ 300 per doz.

3. *Purchased computer for office use from M/s. office*

Goods Co. on credit for ₹ 30,000.

4. *Purchased on credit from The Paper Co.*

5 reams of white paper @ ₹100 per ream.

10 reams of ruled paper @ ₹150 per ream.

Less : Trade Discount @ 10%

5. *Purchased one dozen gel pens @ ₹15 each from M/s. Verma Bros. on credit.*

Make out the Purchase Book of M/s. Narain & Co.

SOLUTION

Purchases Book

Date	Particulars	Details	Amount
2022		₹	₹
Feb. 1	M/s. Brown & Co.		
	5 gross pencils @ ₹ 100 per gross	500.00	
	1 gross register @ ₹ 240 per doz.	2880.00	
		3380.00	
	Less : 10% trade discount	(338)	3,042
"4	The Paper Co.		
	5 reams white paper @ ₹ 100 per ream	500.00	
	10 reams ruled paper @ ₹ 150 per ream	1500.00	
		2,000.00	
	Less : 10% trade discount	(200.00)	1,800
5	M/s. Verma Bros.		
	1 doz. gel pens @ ₹ 15 each	180	180
		Total	5022

Note : Purchases of cash and purchase of computer are not recorded in the Purchase Book.

ILLUSTRATION 2

Enter the following transactions in Purchase Book and post them into ledger.

2022

April 4 *Purchased from Ajay Enterprises, Delhi*

100 Doz. Rexona Hawai Chappal @ ₹120 per doz.

200 Doz. Palki Leather Chappal @ ₹300 per Doz.

Less : Trade discount @ 10%

Freight charged ₹ 150.

April 15 *Purchased from Balaji Traders, Delhi*

50 doz. Max Shoes @ ₹ 400 per doz.

100 pair Sports Shoes @ ₹ 140 per pair.

Less : Trade discount @ 10%.

Freight charged ₹ 200.

April 28 *Purchased from Tripti Industries, Bahadurgarh*

40 pair leather shoes @ ₹ 400 per pair

100 doz. Rosy Hawai Chappal @ ₹ 180 per doz.

Less : Trade discount @ 10%.

Freight charged ₹ 100.

SOLUTION

Purchase Book

Date 2022	Particulars	Details	Gross Amount	Trade Discount	Net Price	Freight	Total Amount
April 4	Ajay Enterprises						
	100 doz Rexona Hawai chappal @ ₹ 120 per doz - ₹ 12,000	12,000					
	200 doz Palki Leather Chappal @ ₹ 300 per doz - ₹ 60,000	60,000					
	Less: trade discount @ 10%		72,000	7,200	64,800	150	64,950
April 15	Balaji Traders, Delhi						
	50 doz max Shoes @ ₹ 400 per doz - ₹ 20,000	20,000					
	100 pair Sports shoes @ ₹ 140 per pair - ₹ 14,000	14,000					
	Less: Trade discount @ 10%		34,000	3,400	30,600	200	30,800

April 28	Tripti Industries, Bahadurgarh 40 pair Leather shoes @ ₹ 400 per pair - ₹ 16,000 100 doz Rosy Hawai Chappal: @ ₹ 180 per doz - ₹ 18,000 *Less*: Trade discount @ 10%	16,000 18,000	34,000	3,400	30,600	100	30,700
			1,40,000	14,000	1,26,000	450	1,26,450

Ledgers

Dr. **Purchases A/c** Cr.

2022		₹	2022		₹
April 30	To amount as per purchase book	1,26,000			

Dr. **Freight A/c** Cr.

2022		₹	2022		₹
April 30	To amount as per purchase book	450			

Dr. **Ajay Enterprises** Cr.

2022		₹	2022		₹
			April 4	By Purchase A/c (From Purchase Book) By Freight A/c (From Purchase Book)	64,800 150

Dr. **Balaji Traders** Cr.

2022		₹	2022		₹
			April 15	By Purchase A/c (From Purchase Book) By Freight A/c (From Purchase Book)	30,600 200

Dr. **Tripati Industries** Cr.

2022		₹	2022		₹
			April 28	By Purchase A/c (From Purchase Book)	30,600
				By Freight A/c (From Purchase Book)	100

POSTING THE PURCHASES BOOK

The Purchases Book shows the names of the parties from whom goods have been purchased on credit. These parties are now trade payables. Their accounts have to be credited for the respective amounts shown in the purchase book. The total of the amounts column shows the credit purchases made in a period. The amount is debited to the Purchase Account to indicate receipt of goods. In Illustration 1, the Purchases Account is debited by ₹ 5,022, M/s. Brown & Co. is credited by ₹ 3,042, The Paper Company by ₹1,800 and M/s. Verma Bros. by ₹180. The total of the amounts put on the credit side equals the debit. Thus the double entry is completed.

4.4 SALES BOOK

The Sales Book is a register specially kept to record credit sales of goods dealt in by the firm, cash sales are entered in the Cash Book and not in the Sales Book. Credit sales of items other than the goods dealt in by the firm are not entered in the Sales Book rather they are journalised. The rules are the same as for the Purchases Book.

Entries in the Sales Book are also made in the same manner as in the Purchase Book. The particulars column will record the name of the customers concerned together with particulars and quantities of the goods sold. For each item, the amount is entered in the details column; after totalling the amounts for one sale, charges for packing etc; are added and the trade discount, if any is deducted: the net amount is put in the outer column. The total of this column will show the total credit sales for a period.

ILLUSTRATION 3

The following are some of the transaction of M/s Kishore & Sons of the year 2022 as per their Waste Book. Make out their Sales Book.

Sold to M/s. Gupta & Verma on credit:

30 shirts @ ₹ 800 per shirt.

20 trousers @ ₹1,000 per trouser.

Less : Trade Discount @ 10%

Sold furniture to M/s. Sehgal & Co. on credit ₹8,000.

Sold 50 shirts to M/s. Jain & Sons @ ₹800 per shirt.

Sold 13 shirts to Cheap Stores @ ₹750 each for cash.

Sold on credit to M/s. Mathur & Jain.

100 shirts @ ₹750 per shirt

10 overcoats @ ₹5,000 per overcoat.

Less: Trade Discount @ 10%

SOLUTION

Sales Book

Date	**Particulars**	**Details ₹**	**Amount ₹**
2022	M/s. Gupta & Verma		
	30 shirts @ ₹800	24,000	
	20 Trousers @ ₹1,000	20,000	
		44,000	
	Less : 10%	(4,400)	
	Sales as per invoice no. dated		39,600
	M/s. Jain & Sons 50 shirts @ ₹800		
	Sale as per invoice no. dated		40,000
	M/s Mathur & Jain		
	100 shirts @ ₹750	75,000	
	10 overcoats @ ₹5,000	50,000	
		1,25,000	
	Less : 10%	(12,500)	
	Sales as per invoice no. dated......		1,12,500
		Total	1,92,100

Note : Cash sale and sale of furniture are not entered in Sales Book.

POSTING THE SALES BOOK

The names appearing in the Sales Book are of those parties which have received the goods. The accounts of the parties have to be debited with the respective amounts. The total of the Sales Book shows the credit sales made during the period concerned; the amount is credited to the Sales Account. In the Illustration 3, ₹ 1,92,100 is credited to the Sales Account; ₹39,600 is debited to M/s. Gupta and Verma ₹40,000 to M/s Jain and Sons and ₹1,12,500 to M/s Mathur & Jain. The amount put on the credit side is equal to the total of the amount put on the debit side. Thus, the double entry principle is followed correctly.

4.5 SALES RETURNS BOOK OR RETURNS INWARD BOOK

If customers frequently return the goods sold to them, it would be convenient to record the returns in a separate book, which is named as the Sales Returns Book or the Returns Inward Book. The rules of the book is similar to the Sales Book and entries are also made in the same manner. The following, assumed figures, will illustrate this:

Returns Inward Book

Date	Particulars	Details	L.F.	Amount
2022				₹
June 7	Sunil Bank & Co.			
	6 Copies-Double Entry			
	Bookkeeping by T.S. Grewal @ ₹ 7	42.00		
	Less : Trade Discount 10%	(4.20)		37.80
	Kailash & Co.			
	1 Copy-Business Methods by R.K. Gupta			3.50
		Total		41.30

4.6 PURCHASE RETURNS OR RETURNS OUTWARD BOOK

Such a book conveniently records return of goods or material purchased to the suppliers. However, if the returns are not frequent, it may be sufficient to record the transaction in the journal. The rules of the Purchase Returns or Returns Outward Book is similar to that of the Purchase Book; entries are also similarly made, as the illustration given below shows:

Returns Outward Book

Date 2022	**Particulars**	₹	**Amount ₹**
June 2	Premier Electric Co.		175.00
	One 36" Usha Ceiling Fan		
" 28	Mohan Electric Co.		
	Ten Iron Heaters	150.00	
	Less : Discount	(15.00)	135.00
	Total		310.00

POSTING OF THE RETURN BOOKS

The Sales Return Book will show the total of the returns made by customers. The total of the sales returns is in reduction of the sales. Therefore, the amount may be debited to the Sales Account but, usually, a separate account called Returns Inward Account is opened and the total of the sales returns is debited to this accounts. The customers who have returned the goods are credited with the respective amounts.

It should be noted that on goods being received and accepted back from the customers, a credit note is issued to the customers concerned. This shows the amount to be credited to the customer's account.

Similarly, when goods are returned to suppliers they will issue the necessary credit note; also the firm returning the goods will issue a debit note to the supplier, indicating the amount for which the supplier account is being debited.

The total of Returns Outwards Book shows the total purchase returns made. The amount can be credited to the Purchase Account, but in practice, it is credited to a separate account called Purchase Returns or Returns Outward Account. The suppliers whose names appear in the Book have received the goods, so their accounts are debited. This is shown in the illustration given below:

ILLUSTRATION 4

Post the following into the ledger

Returns Outward Book

Date 2022	*Particulars*	*Details ₹*	*Amount ₹*
Nov. 20	*Rajindra Prakash & Sons*		
	One 36" Usha Ceiling Fan	*200.00*	
	Less : Trade Discount @ 10%	*(20.00)*	*180.00*
" 30	*Modern Electric Company*		*100.00*
	Total		*280.00*

SOLUTION

Ledger

Dr. **Rajindra Parkash & Sons** Cr.

Date 2022	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Nov. 20	To Returns Outward A/c (From Returns Outward Book)		180.00				

Dr. **Modern Electric Co.** Cr.

Date 2022	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Nov. 30	To Returns Outward A/c (From Returns Outward Book)		100.00				

Dr. **Returns Outward Account** Cr.

Date 2022	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
				Nov. 30	By Sundries as per Returns Outward Book		280.00

BILLS RECEIVABLE BOOKS AND BILLS PAYABLE BOOKS

If the firm usually receives a number of promissory notes or hundies, it would be convenient to record the transaction in a separate book called the Bills Receivable Book. Similarly, if promissory notes or hundies are frequently issued, the Bills Payable Book will be convenient. This will be discussed later.

4.7 IMPORTANCE OF JOURNAL

Students are now familiar with the journal. They also know that :

(i) Cash transactions are recorded in the cash book;

(ii) Credit purchases of goods or materials are recorded in the purchases book;

(iii) Credit sales of goods are recorded in the sales book;

(iv) Returns from customers are recorded in the sale returns book; and

(v) Returns to suppliers are entered in the purchase returns book.

Bill received or accepted transactions are entered in the bills receivable books or the bills payable books, if these are maintained. Apart from the transactions mentioned above, there are other entries also which have to be recorded. For them the proper place is the journal. In fact, if there is no special book meant to record a transaction, it is recorded in the journal (proper). The role of the journal is thus restricted to the following types of entries:

(i) **Opening entries :** When books are started for the new year, the opening balance of assets and liabilities are journalised.

(ii) **Closing entries :** At the end of the year, the profit and loss account is prepared. For this purpose, the nominal accounts are transferred to profit and loss account. This is done through journal entries called closing entries.

(iii) **Rectification entries :** If an error has been committed, it is rectified through a journal entry.

(iv) **Transfer entries :** If some amount is to be transferred from one account to another, the transfer will be made through a journal entry.

(v) **Adjusting entries :** At the end of the year the amount of expenses or income may have to be adjusted for amounts received in advance or for amounts not yet settled in cash. Such an adjustment is also made through journal entries. Usually, the entries pertain to the following:

(a) Outstanding expenses, i.e., expenses incurred but not yet paid;

(b) Prepared expenses, i.e., expenses paid in advance for future period;

(c) Interest on capital, i.e., the interest on proprietor's investment in the business; and

(d) Depreciation, i.e., fall in the value of the assets used on account of wear and tear.

For above type of transactions/events, journal entries are necessary.

(vi) Entries on dishonour of Bills : If someone who accepted a promissory note (or bill) is not able to pay in on the due date, a journal entry will be necessary to record the non-payment or dishonour of bills.

(vii) Miscellaneous entries : The following entries will also require journalising:

(a) Credit purchase of items other than goods dealt in or materials required for production of goods e.g. credit purchase of furniture or machinery will be journalised.

(b) An allowance to be given to the customers or a charge to be made to them after the issue of the invoice.

(c) Receipt or issue of promissory notes, if separate bill books have not been maintained.

(d) If an amount becomes irrecoverable, say, because, of the customer becoming insolvent.

(e) Effects of accidents such as loss of property by fire.

(f) Transfer of net profit to capital account.

ILLUSTRATION 5

From the following transactions, prepare the Purchases Returns Book of Alpha & Co., a saree dealer :

Date	***Debit Note No.***	***Particulars***
04.01.2022	*101*	*Returned to Goyal Mills, Surat - 5 polyester sarees @ ₹ 1,000.*
09.01.2022		*Garg Mills, Kota - accepted the return of goods (which were purchased for cash) from us - 5 Kota sarees @ ₹ 400.*
16.01.2022	*102*	*Returned to Mittal Mills, Bangalore - 5 silk sarees @ ₹ 2,600.*
30.01.2022		*Returned one computer (being defective) @ ₹ 35,000 to B & Co.*

SOLUTION

Purchase Returns Book

Date	Debit Note No.	Name of supplier	L.F.	Amount
2022				
Jan. 4	101	Goyal Mills, Surat		5,000
Jan. 16	102	Mittal Mills, Bangalore		13,000
Jan. 31		Purchases Returns Account (Cr.)		18,000

SUMMARY

- Instead of recording all journal entries in one register, it is better to categorize the entries on the basis of type of transactions.
- Various subsidiary books are maintained so as to record transactions of one type in each register. These are also called books of original entry or prime entry.
- Example of subsidiary books are purchases book, sales book, purchase returns books, sales returns book, bills receivable book, bills payable book etc. On the basis of these subsidiary books, the ledger accounts are prepared.

TEST YOUR KNOWLEDGE

True and False

1. *Transactions recorded in the purchase book include only purchases of goods on credit transactions.*
2. *Transactions regarding the purchase of fixed asset are recorded in the purchase book.*
3. *Cash sales are recorded in the sales book.*
4. *Subsidiary books are also known as the books of original entry.*
5. *Bills receivable book is a subsidiary book.*
6. *Return inward book is also known as purchase return book.*
7. *Purchase of a second hand machinery will be recorded in purchase book.*
8. *Total of sales return book may be posted to the debit side of sales account.*
9. *If the sales are on a frequent basis, the transactions are recorded in the sales book.*

Multiple Choice Questions

1. *In Purchases Book, the record is in respect of __________________________*

   (a) *Cash purchase of goods.*

   (b) *Credit purchase of goods dealt in.*

   (c) *All purchases of goods.*

2. *The Sales Returns Book records __________________________*

   (a) *The return of goods purchased.*

   (b) *Return of anything purchased.*

   (c) *Return of goods sold.*

3. *The Sales Book __________________________*

   (a) *Is a part of journal.*

   (b) *Is a part of the ledger.*

   (c) *Is a part of the balance sheet.*

4. *The weekly or monthly total of the Purchase Book is __________________________*

   (a) *Posted to the debit of the Purchases Account.*

   (b) *Posted to the debit of the Sales Account.*

   (c) *Posted to the credit of the Purchases Account.*

5. *The total of the Sales Book is posted to __________________________*

   (a) *Credit of the Sales Account.*

   (b) *Credit of the Purchases Account.*

   (c) *Credit of the Capital Account.*

6. *In which book of original entry, will you record an allowance of ₹50 which was offered for an early payment of cash of ₹1,050 __________________________.*

   (a) *Sales Book*

   (b) *Cash Book*

   (c) *Journal Proper (General Journal)*

7. *A second hand motor car was purchased on credit from B Brothers for ₹10,000 will be recorded in ________________________.*

   (a) *Journal Proper (General Journal)*

   (b) *Sales Book*

   (c) *Cash Book*

   (d) *Purchase Book*

8. *In which book of original entry, will you record a bills receivable of ₹1,000, which was received from a debtor in full settlement for a claim of ₹1,100, is dishonoured __________________.*

   (a) *Purchases Return Book*

   (b) *Bills Receivable Book*

   (c) *Journal Proper (General Journal)*

Theory Questions

1 *Which subsidiary books are normally used in a business?*

2. *What are the advantages of subsidiary books?*

Practical Questions

1. *Enter the following transactions in Sales Book of M/s. Pranat Engineers Ltd., Delhi.*

   2022

   Jan. 2. Sold to M/s. Ajanta Electricals, Delhi 5 pieces of Ovens @ ₹6,000/- each less Trade discount @ 10%.

   8 Sold to M/s. Electronics Plaza, 10 pieces of Tablets @ ₹ 8,000/- each less trade discount 5%.

   15 Sold to M/s. Haryana Traders, 5 pieces of Juicers @ ₹3,500/- each less trade discount @ 10%.

2. *Post into the ledger, the entries of Sales Book prepared in Question1.*

ANSWERS/HINTS

True and False

1. True: Since cash purchases are taken to the cash book , it is only credit transactions that are recorded in the purchases book.
2. False: Transactions regarding the purchase of fixed asset are not recorded in the purchase book, only the credit purchases of goods are recorded in it.
3. False: Credit sales are recorded in the sales book.
4. True: Subsidiary books are maintained as an alternate to the journal.
5. True: Bills receivable is one of the subsidiary book.
6. False: Return inward book is also known as sales return book.
7. False: Purchase of a second hand machinery will not be recorded in purchase book.
8. True: Since sales return is reduction from the total sales value, it is debited in the sales account.
9. True: When there are numerous transactions then there are subsidiary books like the sales book where there are recorded instead of regular journal entries.

Multiple Choice Questions

1.	**(b)**	2.	**(c)**	3.	**(a)**	4.	**(a)**	5.	**(a)**	6.	**(b)**
7.	**(a)**	8.	**(c)**								

Theoretical Questions

1. Refer para 4.1 of this unit for subsidiary books normally mainlined in a business.
2. For advantages of Subsidiary Books, refer para 4.1 of this unit.

Practical Problems

1. **Sales Book**

Date	Particulars	Gross Amount (₹)	Trade Discount (₹)	Net Price (₹)
2022 Jan. 2	 M/s. Ajanta Electricals			

	5 pieces of Ovens @ ₹ 6,000 each			
	Less: 10% discount	30,000	3,000	27,000
8	M/s. Electronics Plaza			
	10 pieces of Tablets @ ₹ 8,000 each,			
	less 5% trade discount	80,000	4,000	76,000
15	M/s. Haryana Traders			
	5 pieces of Juicers @ ₹ 3,500 each,			
	less 10% trade discount	17,500	1,750	15,750
		1,27,500	8,750	1,18,750

2. **Ledger**

M/s. Ajanta Electricals

Date 2022	Particulars	L.F.	Amount (₹)	Date 2022	Particulars	L.F.	Amount (₹)
Jan. 2	To Sales A/c (From Sales Book)		27,000				

M/s. Electronics Plaza

Date 2022	Particulars	L.F.	Amount (₹)	Date 2022	Particulars	L.F.	Amount (₹)
Jan. 8	To Sales A/c (From Sales Book)		76,000				

M/s. Haryana Traders

Date 2022	Particulars	L.F.	Amount (₹)	Date 2022	Particulars	L.F.	Amount (₹)
Jan. 15	To Sales A/c (From Sales Book)		15,750				

Sales Account

Date 2022	Particulars	L.F.	Amount (₹)	Date 2022	Particulars	L.F.	Amount (₹)
				Jan. 31	By Sundries (As per Sales Book)		1,18,750

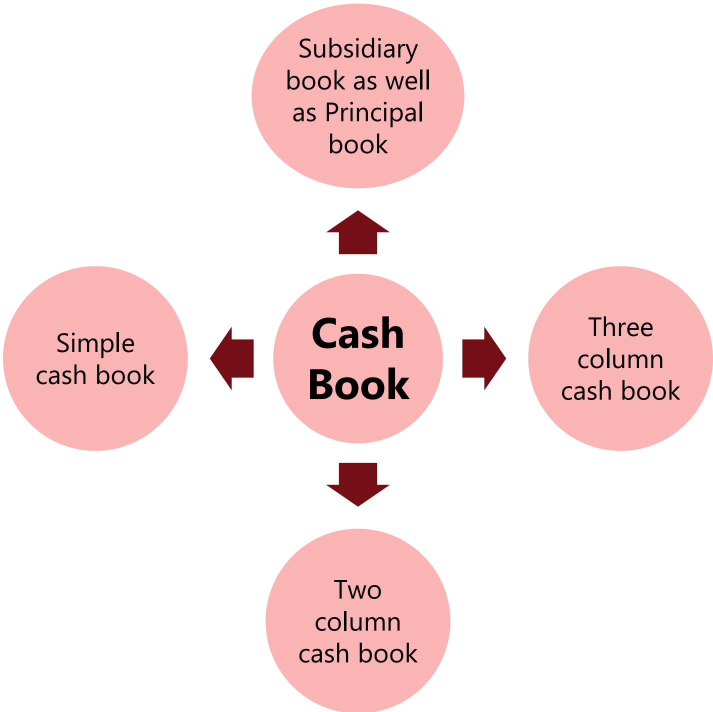
UNIT 5 : CASH BOOK

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand that a Cash Book is a type of subsidiary book but treated as a principal book.
- Be familiar with various kinds of Cash Books, viz., Simple Cash Book, Two-column Cash Book and Three-column Cash Book.
- Learn the technique of preparation of Simple Cash Book and how to balance it.
- See how Double-Column Cash Book is prepared adding discount column alongwith cash column.
- Understand the techniques of preparing Three-column Cash Book.
- Understand what is a Petty Cash Book and the Imprest System of Petty Cash.
- Note the advantages of the Petty Cash Book.
- Learn how to maintain a Petty Cash Book and how to post the entries of the Petty Cash Book in the ledger.
- Understand the accounting of credit/debit sales transactions.

UNIT OVERVIEW



5.1 CASH BOOK - A SUBSIDIARY BOOK AND A PRINCIPAL BOOK

Cash transactions are straightaway recorded in the Cash Book and on the basis of such a record, ledger accounts are prepared. Therefore, the Cash Book is a subsidiary book. But the Cash Book itself serves as the cash account and the bank account; the balances are entered in the trial balance directly. The Cash Book, therefore, is part of the ledger also. Hence, it has also to be treated as the principal book. The Cash Book is thus both a subsidiary book and a principal book.

5.2 KINDS OF CASH BOOK

The main Cash Book may be of the three types:

(i) Simple Cash Book;

(ii) Two-column Cash Book;

(iii) Three-column Cash Book.

In addition to the main Cash Book, firms also generally maintain a petty cash book but that is purely a subsidiary book.

SIMPLE CASH BOOK

Such a cash book appears like an ordinary account, with one amount column on each side. The left-hand side records receipts of cash and the right-hand side the payments.

Balancing: The cash book is balanced like other accounts. The total of receipts column is always greater than total of payments column. The difference is written on the credit side as 'By balance c/d'. The totals are then entered in the two columns opposite one another and then on the debit side the balance is written as "To Balance b/d", to show cash balance in hand in the beginning of next period.

ILLUSTRATION 1

Enter the following transactions in a Simple Cash Book:

2022		₹
Jan.1	*Cash in hand*	*1,200*
"5	*Received from Ram*	*300*
"7	*Paid Rent*	*30*
"8	*Sold goods for cash*	*300*
"10	*Paid to Shyam*	*700*
"27	*Purchased Furniture*	*200*
"31	*Paid Salaries*	*100*
"31	*Rent due, not yet paid, for January*	*30*

SOLUTION

Dr. **Cash Book** Cr.

Date 2022	Receipts	L.F.	Amount ₹	Date 2022	Payments	L.F.	Amount ₹
Jan. 1	To Balance b/d		1,200	Jan. 07	By Rent A/c		30
" 5	To Ram A/c		300	" 10	By Shyam A/c		700
" 8	To Sales A/c		300	" 27	By Furniture A/c		200

				" 31	By Salaries A/c		100
				" 31	By Balance c/d		770
			1,800				1,800
2022							
Feb. 1	To Balance b/d		770				

Note :

(i) In the simple cash book only the cash receipts and cash payments are recorded.

(ii) The total of debit side is always greater than the total of credit side since the payment cannot exceed the available cash.

(iii) The simple cash book is like an ordinary account.

(iv) Rent due not yet paid for January has not been recorded in the cash book because no cash has been paid, hence it will be recorded through normal Journal entry.

DOUBLE-COLUMN CASH BOOK

If along with column for "Amount" to record cash receipts and cash payments another column is added on each side to record the cash discount allowed or the discount received, or a column on the debit side showing bank receipts and another column on the credit side showing payments through bank. It is a double-column cash book.

Cash discount is an allowance which often accompanies cash payments. For example, if a customer owes ₹ 500 but is promised that 2% will be deducted if payment is made within a certain period, the customer can clear his account by paying promptly ₹ 490. Cash received will be ₹ 490 and ₹ 10 will be the discount for the firm receiving the payment and discount is a loss; for the person making the payment it is a gain. Since cash discount is allowed only if cash is paid, it is convenient to add a column for discount allowed on the receipt side of the cash book and a column for discount received on the payment side of the cash book.

Balancing: It should be noted that the discount columns are not balanced. They are merely totalled. The total of the discount column on the receipts side shows total discount allowed to customers and is debited to the Discount Account. The total of the column on the payments side shows total discount received and is credited to the Discount Account. The Cash columns are balanced, as already shown. The bank columns are also balanced and the balancing figure is called bank balance. Thus a double column cash book should have two columns on each side comprising of either cash and discount transaction or cash and bank transactions.

In the cash column on the debit side, actual cash received is entered; the amount of the discount allowed, if any, to the customer concerned is entered in the discount column. Similarly, actual cash paid is entered in the cash column on the payments side and discount received in the discount column. Also the bank column on the debit side records all receipts through bank and the same column on the credit side shows payment through bank.

ILLUSTRATION 2

Ganesh commenced business on 1st April, 2022 with ₹ 2,000 as capital. He had the following cash transactions in the month of April 2022:

		₹			₹
April 1	*Purchased furniture*		*April 7*	*Paid for petty expenses*	*15*
	and paid cash	*250*	*" 8*	*Cash purchases*	*150*
"2	*Purchased goods*	*500*			
"4	*Sold goods for cash*	*950*			
			13	*Paid for labour*	*1,000*
"5	*Paid cash to Ram Mohan*	*560*			
"6	*He allowed discount*	*10*	*""*	*Paid Ali & Sons*	*400*
"6	*Received cash from*			*They allowed discount*	*8*
	Krishna & Co.	*600*	*""*		
	Allowed discount	*20*			

Make out the two-column Cash Book (Cash and discount column) for the month of April, 2022.

SOLUTION

Cash Book

Dr. Date 2022	**Receipts**	**L.F.**	**Discount ₹**	**Amount ₹**	**Date 2022**	**Payments**	**L.F.**	**Discount ₹**	**Cr. Amount ₹**
April 1	To Capital A/c			2,000	April 1	By Furniture A/c			250
" 4	To Sales A/c			950	" 2	By Purchases A/c			500
" 6	To Krishna A/c		20	600					
					" 5	By Ram Mohan		10	560
					" 7	By Petty Expenses A/c			15

					" 8	By Purchases A/c			150
					" 13	By wages A/c			1,000
					" 13	By Ali & Sons		8	400
					" 30	By Balance c/d			675
			20	3,550				18	3,550
May 1	To Balance b/d			675					

To summarise:

(i) the discount columns in the cash book are totalled;

(ii) they are not balanced; and

(iii) their totals are entered in the discount received/paid account in the ledger.

Note: The person who pays, is credited by both the cash paid by him and the discount allowed to him. Similarly, the person to whom payment is made, is debited with both the amount paid and the discount allowed by him.

THREE-COLUMN CASH BOOK

A firm normally keeps the bulk of its funds at a bank; money can be deposited and withdrawn at will if it is current account. Probably payments into and out of the bank are more numerous than strict cash transactions. There is only a little difference between cash in hand and money at bank. Therefore, it is very convenient if, on each side in the cash book, another column is added to record cash deposited at bank (on the receipt side of the cash book) and payments out of the bank (on the payment side of the cash book).

For writing up the three-column cash book the under mentioned points should be noted:

1. While commencing a new business, the amount is written in the cash column if cash is introduced and in the bank column if it is directly put into the bank with the description "To Capital Account". If a new cash book is being started for an existing business, the opening balances are written as : "To Balance b/d".

2. All receipts are written on the receipts side, cash in the cash column and cheques in the bank column. If any discount is allowed to the party paying the amount, the discount is entered in the discount column. In the particulars column the name of the account in respect of which payment has been received is written.

3. All payments are written on the payments side, cash payment in the cash column and payments by cheques in the bank column. If some discount has been received from the party receiving the payment, it is entered in the discount column.

4. *Contra Entries:* Often cash is withdrawn from bank for use in the office. In such a case the amount is entered in the bank column on the payments side and also in the cash column on the receipts side. In the reverse case of cash being sent to the bank, the amount is recorded in the bank column on the receipts side and in cash column on payment side. Against such entries, the letter "C" should be written in the L.F column, to indicate that these are contra transaction and no further posting is required for them.

   Note: If initially cheques received are entered in the cash column and then sent to the bank, the entry is as if cash has been sent to the bank.

   While recording contra entries, the basic but important rules should be followed -

(a)	The Receiver	Dr.
	The Giver	Cr.
(b)	All what comes in	Dr.
	All what goes out	Cr.

   e.g. where a Cash Book with separate columns for Bank Account is maintained.

   (a) If cash is deposited in Bank Account, the Bank will be the Receiver, hence it will be Debited and as the cash is going out, cash will be credited.

   (b) If cash is withdrawn from the Bank Account, the Bank will be the Giver, hence it will be Credited and, as the cash is coming in, cash will be Debited.

5. If some cheque sent to the bank is dishonoured, i.e., the bank is not able to collect the amount, it is entered in the bank column on the credit side with the name of the concerned party in the particulars column.

6. If some cheque issued by the firm is not paid on presentation, it is entered in the Bank column on the debit side with the name of the party to whom the cheque was given.

7. In a rare case, a cheque received may be given to some other party, i.e., endorsed. On receipt, it must have been entered in the bank column on the debit side; on endorsement the amount will be written in the bank column on the credit side.

   The advantages of such type of Cash Book are that -

   (a) the Cash Account and the Bank Account are prepared simultaneously, therefore the double entry is completed in the Cash Book itself. Thus the contra entries can be easily cross-checked in Cash column in one side and the Bank column in the other side of the Cash Book. Also the chances of error are reduced.

(b) the information regarding Cash in Hand and the Bank Balance can be obtained very easily and quickly as there is no need to prepare Ledger of the Bank Account.

In case of maintaining more than one Bank Account, separate column can be add for each Bank Account. Transactions between these two or more Bank Accounts can be recorded and tallied with a much less effort.

Suppose, there are two Bank Accounts namely PNB Current Account and SBI-Cash Credit Account. Now, if a cheque is issued from PNB cheque Book to SBI Account, the receiver - i.e., SBI Account will be debited and the giver i.e. the PNB Account shall be credited.

Balancing: The discount columns are totalled but not balanced. The cash columns are balanced exactly in the same manner as indicated for the simple cash book. The process is similar for balancing the bank columns also. It is possible, however, that the bank may allow the firm to withdraw more than the amount deposited i.e., to have an overdraft, In such a case, the total of the bank column on the credit side is bigger than the one on the debit side. The difference is written on the debit side as "To Balance c/d." Then the totals are written on the two sides opposite one another, the balance is then entered on the credit side as "By Balance b/d."

However, in usual cases debits into the bank will exceed the withdrawals or payments out of the bank. Then the bank columns are balanced just like the cash columns.

ILLUSTRATION 3

Enter the following transactions in Cash Book with Discount and Bank Columns. Cheques are first treated as cash receipt.

2022		₹
Jan.1	*Chandrika commences business with Cash*	*20,000*
" 3	*He paid into Current A/c*	*19,000*
" 4	*He received cheque from Kirti & Co. on account*	*600*
" 7	*He pays in bank Kirti & Co.'s cheque*	*600*
" 10	*He pays Rattan & Co. by cheque and is allowed discount ₹ 20*	*330*
" 12	*Tripathi & Co. pays into his Bank A/c*	*475*
" 15	*He receives cheque from Warshi and allows him discount ₹ 35*	*450*

"	20	*He receives cash ₹ 75 and cheque ₹ 100 for cash sale*	
"	25	*He pays into Bank, including cheques received on 15th and 20th*	*1,000*
"	27	*He pays for cash purchase*	*275*
"	30	*He pays sundry expenses in cash*	*50*

SOLUTION

Dr. **Cash Book** Cr.

Date	Receipts	L.F.	Discount ₹	Cash ₹	Bank ₹	Date	Payments	L.F.	Discount ₹	Cash ₹	Bank ₹
2022						2022					
Jan. 1	To Capital A/c			20,000		Jan. 3	By Bank A/c	C		19,000	
3	To Cash	C			19,000	7	By Bank A/c	C		600	
4	To Kirti & Co.			600		10	By Ratan & Co.		20		330
7	To Cash	C			600	25	By Bank A/c	C		1,000	
12	To Tripathi & Co.				475	27	By Purchases A/c			275	
15	To Warshi		35	450		30	By S. Exp. A/c			50	
20	To Sales A/c			175							
25	To Cash	C			1,000						
						31	By Balance c/d			300	20,745
			35	21,225	21,075				20	21,225	21,075
Feb. 1	To Balance b/d			300	20,745						

5.3 POSTING THE CASH BOOK ENTRIES

Students would have seen that the cash columns in the cash book is actually the cash account and the bank column is actually bank account. Also, the discount columns are memorandum columns, meant only to provide information about the total discount allowed and total discount received.

The debit side columns for cash and bank indicate receipts. Therefore, the amounts debited in the cash book should be put to the credit of the account in respect of which cash or cheque has been received. For instance, in the cash book given above we see that ₹175 have been received for sale of goods. For posting, the amount is credited to the Sales Account as "By Cash ₹175." We also see M/s. Warsi have paid ₹450 and also they have been allowed ₹ 35 as discount; thus they have discharged a debt of ₹485. In the account of M/s. Warsi, the posting is on the credit side as

By Cash	₹ 450
By Discount	₹ 35
or as:	
By Sundries	₹ 485

All payments are recorded on the credit side. The particulars columns show on what account payments have been made. In the ledger accounts concerned the amount is put on the debit side. For example, the cash book shows that a cheque for ₹ 330 has been issued to M/s. Ratan & Co. and also that they have allowed a discount of ₹ 20; thus an obligation of ₹ 350 has been met. In the account of M/s. Ratan & Co. the posting is:

To Bank	₹ 330
To Discount	₹ 20
Or	
To Sundries	₹ 350

The rule thus develops: From the debit side of the cash book, credit the various accounts with their respective amounts (including any discount that may have been allowed); from the credit side of cash book, the posting will be to the debit of the accounts mentioned in the particular column with their respective amounts (including the discount which may have been received).

As has been shown already, the total of the discount columns on the debit side is debited to the discount account; the total of the column discount on the credit side is credited to the discount account. From the cash book given on the previous page ₹ 35 is debited and ₹ 20 be credited to the discount account.

5.4 PETTY CASH BOOK

In the firm a number of small payments, such as for telegrams, taxi fare, cartage, etc., have to be made. If all these payments are recorded in the cash book, it will become unnecessarily heavy. Also, the main cashier will be overburdened with work. Therefore, it is usual for firms to appoint a person as 'Petty Cashier' and to entrust the task of making small payments say below ₹ 200, to him. Of course he will be reimbursed for the payments made. Later, on an analysis, the respective account may be debited.

IMPREST SYSTEM OF PETTY CASH

It is convenient to entrust a definite sum of money to the petty cashier in the beginning of a period and to reimburse him for payments made at the end of the period. Thus, he will have again the fixed amount in the beginning of the new period. Such a system is known as the imprest system of petty cash.

The system is very useful specially if an analytical Petty Cash Book is used. The book has one column to record receipt of cash (which is only from the main cashier) and other columns to record payments of various types. The total of the various columns show why payments have been made and then the relevant accounts can be debited.

(i) The amount fixed for petty cash should be sufficient for the likely small payments for a relatively short period, say for a week or a fortnight.

(ii) The reimbursement should be made only when petty cashier prepares a statement showing total payments supported by vouchers, i.e., documentary evidence and should be limited to the amount of actual disbursements.

(iii) The vouchers should be filed in order.

(iv) No payment should be made without proper authorisation. Also, payments above a certain specified limit should be made only by the main cashier.

(v) The petty cashier should not be allowed to receive any cash except for reimbursement.

In the petty cash book the extreme left-hand column records receipts of cash. The money column towards the right hand side shows total payments for various purposes; a column is usually provided for sundries to record infrequent payments. The sundries column is analysed. At the end of the week or the fortnight the petty cash book is balanced. The method of balancing is the same as for the simple cash book.

ILLUSTRATION 4

Prepare a Petty Cash Book on the imprest System from the following:

2022			₹
Jan.	*1*	*Received ₹100 for petty cash*	
"	*2*	*Paid bus fare*	*.50*
"	*2*	*Paid cartage*	*2.50*
"	*3*	*Paid for Postage*	*5.00*
"	*3*	*Paid wages for casual labourers*	*6.00*
"	*4*	*Paid for stationery*	*4.00*
"	*4*	*Paid Bus charges*	*2.00*
"	*5*	*Paid for the repairs to chairs*	*15.00*
"	*5*	*Bus fare*	*1.00*

"	*5*	*Cartage*	*4.00*
"	*6*	*Postage*	*7.00*
"	*6*	*Bus charges*	*3.00*
"	*6*	*Cartage*	*3.00*
"	*6*	*Stationery*	*2.00*
"	*6*	*Refreshments to customers*	*5.00*

SOLUTION

Petty Cash Book

Receipts ₹	Date 2022	V. No.*	Particulars	Total ₹	Con-veyance ₹	Cartage ₹	Statio-nery ₹	Postage ₹	Wages ₹	Sundries ₹
100	Jan.1		To Cash							
	2	1	By Conveyance	.50	.50					
		2	By Cartage	2.50		2.50				
	3	3	By Postage	5.00				5.00		
		4	By Wages	6.00					6.00	
	4	5	By Stationery	4.00			4.00			
		6	By Conveyance	2.00	2.00					
	5	7	By Repairs to Furniture	15.00						15.00
		8	By Conveyance	1.00	1.00					
		9	By Cartage	4.00		4.00				
	6	10	By Postage	7.00				7.00		
	"	11	By Conveyance	3.00	3.00					
	"	12	By Cartage	3.00		3.00				
	"	13	By Stationery	2.00			2.00			
	"	14	By General Expenses	5.00						5.00
				60.00	6.50	9.50	6.00	12.00	6.00	20.00
			By Balance c/d	40.00						
100				100.00						
40.00			To Balance b/d							
60.00	8		To Cash							

* Voucher Numbers

ADVANTAGES OF PETTY CASH BOOK

There are mainly three advantages:

(i) Saving of time of the chief cashier;

(ii) Saving in labour in writing up the cash book and posting into the ledger; and

(iii) Control over small payments.

POSTING THE PETTY CASH BOOK

In the ledger, a petty cash account is maintained, when an amount is given to the petty cashier, the petty cash account is debited. Each week or forthnight, the total of the payments made is credited to this account. The petty cash account will then show the balance in the hand of the cashier; on demand he should be able to produce it for counting. At the end of the period/year, the balance is shown in the balance sheet as part of cash balance.

Of course, the payments must be debited to their respective accounts as shown by the petty cash book. For this two methods may be used:

(i) From the petty cash book the total of the various columns may be directly debited to the concerned accounts; or

(ii) A journal entry may first be prepared on the basis of the petty cash book, debiting the accounts shown by the various analysis columns, and crediting the total of the payment of the petty cash accounts.

For Illustration 4 the journal entry and relevant accounts are as follows:

2022		Dr. ₹	Cr. ₹
Jan. 6	Conveyance Account	6.50	
	Cartage Account	9.50	
	Stationery Account	6.00	
	Postage Account	12.00	
	Wages Account	6.00	
	Repairs Account	15.00	
	General Expenses Account	5.00	
	To Petty Cash Account		60.00
	(Being the analysis of the Petty Cash Book for the week ending Jan. 6)		

	Entry for cash handed over to the Petty Cashier		
	Petty Cash Account	60	
	To Cash Account		60
	(Being Cash received)		

Petty Cash Account

Date 2022	Particulars	Folio	Amount ₹	Date 2022	Particulars	Folio	Amount ₹
Jan.1	To Cash		100.00	Jan. 6	By Sundries:		
"6	To Cash		60.00		Conveyance		6.50
					Cartage		9.50
					Stationery		6.00
					Postage		12.00
					Wages		6.00
					Repairs		15.00
					General Expenses		5.00

ILLUSTRATION 5

Enter the following transaction in Cash Book with Discount and Bank columns. Cheques are first treated as cash receipts –

2022		*₹*
March 1	*Cash in Hand*	*15,000*
	Overdraft in Bank	*500*
2	*Cash Sales*	*3,000*
3	*Paid to Sushil Bros. by cheque*	*3,400*
	Discount received	*100*
5	*Sales through credit card*	*2,800*
6	*Received cheque from Srijan*	*6,200*
7	*Endorsed Srijan's cheque in favour of Adit*	
9	*Deposit into Bank*	*6,800*
10	*Received cheque from Aviral and deposited the same into Bank by allowing discount of ₹ 50*	*3,600*

12	*Adit informed that Srijan's cheque is dishonoured. Now cash is received from Srijan and amount is paid to Adit through own cheque*	
15	*Sales through Debit Card*	*3,200*
24	*Withdrawn from Bank*	*1,800*
28	*Paid to Sanchit by cheque*	*3,000*
30	*Bank charged 1% commission on sales through Debit/Credit Cards*	

SOLUTION

Dr. **Cash Book** Cr.

Date	Particulars	L.F.	Discount ₹	Cash ₹	Bank ₹	Date	Particulars	L.F.	Discount ₹	Cash ₹	Bank ₹
2022						2022					
March 1	To Balance b/d			15,000		March 1	By Balance b/d				500
2	To Sales			3,000		3	By Sushil Bros.		100		3,400
5	To Sales				2,800	7	By Adit			6,200	
6	To Srijan			6,200		9	By Bank	C		6,800	
9	To Cash A/c	C			6,800	12	By Adit				6,200
10	To Aviral		50		3,600	24	By Cash A/c	C			1,800
12	To Srijan			6,200		28	By Sanchit				3,000
15	To Sales A/c				3,200	30	By Commission				60
24	To Bank A/c	C		1,800		31	By Balance c/d			19,200	1,440
			50	32,200	16.400				100	32,200	16,400

Note: If the received cheque is endorsed to the other party on the same day, then no entry is required. However, in the above case posting has been done through cash column as the endorsement is done on next day.

5.5 ENTRIES FOR SALE THROUGH CREDIT/DEBIT CARDS

Now-a-days sales through Credit/Debit Cards are issued by almost every Bank in India either directly or with collaboration of some other agencies. HSBC Card, SBI Card, BOB Card, ICICI Bank Card, HDFC Card and Andhra Bank Card are some of the popular Cards.

The procedure for issuing Credit/Debit Cards are as follows -

1. A small Plastic Card, called Credit Card is issued by the bank to a prospective customer, after verifying his credibility, which is generally measured by his income sources. Debit Card is issued by bank to a customer who has an account with the bank. Now a days ATM Card issued by the bank can also be used as Debit Card. This card would contain an embossed 16 digit number and also the name of the cardholder.
2. Generally Bank charges annual subscription fees from the credit card holder. No fee is charged in case of Debit Card, though some banks charge a nominal fee on Debit Card also.
3. When the Card holder intends to buy some goods or services through Credit or Debit Card, the seller insert the customer's debit/credit card in the card machine and inputs the amount of sales and gives back to customers for feeding the password (i.e Personal Identification Number – PIN) for authorising the transactions. One copy of the receipt is given to the customer and other once is kept by the sellier for its record.
4. The seller sums up the different amounts sold like this and submits, generally everyday, to his bank all the forms. The amount is credited by the bank to the seller's account and debited to the account of the Bank or the company issuing the Credit/Debit Card.
5. The bank issuing the Card, charges commission for each such transaction, which varies between 1% to 4% and is immediately debited to seller's bank account.
6. The bank sends a monthly statement to the card holder. In case of Debit Card the account is immediately debited to the card holder's account, whereas in case of Credit Card, card holder has to pay the amount in full or part. However, if not paid in full, the interest is charged.

ACCOUNTING FOR CREDIT/DEBIT CARD SALE

From the seller's point of view, this type of sale is equivalent to a cash sale. Commission charged by the bank will be treated as selling expenses. The following journal entries will be made in the seller's books of accounts.

1.	Bank A/c	Dr.
	To Sales Account	
	(Sales made through Credit/Debit Card)	
2.	Commission Account	Dr.
	To Bank Account	
	(Commission charged by bank)	

SUMMARY

- Cash book contains cash transactions and also bank transactions, if it has a separate book column. It is both a subsidiary book and a principal book.
- Cash book can be prepared with discount column also.
- For small payments, petty cash book is maintained separately for recording the particulars of payment and its amount. The fixed amount is given to the petty cashier for making small payments in the beginning of the period. The amount spent is replenished so that he will have again the fixed sum in the beginning of the next period. This system is known as imprest system of petty cash book.

TEST YOUR KNOWLEDGE

True and False

1. *Cash book is a subsidiary book as well as a principal book.*
2. *Two column cash book consists of two columns cash column & bank column.*
3. *Discount column of cash book is never balanced.*
4. *Contra entry is passed in a two column cash book.*
5. *If the bank column is showing the opening balance on credit side, it is an overdraft.*
6. *A cash book records cash transactions as well as credit transactions.*
7. *Discount column of cash book records the trade discount.*

Multiple Choice Questions

1. *The total of discounts column on the debit side of the cash book, recording cash discount deducted by customers when paying their accounts, is posted to the ___________________________*

   (a) *Credit of the discount allowed account.*

   (b) *Debit of the discount allowed account*

   (c) *Credit of the discount received account.*

2. *Cash book is a type of __________ but treated as a ____________ of accounts.*

   (a) *Subsidiary book, principal book*

   (b) *Principal book, subsidiary book*

   (c) *Subsidiary book, subsidiary book*

3. *Which of the following is not a column of a three-column cash book?*
   (a) *Cash column*
   (b) *Bank column*
   (c) *Petty cash column*
4. *Contra entries are passed only when ________________________*
   (a) *Double-column cash book is prepared*
   (b) *Three-column cash book is prepared*
   (c) *Simple cash book is prepared*
5. *The Cash Book records ________________________*
   (a) *All cash receipts*
   (b) *All cash payments*
   (c) *All cash receipts and payments*
6. *The balance in the petty cash book is ________________________*
   (a) *An expense*
   (b) *A profit*
   (c) *An asset*
7. *If Ram has sold goods for cash, the entry will be recorded ________________________*
   (a) *In the Cash Book*
   (b) *In the Sales Book*
   (c) *In the Journal*

Theory Questions

1. *Is cash book a subsidiary book or a principal book? Explain.*
2. *What are the various kinds of cash book?*
3. *What are the advantages of a three column cash book?*

Practical Questions

1. *Shri Ramaswamy maintains a Columnar Petty Cash Book on the Imprest System. The imprest amount is ₹500. From the following information, show how his Petty Cash Book would appear for the week ended 12th September, 2022:*

		₹
7-9-2022	*Balance in hand*	*134.90*
	Received Cash reimbursement to make up the imprest	*365.10*
	Stationery	*49.80*
8-9-2022	*Miscellaneous Expenses*	*20.90*
9-9-2022	*Repairs*	*156.70*
10-9-2022	*Travelling*	*68.50*
11-9-2022	*Stationery*	*71.40*
12-9-2022	*Miscellaneous Expenses*	*6.30*
13-9-2022	*Repairs*	*48.30*

ANSWERS/HINTS

True and False

1. True: Since the balance is directly taken to the Trial balance from cash book. Hence, it is a subsiadiary book as well as principal book.

2. True: Two column cash book consists of two columns either cash column & discount column or cash column & bank column.

3. True: Discount column is totalled and transferred to the discount allowed or received account.

4. False: Contra entry is passed in a three column cash book which includes bank and cash columns.

5. True: The debit side of opening balance shows a favourable balance, whereas the credit balance is an unfavourable balance and treated as overdraft.

6. False: A cash book records only cash transactions.

7. False: Discount column of cash book records the cash discount. Trade discount is not shown in the books of accounts.

Multiple Choice Questions

1.	**(b)**	2.	**(a)**	3.	**(c)**	4.	**(b)**	5.	**(c)**	6.	**(c)**
7.	**(a)**										

Theoretical Questions

1. Cash transactions are straightaway recorded in the Cash Book and on the basis of such a record, ledger accounts are prepared. Therefore, the Cash Book is a subsidiary book. But the Cash Book itself serves as the cash account and the bank account, if bank column is also included; the balances are entered in the trial balance directly. The Cash Book, therefore, is part of the ledger also. Hence, it is also treated as the principal book. The Cash Book is thus both a subsidiary book and a principal book.

2. The main Cash Book may be of the three types:

(i) Simple Cash Book;

(ii) Two-column Cash Book;

(iii) Three-column Cash Book.

In addition to the main Cash Book, firms also generally maintain a petty cash book but that is purely a subsidiary book.

3. The advantages of three column Cash Book are that -

(a) the Cash Account and the Bank Account are prepared simultaneously, therefore the double entry is completed in the Cash Book itself. Thus the contra entries can be easily cross-checked in Cash column in one side and the Bank column in the other side of the Cash Book. The chances of error are also reduced.

(b) the information regarding Cash in Hand and the Bank Balance can be obtained very easily and quickly as there is no need to prepare Ledger of the Cash and Bank Account.

Practical Problems

1. **Petty Cash Book**

Date 2022	Receipts	Amount ₹	Date 2022	Payments	Total Amount ₹	Stationery ₹	Travelling ₹	Misc Exps. ₹	Repairs ₹
Sept. 7	To Balance b/d	134.90	7	By Stationery	49.80	49.80			
	To Reimbursement	365.10	8	By Misc. Expenses	20.90			20.90	
			9	By Repairs	156.70				156.70
			10	By Travelling	68.50		68.50		
			11	By Stationery	71.40	71.40			
			12	By Misc. Expenses	6.30			6.30	
			13	By Repairs	48.30				48.30
					421.90	121.20	68.50	27.20	205.00
				By Balance c/d	78.10				
		500.00			500.00				
	To Balance b/d	78.10							

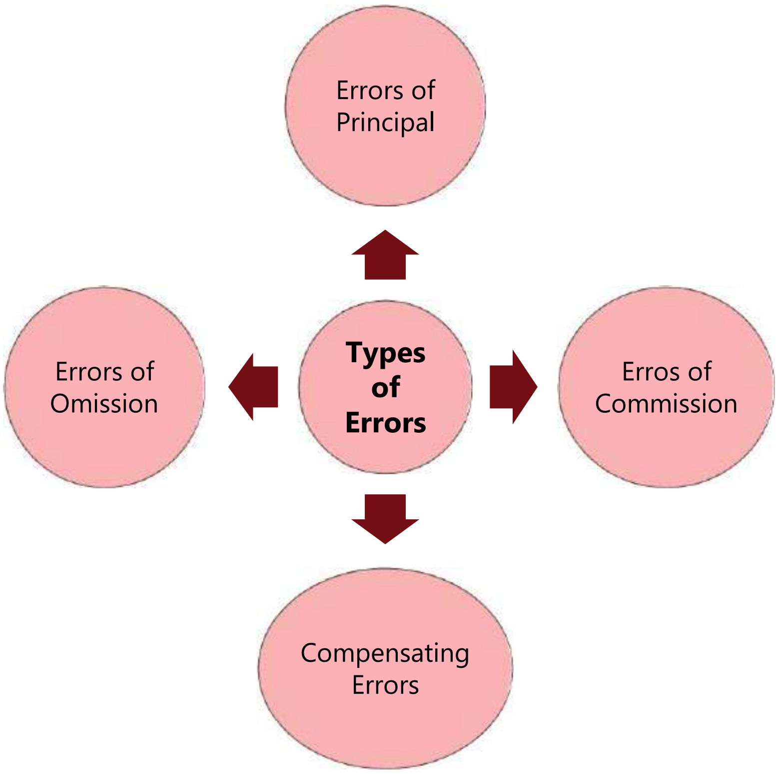
UNIT 6 : RECTIFICATION OF ERRORS

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand different types of errors which may occur in the course of recording transactions and events.
- Be familiar with the steps involved in locating errors.
- Learn the nature of one-sided errors and two-sided errors.
- Understand why suspense account is opened for rectification of errors.
- Understand the technique of correcting errors of one period in the next accounting period.

UNIT OVERVIEW



6.1 INTRODUCTION

Unintentional omission or commission of amounts and accounts in the process of recording the transactions are commonly known as errors. These various unintentional errors can be committed at the stage of collecting financial information/data on the basis of which financial statements are drawn or at the stage of recording this information. Also errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight. To check the arithmetic accuracy of the journal and ledger accounts, trial balance is prepared. If the trial balance does not tally, then it can be said that there are errors in the accounts which require rectification thereof. Some of these errors may affect the Trial Balance and some of these do not have any impact on the Trial Balance although such errors may affect the determination of profit or loss, assets and liabilities of the business.

Illustrative Case of Errors and their Nature

We have seen that after preparing ledger accounts a trial balance is taken out where debit and credit balances are separately listed and totalled. If the totals of debit and credit do not agree, it is definite that there are some errors We shall now study the types of errors which may be committed and how they may be rectified. For this purpose, the working of the following illustrative cases should be carefully seen.

Illustrative Cases of Errors

(a) **Wrong Entry:** Let us start from the first phase of the accounting process. Where wrong amount of transactions and events are recorded in the subsidiary books, Journal Proper and Cash Book.

Example 1: Credit purchases ₹17,270 are entered in the Purchases Day Book as ₹17,720. Credit sales of ₹15,000 gross less 1% trade discount are wrongly entered in Sales Day Book at ₹15,000. Cheque issued ₹19,920 are wrongly entered in the credit of bank column in the Cash Book as ₹19,290.

(b) **Wrong casting of subsidiary books:** Subsidiary books are totalled periodically and posted to the appropriate ledger accounts. There may be totalling errors. Totalling errors may arise due to wrong entry or simply these may be independent errors.

Example 2: For the month of January, 2022 total of credit sales are ₹1,75,700, this is wrongly totalled as ₹1,76,700 and posted to sales account as ₹1,76,700.

(c) **In case of cash book,** wrong castings will result in wrong calculation of the balance c/d.

Example 3: The following cash transactions of M/s. Tularam & Co. occurred:

2023

Jan. 1	Balance - cash ₹1,200 bank ₹16,000;
Jan. 2	Cheque issued to M/s. Bholaram & Co., a supplier, for ₹22,500;
Jan. 6	Cheque collected from M/s. Scindia & Bros. ₹42,240 and deposited for clearance;
Jan. 7	Cash sales ₹27,200 and paid wages ₹12,400;
Jan. 8	Cash sales ₹ 37,730 and cash deposited to bank ₹ 35,000.

The following Cash Book entries are passed:

Dr. **Cash Book** Cr.

Date	Particulars	Cash	Bank	Date	Particulars	Cash	Bank
2023		₹	₹	2023		₹	₹
Jan. 1	To Balance b/d	1,200	16,000	Jan. 2	By M/s Bholaram & Co. A/c		22,500

Jan. 6	To M/s. Scindia & Bros. A/c		**42,420**		By Wages A/c	**12,200**	
Jan. 7	To Sales A/c	27,200			By Bank A/c	**34,500**	
Jan. 8	To Sales A/c	**37,370**			By Balance c/d	19,070	71,420
Jan. 8	To Cash A/c		**34,500**				
		65,770	**93,920**			65,770	**93,920**

Wrong entries and wrong casting are shown in bold prints. However, errors of cash entries generally are not carried. Usually cash balances are tallied daily. So errors are identified at an early stage. But bank balance cannot be checked daily and thus errors may be carried until bank reconciliation is done. In the above example, there are four wrong entries and one wrong casting. Bank and cash balances are affected by these errors.

(d) **Wrong posting from subsidiary books:** In this case, the wrong amount may be posted to the ledger account or the amount may posted to the wrong side or to the wrong account. For example, purchases from A may be posted to B's account.

(e) **Wrong casting of ledger balances:** Likewise Cash Book, any ledger account balance may be casted wrongly. Obviously wrong postings make the balance wrong; but that is not wrong casting of balances. Whenever there arises independent casting error as in the case of bank column in the Cash Book of example (4), that is called wrong casting to ledger balances.

Example 4: The following are the credit purchases of M/s. Ballav Bros.:

2023

Jan. 1 Purchases from M/s. Saurabh & Co.- gross ₹1,00,000 less 1% trade discount.

Jan. 3 Purchases from M/s. Netai & Co.- gross ₹ 70,000 less 1% trade discount.

Jan. 6 Purchases from M/s. Saurabh & Co.- gross ₹ 60,000 less 1% trade discount

Let us cast M/s. Saurabh & Co.'s Account:

Dr. **M/s Saurabh & Co. Account** Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2023			**2023**		
Jan. 1	To Balance c/d	1,55,400	Jan. 1	By Purchases A/c	99,000
			Jan. 6	By Purchases A/c	59,400
		1,55,400			***1,55,400**

*While casting the credit side, an error has been committed and so the account is wrongly balanced.

Example 5: Goods are purchased on credit from M/s. Saurabh & Co. for ₹ 27,030 and from M/s. Karnataka Suppliers for ₹ 28,050. The following Purchase Day Book is prepared:

Purchases Day Book

Date	Particulars	Amount
		₹
	M/s. Saurabh & Co.	27,050
	M/s. Karnataka Suppliers	28,030
		55,080

In the above Purchase Day Book, both the transactions are entered wrongly but the first error has been compensated by the second. Even if these errors are not rectified Trial Balance would tally.

Trial Balance

Particulars	Dr.	Cr.
	₹	₹
M/s. Saurabh & Co.		27,050
M/s. Karnataka Suppliers		28,030
Purchases Account	55,080	
	55,080	55,080

6.2 STAGES OF ERRORS

Errors may occur at any of the following stages of the accounting process:

AT THE STAGE OF RECORDING THE TRANSACTIONS IN JOURNAL

Following types of errors may happen at this stage:

(i) Errors of principle,

(ii) Errors of omission,

(iii) Errors of commission.

AT THE STAGE OF POSTING THE ENTRIES IN LEDGER

(i) Errors of omission:

(a) Partial omission,

(b) Complete omission.

(ii) Errors of commission:

(a) Posting to wrong account,

(b) Posting on the wrong side,

(c) Posting of wrong amount.

AT THE STAGE OF BALANCING THE LEDGER ACCOUNTS

(i) Wrong Totalling of accounts,

(ii) Wrong Balancing of accounts.

AT THE STAGE OF PREPARING THE TRIAL BALANCE

(i) Errors of omission,

(ii) Errors of commission:

(a) Taking wrong account,

(b) Taking wrong amount,

(c) Taking to the wrong side.

On the above basis, we can classify the errors in four broad categories:			
Errors of Principle	Errors of Omission	Errors of Commission	Compensating Errors

6.3 TYPES OF ERRORS

Basically errors are of two types:

(a) **Errors of principle:** When a transaction is recorded in contravention of accounting principles, like treating the purchase of an asset as an expense, it is an error of principle. In this case, there is no effect on the trial balance since the amounts are placed on the correct side, though in a wrong account. Suppose on the purchase of a computer, the office expenses account is debited; the trial balance will still agree.

(b) **Clerical errors:** These errors arise because of mistake committed in the ordinary course of the accounting process. These are of three types:

(i) *Errors of Omission:* If a transaction is completely or partially omitted from the books of account, it will be a case of omission. Examples would be: not recording a credit purchase of furniture or not posting an entry into the ledger.

(ii) *Errors of Commission:* If an amount is posted in the wrong account or it is written on the wrong side or the totals are wrong or a wrong balance is struck, it will be a case of "errors of commission."

(iii) *Compensating Errors:* If the effect of errors committed cancel out, the errors will be called compensating errors. The trial balance will agree. Suppose an amount of ₹10 received from A is not credited to his account and the total of the sales book is ₹10 in excess. The omission of credit to A's account will be made up by the increased credit to the Sales Account.

From another point of view, error may be divided into two categories:

(a) Those that affect the trial balance - because of these errors, trial balance does not agree; these are the following:

(i) Wrong casting of the subsidiary books.

(ii) Wrong balancing of an account.

(iii) Posting an amount on the wrong side.

(iv) Posting the wrong amount.

(v) Omitting to post an amount from a subsidiary book.

(vi) Omitting to post the totals of subsidiary book.

(vii) Omitting to write the cash book balances in the trial balance.

(viii) Omitting to write the balance of an account in the trial balance.

(ix) Writing a balance in wrong column of the trial balance.

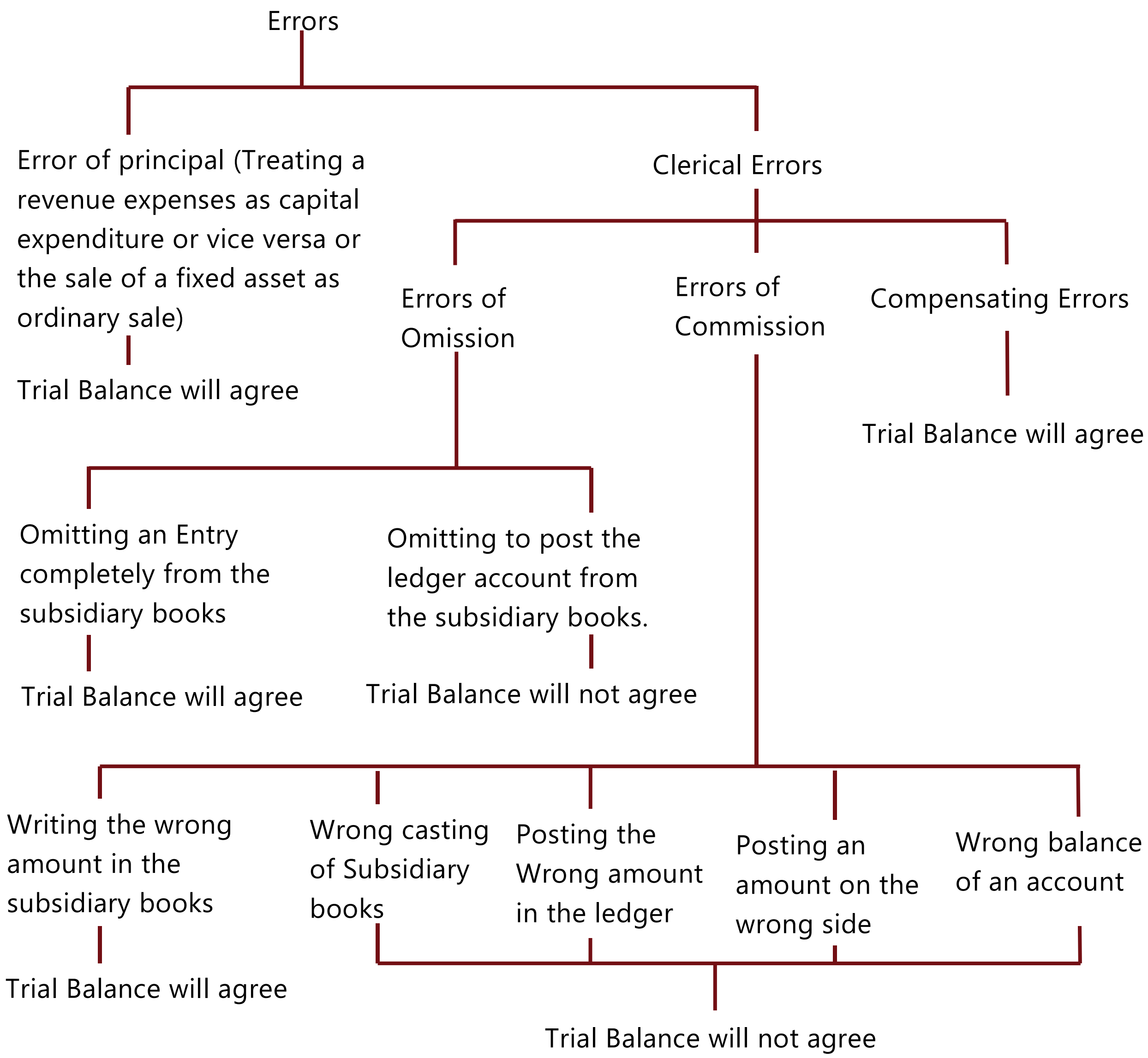
(x) Totalling the trial balance wrongly.

(b) The errors that do not affect the trial balance are the following:

(i) Omitting an entry altogether from the subsidiary book.

(ii) Making an entry with the wrong amount in the subsidiary book.

(iii) Posting an amount in a wrong account but on the correct side, e.g., an amount to be debited to A is debited to B, the trial balance will still agree.



6.4 STEPS TO LOCATE ERRORS

Even if there is only a very small difference in the trial balance, the errors leading to it must be located and rectified. A small difference may be the result of a number of errors. The following steps will be useful in locating errors :

(i) The two columns of the trial balance should be totalled again. If in place of a number of accounts, only one amount has been written in the trial balance the list of such accounts should be checked and totalled again. List of Trade receivables is the example from which Trade receivable balance is derived.

(ii) It should be seen that the cash and bank balances have been written in the trial balance.

(iii) The exact difference in the trial balance should be established. The ledger should be gone through again; it is possible that a balance equal to the difference has been omitted from the trial balance. The difference should also be halved; it is possible that balance equal to half the difference has been written in the wrong column.

(iv) The ledger accounts should be balanced again.

(v) The casting of subsidiary books should be checked again, especially if the difference is ₹ 1, ₹ 100 etc.

(vi) If the difference is very big, the balance in various accounts should be compared with the corresponding accounts in the previous period. If the figures differ materially, those cases should be further scrutinised; it is possible that an error has been committed. Suppose the sales account for the current year shows a balance of ₹ 32,53,000 whereas it was ₹ 36,45,000 last year; it is possible that there is an error in the Sales Account.

(vii) Postings of the amounts equal to the difference or half the difference should be checked. It is possible that an amount has been omitted to be posted or has been posted on the wrong side.

(viii) If there is still a difference in the trial balance, a complete checking will be necessary. The posting of all the entries including the opening entry should be checked. It may be better to begin with the nominal accounts.

6.5 RECTIFICATION OF ERRORS

Errors should never be corrected by overwriting. The correction should be made by making another suitable entry, called as rectification entry. In fact the rectification of an error depends on at which stage it is detected. An error can be detected at any one of the following stages:

(a) Before preparation of Trial Balance.

(b) After Trial Balance but before the final accounts are drawn.

(c) After final accounts, i.e., in the next accounting period.

6.5.1 Before preparation of Trial Balance

There are some errors which affect one side of an account or which affect more than one account in such a way that it is not possible to pass a complete rectification entry. In other words, there are some errors which can be corrected, if detected at this stage, by making rectification statement in the appropriate side(s) of concerned account(s). It is important to note here that such errors may involve only one account or more than one account. Read the following illustrations:

(i) The sales book for November is undercast by ₹ 200. The effect of this error is that the Sales Account has been credited short by ₹ 200. Since the account is posted by the total of the sales book, there is no error in the accounts of the customers since they are posted with amounts of individual sales. Hence only the Sales Accounts is to be corrected. This will be done by making an entry for ₹ 200 on the credit side: "By undercasting of Sales Book for November ₹ 200".

(ii) While posting the discount column on the debit side of the cash book the discount of ₹ 10 allowed to Ramesh has not been posted. There is no error in the cash book, the total of discount column presumably has been posted to the discount account on the debit side. The error is in not crediting Ramesh by ₹ 10. This should now be done by the entry "By omission of posting of discount on ----- ₹10".

(iii) ₹ 200 received from Ram has been entered by mistake on the debit side of his account. Since the cash book seems to have been correctly written, the error is only in the account of Ram - he should have been credited and not debited by ₹ 200. Not only the wrong debit is to be removed but also a credit of ₹ 200 is to be given. This can be done now by entering ₹ 400 on the credit side of his account. The entry will be "By Posting on the wrong side - ₹ 400".

(iv) ₹ 50 was received from Mahesh and entered on the debit side of the cash book but was not posted to his account. By the error, which affects only the account of Mahesh, ₹ 50 has been omitted from the credit side of his account. The rectification will be by the entry. "By Omission of posting on the ₹ 50."

(v) ₹ 51 paid to Mohan has been posted as ₹15 to the debit of his account. Mohan has been debited short by ₹ 36. The rectifying entry is "To mistake in posting on ₹ 36".

(vi) Goods sold to Ram for ₹1,000 was wrongly posted from sales day book to the debit of purchase account. Ram has however been correctly debited. Here the error affects two accounts, viz., purchases account and sales account but we cannot pass a journal entry for its rectification because both the accounts need to be credited. The rectification will be done by the entry "By wrong posting on ₹ 1,000" in the credit of purchases account and also "By omission of posting on - ₹ 1,000" in the credit sales account.

(vii) Bills receivable from Mr. A of ₹ 500 was posted to the credit of Bills payable Account and also credited to A account. Here also although two accounts are involved we cannot pass a complete journal entry for rectification. The rectification will be done by the entry "To wrong posting on ₹ 500" in debit of Bills payable Account and also "To omission of posting on ₹ 500" in the debit of Bills Receivable Account.

(viii) Goods purchased from Vinod for ₹ 1,000 was wrongly credited to Vimal account by ₹ 100. Again we cannot pass a complete journal entry for rectification even though two accounts are involved. The rectification will be done by the entry "To wrong posting on ₹100" in the debit of Vimal account and "By omission of posting on ₹ 1,000" in the credit of Vinod account.

Thus, from the above illustrations, it is clear that the general rule of errors affecting two accounts can be corrected by a journal entry does not hold true always.

ILLUSTRATION 1

How would you rectify the following errors in the book of Rama & Co.?

1. *The total to the Purchases Book has been undercast by ₹ 100.*
2. *The Returns Inward Book has been undercast by ₹ 50.*
3. *A sum of ₹ 250 written off as depreciation on Machinery has not been debited to Depreciation Account.*
4. *A payment of ₹ 75 for salaries (to Mohan) has been posted twice to Salaries Account.*
5. *The total of Bills Receivable Book ₹ 1,500 has been posted to the credit of Bills Receivable Account.*
6. *An amount of ₹151 for a credit sale to Hari, although correctly entered in the Sales Book, has been posted as ₹ 115.*
7. *Discount allowed to Satish ₹25 has not been entered in the Discount Column of the Cash Book. the amount has been posted correctly to the credit of his personal account.*

SOLUTION

1. The Purchases Account should receive another debit of ₹100 since it was debited short previously:

   "To Undercasting of Purchases Book for the month of --- ₹100."

2. Due to this error the Returns Inward Account has been posted short by ₹ 50 : the correct entry will be:

   "To Undercasting of Returns Inward Book for the month of --- ₹50."

3. The omission of the debit to the Depreciation Account will be rectified by the entry:

   "To Omission of posting on ₹ 250".

4. The excess debit will be removed by a credit in the Salaries Account by the entry:

   "By double posting on ₹ 75".

5. ₹1,500 should have been debited to the Bills Receivable Account and not credited. To correct the mistake, the Bills Receivable Account should be debited by ₹ 3,000 by the entry:

   "To Wrong posting of B/R received on ₹ 3,000"

6. Hari's personal A/c is debited ₹ 36 short. The rectification entry will be:

   "To Wrong posting ₹ 36".

7. Due to this error, the discount account has been debited short by ₹ 25. The required entry is :

   "To Omission of discount allowed to Satish on ₹ 25."

So far we have discussed the correction of errors which affected only one Account or more than one account but for which rectifying entries were not complete journal entries. We shall now take up the correction of errors which affect more than one account in such a way that complete journal entries are possible for their rectification. Read the following illustrations:

(i) The purchase of machinery for ₹ 2,000 has been entered in the purchases book. The effect of the entry is that the account of the supplier Ram & Co. has been credited by ₹ 2,000 which is quite correct. But the debit to the Purchases Account is wrong : the debit should be to Machinery Account. To rectify the error, the debit in the purchases Account has to be transferred to the Machinery Account. The correcting entry will be to Credit Purchases Account and debit the Machinery Account. Please see the three entries made below: the last entry rectifies the error:

Particulars	**Debits** ₹	**Credits** ₹
Wrong Entry:		
Purchases Account	2,000	
To Ram & Co.		2,000
Correct Entry:		
Machinery Account	2,000	
To Ram & Co.		2,000
Rectifying Entry:		
Machinery Account	2,000	
To Purchases Account		2,000

(ii) ₹100 received from Kamal Kishore has been credited in the account of Krishan Kishore. The error is that there is a wrong credit in the account of Krishan Kishore and omission of credit in the account of Kamal Kishore; Krishan Kishore should be debited and Kamal Kishore be credited. The following three entries make this clear:

Particulars	**Debits** ₹	**Credits** ₹
Wrong Entry:		
Cash Account	100	
To Krishan Kishore		100
Correct Entry:		
Cash Account	100	
To Kamal Kishore		100
Rectifying Entry:		
Krishan Kishore	100	
To Kamal Kishore		100

(iii) The sale of old machinery, ₹1,000 has been entered in the sales book. By this entry the account of the buyer has been correctly debited by ₹1,000. But instead of crediting the Machinery Account. Sales Account has been credited. To rectify the error this account should be debited and the Machinery Account credited. See the three entries given below:

Particulars	**Debits** ₹	**Credits** ₹
Wrong Entry:		
Buyer's Account	1,000	
To Sales Account		1,000
Correct Entry:		
Buyer's Account	1,000	
To Machinery Account		1,000
Rectifying Entry:		
Sales Account	1,000	
To Machinery Account		1,000

ILLUSTRATION 2

The following errors were found in the book of Ram Prasad & Sons. Give the necessary entries to correct them.

(1) *₹ 500 paid for furniture purchased has been charged to ordinary Purchases Account.*

(2) *Repairs made were debited to Building Account for ₹ 50.*

(3) *An amount of ₹100 withdrawn by the proprietor for his personal use has been debited to Trade Expenses Account.*

(4) *₹100 paid for rent debited to Landlord's Account.*

(5) *Salary ₹ 125 paid to a clerk due to him has been debited to his personal account.*

(6) *₹ 100 received from Shah & Co. has been wrongly entered as from Shaw & Co.*

(7) *₹ 700 paid in cash for a typewriter was charged to Office Expenses Account.*

SOLUTION

Journal

Sr. No.	Particulars	Dr. ₹	Cr. ₹
(1)	Furniture A/c	500	
	To Purchases A/c		500
	(Correction of wrong debit to Purchases A/c for furniture purchased)		
(2)	Repairs A/c	50	
	To Building A/c		50
	(Correction of wrong debit to building A/c for repairs made)		
(3)	Drawings A/c.	100	
	To Trade Expenses A/c		100
	(Correction of wrong debit to Trade Expenses A/c for cash withdrawn by the proprietor for his personal use)		
(4)	Rent A/c	100	
	To Landlord's Personal A/c		100
	(Correction of wrong debit to landlord's A/c for rent paid)		

(5)	Salaries A/c To Clerk's (Personal) A/c (Correction of wrong debit to Clerk's personal A/c for salaries paid)	125	 125
(6)	Shaw & Co. To Shah & Co. (Correction of wrong credit to Shaw & Co. Instead of Shah & Co.)	100	 100
(7)	Typewriter A/c To Office Expenses A/c (Correction of wrong debit to Office Expenses A/c for purchase of typewriter)	700	 700

ILLUSTRATION 3

Give journal entries to rectify the following:

(1) A purchase of goods from Ram amounting to ₹150 has been wrongly entered through the Sales Book.

(2) A Credit sale of goods amounting ₹120 to Ramesh has been wrongly passed through the Purchase Book.

(3) On 31st December, 2022 goods of the value of ₹ 300 were returned by Hari Saran and were taken into inventory on the same date but no entry was passed in the books.

(4) An amount of ₹ 200 due from Mahesh Chand, which had been written off as a Bad Debt in a previous year, was unexpectedly recovered, and had been posted to the personal account of Mahesh Chand.

(5) A Cheque for ₹ 100 received from Man Mohan was dishonoured and had been posted to the debit of Sales Returns Account.

SOLUTION

Journal

Sr.No.	Particulars	Dr.(₹)	Cr.(₹)
(1)	Purchases A/c Sales A/c To Ram (Correction of wrong entry in the sales Book for a purchases of goods from Ram)	150 150	 300

(2)	Ramesh	240	
	To Purchases A/c		120
	To Sales A/c		120
	(Correction of wrong entry in the Purchases Book of a credit sale of goods to Ram)		
(3)	Returns Inwards A/c	300	
	To Hari Saran		300
	(Entry of goods returned by him and taken in inventory omitted from records)		
(4)	Mahesh Chand	200	
	To Bad Debts Recovered A/c		200
	(Correction of wrong credit to Personal A/c in respect of recovery of previously written off bad debts)		
(5)	Man Mohan	100	
	To Sales Return A/c		100
	(Correction of wrong debit to Sales Returns A/c for dishonour of cheque received from Man Mohan)		

Thus, it can be said that errors detected before the preparation of trial balance can be rectified either through rectification statements (not entries) or through rectification entries.

6.5.2 After Trial Balance but before Final Accounts

The method of correction of error indicated so far is appropriate when the errors have been located before the end of the accounting period. After the corrections, the trial balance will agree. Sometimes the trial balance is artificially made to agree despite of errors by opening a suspense account and putting the difference in the trial balance to the account - the suspense account will be debited if the total of the credit column in the trial balance exceeds the total of the debit column and vice as versa.

One must note that such agreement of the trial balance is not real. Effort must be made to locate the errors.

The rule of rectifying errors detected at this stage is simple. Those errors for which complete journal entries were not possible in the earlier stage of rectification (i.e., before trial balance) can now be rectified by way of journal entry(s) with the help of suspense account, for it these errors which gave rise to the suspense account in the trial balance. The rectification entry for other type of error i.e. error affecting more than one account in such a way that a complete journal entry is possible for its rectification, can be rectified in the same way as in the earlier stage (i.e. before trial balance).

In a nutshell, it can be said that each and every error detected at this stage can only be corrected by a complete journal entry. Those errors for which journal entries were not possible at the earlier stage will now be rectified by a journal entry(s), the difference or the unknown side is being taken care of by suspense account. Those errors for which entries were possible even at the first stage will now be rectified in the same way.

Suppose, the sales book for November, 2022 is casted short by ₹100 ; as a consequence the trial balance will not agree. The credit column of the trial balance will be ₹100 short and a Suspense Account will be credited by ₹100. To rectify the error the Sales Account will be credited (to increase the credit to the right figure. Now one error remains, the Suspense Account must be closed by debiting the Suspense Account. The entry will be:

Suspense Account	₹100	
To Sales Account		₹100
(Correction of error of undercasting the sales Book for November 2022)		

ILLUSTRATION 4

Correct the following errors (i) without opening a Suspense Account and (ii) opening a Suspense Account:

(a) The Sales Book has been totalled ₹100 short.

(b) Goods worth ₹150 returned by Green & Co. have not been recorded anywhere.

(c) Goods purchased ₹250 have been posted to the debit of the supplier Gupta & Co.

(d) Furniture purchased from Gulab & Bros, ₹1,000 has been entered in Purchases Day Book.

(e) Discount received from Red & Black ₹15 has not been entered in the Discount Column of the Cash Book.

(f) Discount allowed to G. Mohan & Co. ₹18 has not been entered in the Discount Column of the Cash Book. The account of G. Mohan & Co. has, however, been correctly posted.

SOLUTION

If a Suspense Account is not opened.

(a) Since sales book has been casted ₹100 short, the Sales Account has been similarly credited ₹100 short. The correcting entry is to credit the Sales Account by ₹100 as "By wrong totalling of the Sales Book ₹100".

(b) To rectify the omission, the Returns Inwards Account has to be debited and the account of Green & Co. credited. The entry:

Returns Inward Account	Dr.	₹150	
To Green & Co.			₹150
(Goods returned by the firm, previously omitted from the Returns Inward Book)			

(c) Gupta & Co. have been debited ₹250 instead of being credited. This account should now be credited by 500 to remove the wrong debit and to give the correct credit. The entry will be on the credit side... "By errors in posting ₹500".

(d) By this error Purchases Account has to be debited by ₹1,000 whereas the debit should have been to the Furniture Account. The correcting entry will be:

Furniture Account	Dr.	₹1,000	
To Purchases Account			₹1,000
(Correction of the mistake by which of the Furniture Account)			

(e) The discount of ₹15 received from Red & Black should have been entered on the credit side of the cash book. Had this been done, the Discount Account would have been credited (through the total of the discount column) and Red & Black would have been debited. This entry should not be made:

Red & Black	Dr.	₹15	
To Discount Account			₹15
(Rectification of the error by which the discount allowed by the firm was not entered in Cash Book)			

(f) In this case the account of the customer has been correctly posted; the Discount Account has been debited ₹18 short since it has been omitted from the discount column on the debit side of the cash book. The discount account should now be debited by the entry; "To Omission of entry in the Cash Book ₹18."

<u>If a Suspense Account is opened :</u>

	Particulars	**Dr.(₹)**	**Cr.(₹)**
(a)	Suspense Account	100	
	To Sales Account		100
	(Being the correction arising from under- casting of Sales Day Book)		

(b)	Return Inward Account To Green & Co (Being the recording of unrecorded returns)	150	150
(c)	Suspense Account To Gupta & Co. (Being the correction of the error by which Gupta & Co. was debited instead of being credited by ₹ 250).	500	500
(d)	Furniture Account To Purchases Account (Being the correction of recording purchase of furniture as ordinary purchases)	1,000	1,000
(e)	Red & black To Discount Account (Being the recording of discount omitted to be recorded)	15	15
(f)	Discount Account To Suspense Account (Being the correction of omission of the discount allowed from Cash Book customer's account already posted correctly).	18	18

Suspense Account

Dr. Date	Particulars	Amount ₹	Date	Particulars	Cr. Amount₹
	To Sales A/c	100		By Difference in	
	To Gupta & Co.	500		Trial Balance	582
				By Discount A/c	18
		600			600

Notes:

(i) One should note that the opening balance in the Suspense Account will be equal to the difference in the trial balance.

(ii) If the question is silent as to whether a Suspense Account has been opened, the student should make his assumption, state it clearly and then proceed.

ILLUSTRATION 5

Correct the following errors found in the books of Mr. Dutt. The Trial Balance was out by ₹ 493 excess credit. The difference thus has been posted to a Suspense Account.

(a) *An amount of ₹100 was received from D. Das on 31st December, 2022 but has been omitted to enter in the Cash Book.*

(b) *The total of Returns Inward Book for December has been casted short by ₹100.*

(c) *The purchase of an office table costing ₹ 300 has been passed through the Purchases Day Book.*

(d) *₹ 375 paid for Wages to workmen for making show-cases had been charged to "Wages Account".*

(e) *A purchase of ₹ 67 had been posted to the trade payables' account as ₹ 60.*

(f) *A cheque for ₹ 200 received from P. C. Joshi had been dishonoured and was passed to the debit of "Allowances Account".*

(g) *₹ 1,000 paid for the purchase of a motor cycle for Mr. Dutt for his personal use had been charged to "Miscellaneous Expenses Account".*

(h) *Goods amounting to ₹100 had been returned by customer and were taken into inventory, but no entry in respect thereof, was made into the books.*

(i) *A sale of ₹ 200 to Singh & Co. was wrongly credited to their account. Entry was correctly made in sales book.*

SOLUTION

(a) **Journal Entries**

	Particulars		L.F.	₹	₹
(a)	Cash Account	Dr.		100	
	To D. Das				100
	(Being the amount received)				
(b)	Returns Inward Account	Dr.		100	
	To Suspense Account				100
	(Being the mistake in totalling the Returns Inward Book corrected)				

(c)	Furniture Account Dr.		300	
	To Purchases Account			300
	(Being the rectification of mistake by which purchase of furniture was entered in Purchases book and hence now corrected by crediting the Purchases Account)			
(d)	Furniture Account Dr.		375	
	To Wages Account			375
	(Being the wages paid to workmen for making show-cases which should have been capitalised and not to be charged to Wages Account)			
(e)	Suspense Account Dr.		7	
	To Creditors (personal) Account			7
	(Being the mistake in crediting the Trade payables Account less by ₹ 7, now corrected)			
(f)	P.C. Joshi Dr.		200	
	To Allowances Account			200
	(Being the cheque of P.C. Joshi dishonoured, previously debited to Allowances Account)			
(g)	Drawings Account Dr.		1,000	
	To Miscellaneous Expenses			1,000
	(Being the motor cycle purchased for Mr. Dutt debited to his Drawings Account instead of Miscellaneous Expenses Account as previously done by mistake)			
(h)	Returns Inward Account Dr.		100	
	To Debtors (Personal) Account			100
	(Correction of the omission to record return of goods by customers)			
(i)	Singh & Co. Dr.		400	
	To Suspense Account			400
	(Being the correction of mistake by which the account of Singh & Co. was credited by ₹ 200 instead of being debited)			

Suspense Account

Dr.					Cr.
Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
2022		₹	2022		₹
Dec.31	To Difference in Trial Balance	493	Dec. 31	By Returns Inwards A/c	100
" "	To Trade Payables A/c	7	" "	By Singh & Co.	400
		500			500

ILLUSTRATION 6

The following errors, affecting the account for the year 2022 were detected in the books of Jain Brothers, Delhi:

(1) Sale of old Furniture ₹ 150 treated as sale of goods.

(2) Receipt of ₹ 500 from Ram Mohan credited to Shyam Sunder.

(3) Goods worth ₹ 100 brought from Mohan Narain have remained unrecorded so far.

(4) A return of ₹ 120 from Mukesh posted to his debit.

(5) A return of ₹ 90 to Shyam Sunder posted as ₹ 9 in his account.

(6) Rent of proprietor's residence, ₹ 600 debited to rent A/c.

(7) A payment of ₹ 215 to Mohammad Sadiq posted to his credit as ₹125.

(8) Sales Book casted short by ₹ 900 .

(9) The total of Bills Receivable Book ₹ 1,500 left unposted.

You are required to pass the necessary rectifying entries and show how the trial balance would be affected by the errors.

SOLUTION

Journal

	Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
(1)	Sales Account	Dr.		150	
	To Furniture Account				150
	(Rectification of sales of furniture treated as sales of goods)				

(2)	Shyam Sunder	Dr.		500	
	To Rama Mohan				500
	(Rectification of a receipt from Ram Mohan credited to Shyam Sunder)				
(3)	Purchases Account	Dr.		100	
	To Mohan Narain				100
	(Purchases of goods from Mohan Narain unrecorded, now corrected)				
(6)	Drawing Account	Dr.		600	
	To Rent Account				600
	(Rectification of Payment of rent of proprietor's residence treated as payment of office rent)				

N.B. : For 4, 5, 7, 8, 9 no journal entry can be passed as they affect a single account. The correction will be as under:

(4) Credit Mukesh's Account with ₹ 240.

(5) Debit the account of Shyam Sunder by ₹ 81.

(7) Debit the account of Mohammad Sadiq by ₹ 340.

(8) Credit Sales Account by ₹ 900.

(9) Debit Bills Receivable Account with ₹ 1,500.

Effect of the Errors on Trial Balance

1.	No effect		
2.	No effect		
3.	No effect		
4.	Trial Balance credit total short by	₹	240.
5.	Trial Balance debit total short by	₹	81.
6.	No effect		
7.	Trial Balance debit total short by	₹	340.
8.	Trial Balance credit total short by	₹	900.
9.	Trial Balance debit total short by	₹	1,500.

ILLUSTRATION 7

Write out the Journal Entries to rectify the following errors, using a Suspense Account.

(1) *Goods of the value of ₹ 100 returned by Mr. Sharma were entered in the Sales Day Book and posted therefrom to the credit of his account;*

(2) *An amount of ₹150 entered in the Sales Returns Book, has been posted to the debit of Mr. Philip, who returned the goods;*

(3) *A sale of ₹ 200 made to Mr. Ghanshyam was correctly entered in the Sales Day Book but wrongly posted to the debit of Mr. Radheshyam as ₹ 20; and*

(4) *The total of "Discount Allowed" column in the Cash Book for the month of September, 2022 amounting to ₹ 250 was not posted.*

SOLUTION

Journal

	Particulars		L.F.	Dr. ₹	Cr. ₹
(1)	Sales Account	Dr.		100	
	Sales Returns Account	Dr.		100	
	To Suspense Account				200
	(The value of goods returned by Mr. Sharma wrongly posted to Sales and omission of debit to Sales Returns Account, now rectified)				
(2)	Suspense Account	Dr.		300	
	To Mr. Philip				300
	(Wrong debit to Mr. Philip for goods returned by him, now rectified)				
(3)	Mr. Ghanshyam	Dr.		200	
	To Mr. Radheshyam				20
	To Suspense Account				180
	(Omission of debit to Mr. Ghanshyam and wrong credit to Mr. Radhesham for sale of ₹ 200, now rectified)				
(4)	Discount Account	Dr.		250	
	To Suspense Account				250
	(The total of Discount allowed during September, 2022 not posted from the Cash Book; error now rectified)				

6.5.3 Correction in the next Accounting Period

Rectification of errors discussed so far assumes that it was carried out before the books were closed for the concerned year. However, sometimes, the rectification is carried out in the next year, carrying forward the balance in the Suspense Account or even transferring it to the Capital Account. Suppose, the Purchase Book was cast short by ₹1,000 in December, 2022 and a Suspense Account was opened with the difference in the trial balance. If the error is rectified next year and the entry passed is to debit Purchase Account (and credit Suspense Account), it will mean that the Purchases Account for year 2023 will be ₹1,000 more than the amount relating to year 2023 and thus the profit for year 2023 will be less than the actual for that year. Thus, correction of errors in this manner will 'falsify' the Profit and Loss Account.

To avoid this, correction of all amounts concerning nominal accounts, i.e., expenses and incomes should be through a special account styled as "Prior Period Items" or "Profit and Loss Adjustment Account". The balance in the account should be transferred to the Profit and Loss Account. However, these Prior Period Items should be charged after deriving the profit of the current year. 'Prior Period items' are material income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. Prior Period Items should be separately disclosed in the current statement of profit and loss together with their nature and amount in a manner that their impact on current period profit or loss can be perceived.

ILLUSTRATION 8

Mr. Roy was unable to agree the Trial Balance last year and wrote off the difference to the Profit and Loss Account of that year. Next Year, he appointed a Chartered Accountant who examined the old books and found the following mistakes:

(1) Purchase of a scooter was debited to conveyance account ₹3,000.

(2) Purchase account was over-cast by ₹10,000.

(3) A credit purchase of goods from Mr. P for ₹2,000 was entered as a sale.

(4) Receipt of cash from Mr. A was posted to the account of Mr. B ₹1,000.

(5) Receipt of cash from Mr. C was posted to the debit of his account, ₹500.

(6) ₹500 due by Mr. Q was omitted to be taken to the trial balance.

(7) Sale of goods to Mr. R for ₹2,000 was omitted to be recorded.

(8) Amount of ₹2,395 of purchase was wrongly posted as ₹2,593.

Mr. Roy used 10% depreciation on vehicles. Suggest the necessary rectification entries.

SOLUTION

Journal Entries in the books of Mr. Roy

Sr. No.	Particulars	Dr.(₹)	Cr.(₹)
(1)	Motor Vehicles Account	2,700	
	To Profit and Loss Adjustment A/c		2,700
	(Purchase of scooter wrongly debited to conveyance account now rectified-capitalisation of ₹ 2,700, i.e.,₹ 3,000 less 10% depreciation)		
(2)	Suspense Account	10,000	
	To Profit & Loss Adjustment A/c		10,000
	(Purchase Account overcast in the previous year; error now rectified).		
(3)	Profit & Loss Adjustment A/c	4,000	
	To P's Account		4,000
	(Credit purchase from P ₹ 2,000, entered as sales last year; now rectified)		
(4)	B's Account	1,000	
	To A's Account		1,000
	(Amount received from A wrongly posted to the account of B; now rectified)		
(5)	Suspense Account	1,000	
	To C's Account		1,000
	(₹ 500 received from C wrongly debited to his account; now rectified)		
(6)	Trade receivables	500	
	To Suspense Account		500
	(₹ 500 due by Q not taken into trial balance; now rectified)		
(7)	R's Account	2,000	
	To Profit & Loss Adjustment A/c		2,000
	(Sales to R omitted last year; now recorded)		

(8)	Suspense Account	198	
	To Profit & Loss Adjustment A/c		198
	(Excess posting to purchase account last year, ₹ 2,593, instead of ₹ 2,395, now adjusted)		
(9)	Profit & Loss Adjustment A/c	10,898	
	To Roy's Capital Account		10,898
	(Balance of Profit & Loss Adjustment A/c transferred to Capital Account)		
(10)	Roy's Capital Account	10,698	
	To Suspense Account		10,698
	(Balance of Suspense Account transferred to the Capital Account)		

Note : Entries No. (2) and (8) may even be omitted; but this is not advocated.

Profit and Loss Adjustment Account

(Prior Period Items)

	₹		₹
To P	4,000	By Motor Vehicles A/c	2,700
To Roy's Capital (transfer)	10,898	By Suspense A/c	10,000
		By R	2,000
		By Suspense Account	198
	14,898		14,898

Suspense Account

	₹		₹
To Profit & Loss Adjustment A/c	10,000	By Trade Receivables (Q)	500
To C	1,000	By Roy's Capital A/c (Transfer)	10,698
To Profit & Loss Adjustment A/c	198		
	11,198		11,198

SUMMARY

- Unintentional omission or commission of amounts and accounts in the process of recording the transactions are commonly known as errors.
- Accounting errors are generally of four types-
  - (a) Errors of Principle;
  - (b) Errors of Omission;
  - (c) Errors of Commission;
  - (d) Compensating Errors.
- Some errors may affect the Trial Balance and some of these do not.
- The method of rectification of errors depends on the stage at which the errors are detected. If the error is detected before the preparation of trial balance, rectification is carried out by making the statement in the appropriate side of the concerned account.
- In case of the errors detected after the preparation of the trial balance, we open a suspense account with the amount of difference in the trial balance. Then complete journal entries can be passed for rectifying the errors.
- For rectifying the errors detected in the next accounting period, a special account 'Profit and Loss Adjustment Account' is opened for correction of amounts relating to expenses and incomes.

TEST YOUR KNOWLEDGE

True and False

1. *The method of rectification of errors depends on the stage at which the errors are detected.*
2. *In case of error of complete omission, the trial balance does not tally.*
3. *When errors are detected after preparation of trial balance, suspense account is opened.*
4. *When purchase of an asset is treated as an expense, it is known as error of principle.*
5. *Trial balance agrees in case of compensating errors.*
6. *When amount is written on wrong side, it is known as an error of principle.*
7. *On purchase of old furniture, the amount spent on repairs should be debited to repairs account.*

8. *'Profit & Loss adjustment account' is opened to rectify the errors detected in the current accounting period.*

9. *Rent paid to landlord of the proprietors house, must be debited to 'Rent account'.*

10. *If the errors are detected after preparing trial balance, then all the errors are rectified through suspense account.*

Multiple Choice Questions

1. *Goods purchased from A for ₹10,000 passed through the sales book. The error will result in*

   (a) Increase in gross profit.

   (b) Decrease in gross profit.

   (c) No effect on gross profit.

2. *If a purchase return of ₹1,000 has been wrongly posted to the debit of the sales returns account, but has been correctly entered in the suppliers' account, the total of the*

   (a) Trial balance would show the debit side to be ₹1,000 more than the credit.

   (b) Trial balance would show the credit side to be ₹ 1,000 more than the debit.

   (c) The debit side of the trial balance will be ₹ 2,000 more than the credit side.

3. *If the amount is posted in the wrong account or it is written on the wrong side of the account, it is called*

   (a) Error of omission.

   (b) Error of commission.

   (c) Error of principle.

4. *₹ 200 paid as wages for erecting a machine should be debited to*

   (a) Repair account.

   (b) Machine account.

   (c) Capital account.

5. *On purchase of old furniture, the amount of ₹1,000 spent on its repair should be debited to*

   (a) Repair account.

   (b) Furniture account.

   (c) Cash account.

6. *Goods worth ₹50 given as charity should be credited to*
   - (a) *Charity account.*
   - (b) *Sales account.*
   - (c) *Purchase account.*
7. *Goods worth ₹100 taken by proprietor for domestic use should be credited to*
   - (a) *Sales account.*
   - (b) *Proprietor's personal expenses.*
   - (c) *Purchases account.*
8. *Sales of office furniture should be credited to*
   - (a) *Sales Account.*
   - (b) *Furniture Account.*
   - (c) *Purchase Account.*
9. *The preparation of a trial balance is for:*
   - (a) *Locating errors of commission.*
   - (b) *Locating errors of principle.*
   - (c) *Locating clerical errors.*
10. *₹ 200 received from Smith whose account, was written off as a bad debt should be credited to:*
    - (a) *Bad Debts Recovered account.*
    - (b) *Smith's account.*
    - (c) *Cash account.*
11. *Purchase of office furniture ₹1,200 has been debited to General Expense Account. It is:*
    - (a) *A clerical error.*
    - (b) *An error of principle.*
    - (c) *An error of omission.*

Theory Questions

1. *How does errors of omission differ from errors of commission?*
2. *What is error of principle and how does it affect Trial Balance?*
3. *When and how is Suspense account used to rectify errors?*

Practical Questions

1. *The trial balance of Mr. W & H failed to agree and the difference ₹20,570 was put into suspense account pending the investigation which disclosed that:*

   (i) Purchase returns day book had been correctly entered and totalled at ₹6,160, but had not been posted to the ledger.

   (ii) Discounts received ₹1,320 had been debited to discounts allowed.

   (iii) The Sales account had been under added by ₹10,000.

   (iv) A credit sale of ₹1,470 had been debited to a customer account at ₹1,740.

   (v) A vehicle bought originally for ₹7,000 four years ago and depreciated to ₹1,200 had been sold for ₹1,500 in the beginning of the year but no entries, other than in the bank account had been passed through the books.

   (vi) An accrual of ₹560 for telephone charges had been completely omitted.

   (vii) A bad debt of ₹1,560 had not been written off and provision for doubtful debts should have been maintained at 10% of Trade receivables which are shown in the trial balance at ₹23,390 with a credit provision for bad debts at ₹2,320.

   (viii) Tools bought for ₹1,200 had been inadvertently debited to purchases.

   (ix) The proprietor had withdrawn, for personal use, goods worth ₹1,960. No entries had been made in the books.

   You are required to give rectification entries without narration to correct the above errors before preparing annual accounts.

2. *On going through the Trial balance of Ball Bearings Co. Ltd. you find that the debit is in excess by ₹150. This was credited to "Suspense Account". On a close scrutiny of the books, the following mistakes were noticed:*

   (1) The totals of debit side of "Expenses Account" have been casted in excess by ₹ 50.

   (2) The "Sales Account" has been totalled in short by ₹100.

   (3) Supplier account has been overcasted by 225.

   (4) The sale return of ₹100 from a party has not been posted to that account though the Party's account has been credited.

   (5) A cheque of ₹500 issued to the Suppliers' account (shown under Trade payables) towards his dues has been wrongly debited to the purchases.

   (6) A credit sale of ₹50 has been credited to the Sales and also to the Trade receivables Account.

   You are required to

(i) Pass necessary journal entries for correcting the above;

(ii) Show how they affect the Profits; and

(iii) Prepare the "Suspense Account" as it would appear in the ledger.

3. *Mr. A closed his books of account on September 30, 2021 in spite of a difference in the trial balance. The difference was ₹830 the credits being short; it was carried forward in a Suspense Account. In 2022 following errors were located:*

   (i) A sale of ₹2,300 to Mr. Lala was posted to the credit of Mrs. Mala.

   (ii) The total of the Returns Inward Book for July, 2021 ₹1,240 was not posted in the ledger.

   (iii) Freight paid on a machine ₹5,600 was posted to the Freight Account as ₹6,500. 10% Depreciation is charge on this machines.

   (iv) While carrying forward the total in the Purchases Account to the next page, ₹65,590 was written instead of ₹56,950.

   (v) A sale of machine on credit to Mr. Mehta for ₹9,000 on 30th sept. 2021 was not entered in the books at all. The book value of the machine was ₹6,750.

   Pass journal entries to rectify the errors. Have you any comments to make?

4. *A merchant's trial balance as on June 30, 2022 did not agree. The difference was put to a Suspense Account. During the next trading period, the following errors were discovered:*

   (i) The total of the Purchases Book of one page, ₹4,539 was carried forward to the next page as ₹4,593.

   (ii) A sale of ₹573 was entered in the Sales Book as ₹753 and posted to the credit of the customer.

   (iii) A return to a creditor, ₹510 was entered in the Returns Inward Book; however, the creditor's account was correctly posted.

   (iv) Cash received from C. Dass, ₹620 was posted to the debit of G. Dass.

   (v) Goods worth ₹840 were despatched to a customer before the close of the year but no invoice was made out.

   (vi) Goods worth ₹1,000 were sent on sale or return basis to a customer and entered in the Sales Book. At the close of the year, the customer still had the option to return the goods. The sale price was 25% above cost.

   You are required to give journal entries to rectify the errors in a way so as to show the current year's profit or loss correctly.

ANSWERS/HINTS

True and False

1. True: There are 3 different stages when the mistakes are identified and then the rectification depends on the stage of identification of errors.
2. False: In case of error of complete omission, the trial balance tallies.
3. True: In order to balance the difference of balances in the trial balance suspense account is opened.
4. True: Where the accounts being debited is principally incorrect it is termed as error of principle.
5. True: Compensating errors cancel out each other when Trial balance is prepared as the mistake pertains to the same amount being credited and later debited on account of two different mistakes.
6. False: When amount is written on wrong side, it is known as an error of commission.
7. False: On purchase of furniture, the amount spent on repairs should be debited to furniture account as it is a capital expense.
8. False: 'Profit & Loss adjustment account' is opened to rectify the errors detected in the next accounting period.
9. False: Rent paid to land lord of the proprietors house, must be debited to 'Drawings account'.
10. False: If the errors are detected after preparing trial balance, then all the errors are not rectified through suspense account. There may be principal errors, which can be rectified without opening a suspense account.

Multiple Choice Questions

1.	(a)	**2.**	(c)	**3.**	(b)	**4.**	(b)	**5.**	(b)	**6.**	(c)
7.	(c)	**8.**	(b)	**9.**	(c)	**10.**	(a)	**11.**	(b)		

Theoretical Questions

1. (i) Errors of Omission: If a transaction is completely or partially omitted from the books of account, it will be a case of omission. Examples would be: not recording a credit purchase of furniture or not posting an entry into the ledger.

(ii) Errors of Commission: If an amount is posted in the wrong account or it is written on the wrong side or the totals are wrong or a wrong balance is struck, it will be a case of "errors of commission."

2. **Errors of principle:** When a transaction is recorded in contravention of accounting principles, like treating the purchase of an asset as an expense, it is an error of principle. In this case there is no effect on the trial balance since the amounts are placed on the correct side, though in a wrong account. Suppose on the purchase of a typewriter, the office expenses account is debited; the trial balance will still agree.

The method of correction of error indicated so far is appropriate when the errors have been located before the end of the accounting period. After the corrections, the trial balance will agree. Sometimes the trial balance is artificially made to agree inspite of errors by **opening a suspense account** and putting the difference in the trial balance to the account - the suspense account will be debited if the total of the credit column in the trial balance exceeds the total of the debit column; it will be credited in the other case. Each and every error detected after preparation of trial balance can only be corrected by a complete journal entry. Those errors for which journal entries were not possible at the earlier stage will now be rectified by a journal entry(s), the difference or the unknown side is being taken care of by suspense account. Those errors for which entries were possible even at the first stage will now be rectified in the same way.

Practical Questions

1.

	Particulars	**Dr.**	**Cr.**
(i)	Suspense Account	6,160	
	To Return Outward A/c		6,160
(ii)	Suspense Account	2,640	
	To Discount Allowed Account		1,320
	To Discount Received Account		1,320
(iii)	Suspense Account	10,000	
	To Sales Account		10,000
(iv)	Suspense Account	270	
	To Customer Account		270
(v)	Suspense Account	1,500	
	To Vehicle Account		1,200
	To Profit on Sale of Vehicle Account		300

(vi)	Telephone Charges Account	560	
	To Outstanding Expenses Account		560
(vii)	Bad Debts Account (refer W.N 1)	1,560	
	To Trade receivables Account		1,560
	Provision for Doubtful Debts Account (refer W.N. 2)	164	
	To Profit and Loss Account		164
(viii)	Loose Tools Account	1,200	
	To Purchases Account		1,200
(ix)	Drawings Account	1,960	
	To Purchases Account		1,960

Notes:

1. Bad debts will be debited in the profit and loss account.
2. Provision @ 10% of ₹ 21,560 i.e. 2,156; Excess provision ₹164 (2320 - 2156 = 164).

Working Notes :

(i)	Trade receivables as per books		23,390
	Deduction vide item (iv) 270	270	
	Bad Debts	1,560	1,830
			21,560

(ii) **Suspense Account**

	₹		₹
To Return outward Account	6,160	By balance b/d	20,570
To Discount allowed Account	1,320		
To Discount Received Account	1,320		
To Sales Account	10,000		
To Customers Account	270		
To Vehicles Account	1,200		
To Profit on Sale of Vehicle	300		
	20,570		20,570

2. **Journal Entries**

Particulars		L.F.	Dr. ₹	Cr. ₹
Suspense Account	Dr.		50	
To Expenses Account				50
(Being the mistake in totalling of Expenses Account, rectified)				
Suspense Account	Dr.		100	
To Sales Account				100
(Being the mistake in totalling of Sales Accounts rectified)				
Supplier	Dr.		225	
To Suspense Account				225
(Being the mistake in posting from Day Book to Ledger rectified)				
Sales Returns Account	Dr.		100	
To Suspense Account				100
(Being the sales return from a party not posted to "Sales Returns" now rectified)				
Trade payables Account	Dr.		500	
To Purchases Account				500
(Being the payments made to supplier wrongly posted to purchases now rectified)				
Trade receivables Account	Dr.		100	
To Suspense Account				100
(Being the sales wrongly credited to Customer's Account now rectified)				

Suspense Account

	Dr. ₹		Cr. ₹
To Expenses Account	50	By Difference in Trial Balance	150
To Sales Account	100	By Trade payables	225
To Balance c/d	425	By Sales Returns Account	100
		By Trade receivables	100
	575		575
		By Balance b/d	425

Since the Suspense Account does not balance, it is clear that all the errors have not been traced. As a result of the above corrections the Net Profit will be:

	Increased by ₹	Decreased by₹
Mistake in totalling in "Expenses"	50	
Mistake in totalling in "Sales"	100	
Mistake in posting from day book to Ledger under		
"Purchases"	500	
Omission in posting under "Sales Returns"		100
	650	100
Net Increase	550	

As a result of these adjustments, the Profits will be increased by ₹550.

3. **Journal of Mr. A**

Date	Particulars	Dr.	Cr.
		₹	₹
2022 (i)	Mrs. Mala	2,300	
	Mr. Lala	2,300	
	To Suspense A/c		4,600
	(Correction of error by which a sale of ₹ 2,300 to Mr. Lala was posted to the Credit of Mrs. Mala)		
(ii)	Profit and Loss Adjustment A/c	1,240	
	To Suspense A/c		1,240
	(Rectification of omission to post the total of Returns Inward Book for July, 2021)		
(iii)	(a) Machinery A/c	5,600	
	Suspense A/c	900	
	To Profit & Loss Adjustment A/c		6,500
	(Correction of error by which freight paid for a machine ₹ 5,600 was posted to Freight Account at ₹ 6,500 instead of capitalising it)		
	(b) Profit & Loss Adjustment A/c	560	

	To Plant and Machinery A/c (Depreciation @ 10% charged on freight paid on a machine capitalised)		560
(iv)	Suspense A/c To Profit & Loss Adjustment A/c (Correction of wrong carry forward of total in the purchase Account to the next page ₹ 65,590 instead of ₹ 56,950)	8,640	8,640
(v)	Mr. Mehta To Plant & Machinery A/c To Profit & Loss Adjustment A/c (Correction of omission of a sale of machine on credit to Mr. Mehta for ₹ 9,000)	9,000	6,750 2,250

Comments

The Suspense Account will now appear as shown below:

Suspense Account

Date	Particulars	Dr. Amount ₹	Date	Particulars	Cr. Amount ₹
2022	To Profit and Loss Adjustment A/c	900	2022	By Balance b/d	830
	To Profit and Loss Adjustment A/c	8,640	Oct. 1	By Sundries	
				Mrs. Mala	2,300
				Mr. Lala	2,300
				By Profit and Loss Adjustment A/c	1,240
				By balance c/d	2,870
		9,540			9,540

Since the Suspense Account still shows a balance, it is obvious that there are still some errors left in the books.

Profit & Loss Adjustment A/c

(For Prior Period Items)

Date 2022	Particulars	Dr. Amount ₹	Date 2022	Particulars	Cr. Amount ₹
	To Suspense A/c	1,240		By Machinery A/c	5,600
	To Plant and Machinery A/c	560		By Suspense A/c	900
	To Balance c/d	15,590		By Suspense A/c	8,640
				By Mr. Mehta	2,250
		17,390			17,390

4. **Journal Entries**

	Particulars		Dr. ₹	Cr. ₹
(i)	Suspense Account	Dr.	54	
	To Profit and Loss Adjustment A/c			54
	(Correction of error by which Purchase Account was over debited last year- ₹4,593 carried forward instead of ₹4,539)			
(ii)	Profit & Loss Adjustment A/c	Dr.	180	
	Customer's Account	Dr.	1,326	
	To Suspense Account			1,506
	(Correction of the entry by which (a) Sales A/c was over credited by ₹180 (b) customer was credited by ₹753 instead of being debited by ₹573)			
(iii)	Suspense Account	Dr.	1,020	
	To Profit & Loss Adjustment A/c			1,020
	(Correction of error by which Returns Inward Account was debited by ₹510 instead of Returns Outwards Account being credited by ₹ 510)			

(iv)	Suspense Account	Dr.	1,240	
	To C. Dass			620
	To G. Dass			620
	(Removal or wrong debit to G. Dass and giving credit to C. Dass from whom cash was received).			
(v)	Customer's Account	Dr.	840	
	To Profit & Loss Adjustment A/c			840
	(Rectification of the error arising from non-preparation of invoice for goods delivered)			
(vi)	Profit & Loss Adjustment A/c	Dr.	200	
	Inventory Account	Dr.	800	
	To Customer's Account			1,000
	(The Customer's A/c credited with ₹ 1,000 for goods not yet purchased by him; cost of the goods debited to inventory and "Profit" debited to Profit & Loss Adjustment Account)			
(vii)	Profit & Loss Adjustment A/c	Dr.	1,534	
	To Capital Account			1,534
	(Transfer of Profit & Loss Adjustment A/c balance to the Capital Account)			

NOTES

NOTES

CHAPTER 3

BANK RECONCILIATION STATEMENT

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Learn the design of a Bank Pass Book.
- Understand the reasons for difference between Cash Book balance and Pass Book balance and try to ascertain the amount of such differences.
- Learn, how to resolve such difference in a systematic manner.
- Understand the purpose for preparing the bank reconciliation statement and its utility.

UNIT OVERVIEW

Salient Features of Bank Reconciliation Statement

- The reconciliation will bring out any errors that might have been committed either in the cash book or in the pass book
- Any undue delay in the clearance of cheques will be shown up by the reconciliation
- A regular reconciliation discourages the accountant of the bank from embezzlement

Causes of difference in the balances of pass book and cash book

- Timing differences
- Differences arising due to errors in recording the entries

1. INTRODUCTION

Banks are essential institutions in a modern society. With the increase in volume of trade, commerce and business, business entities faced difficulty in transacting in cash for each business activity. They discovered that dealing through bank, on regular basis, would be the better and safer option and finally large business entities switched over to banking transactions instead of dealing in cash. Now-a-days, most of the transactions of the business are done through bank whether it is a receipt or a payment. Rather, it is legally necessary to operate the transactions through bank after a certain limit.

A Bank accepts from people, in general, deposits in various forms, and lends funds to those who need; it also invests some funds in profitable investments. Thus, money which would have been otherwise idle is put to use and is made available to those who need it. Those who deposit the money are able to withdraw it according to the settled terms and conditions. Apart from receiving deposits from and handling cash transactions on behalf of its customers, the bank also renders some other useful services as indicated below:

(i) The bank discounts promissory notes or hundies, i.e., it enables a customer to receive the cash before the due date in consideration of a small charge called discount.

(ii) The bank allows overdraft to its good customers so that they can make payments even when they do not have sufficient balance in the bank. Of course, the overdraft facility is generally secured and must be cleared later.

(iii) The bank grants different types of loans (eg. Working capital, term loan) for a specific period say a year or so, to its customers for smooth functioning of their operations in case of lack of self-funding available with customers'. Such financial assistance is of great help for business.

(iv) The bank on behalf of the customer collects the amount of dividend warrants or interest on securities etc.

(v) On instruction of the customer, the bank makes payments of insurance premium, rent etc. on the due dates.

(vi) The bank sells and purchases shares, debentures or government securities on behalf of its customers.

(vii) Money can be remitted to another place or persons through the bank at a low cost.

(viii) The bank in return, for a consideration, furnishes security or guarantee for its customers whose credit is good.

(ix) The bank also issues letter of credit or travellers' cheque to facilitate commerce or travel.

(x) The bank also provides international banking services such as currency exchange, remittance from abroad, cross country payments, foreign letters of credit, export and import credit, etc.

2. BACKGROUND

In the past, many corporate frauds have incurred by the companies through manipulating entries either in bank statements or in cash book. For e.g. –A company's financial statement may present incorrect bank balance to mislead the stakeholders. Such kind of instances has made reconciliation of bank and cash balances an integral part of internal control maintained by management.

Over the period, reconciling the accounts became an important activity for businesses because it gives an opportunity to check for fraudulent activity happening in the organization and helps to prevent the financial statement errors. Reconciliation is typically done at regular intervals, such as monthly or quarterly, as part of normal accounting procedures, however, frequency is largely dependent on the size of organization and the number of transactions that occur.

3. BANK PASS BOOK

Bank pass book is merely a copy of the customer's account in the books of a bank. The bank either sends periodical statements of account or gives a pass book to its customer in which all deposits and withdrawals made by the customer during the particular period is recorded. Both represent almost a copy of the ledger account of the customer in the books of the bank. Thus, it is the bank's way of keeping the customers informed of the entries made in his account. It is the customer's duty to check the entries and immediately inform the bank of any error that he may notice. These days, customers can easily access their bank statement online any time as facilitated by Net Banking. The form of the pass book is given below:

PASS BOOK

Messers.......................................

in account with

Punjab National Bank

Daryaganj, New Delhi-110002

Account number –

Transaction Period -

Date	Particulars / Transaction	Cheque No.	Withdrawals Dr.	Deposits Cr.	Balance
					Dr. or Cr.
			₹	₹	₹

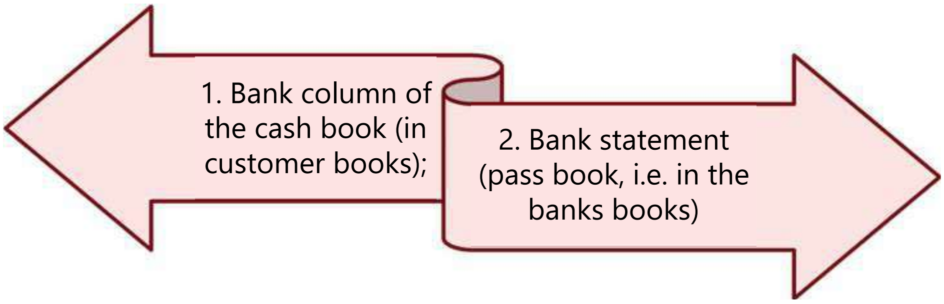
The bank statement of account also has a similar form except that it is on loose sheets or can be in an online format. The bank itself sends the statements to customers but if the customer wants to maintain a pass book then it is their duty to send the pass book to the bank periodically so that it is updated by the bank. These days, many banks' ATMs have the automated machines where one can get the passbook updated without any manual intervention and without visiting the branch of the bank.

Business houses should also obtain at the end of the year a certificate from the bank duly stamped and signed, showing the balance which, the firm carries with the bank as of date. The bank balance shown in the passbook is known as pass book balance for reconciliation purpose. The credit balance as per pass book at a particular point of time is the deposit made by the customer while debit balance as per pass book is the overdraft balance for the customer (i.e. customer owes to bank).

Students may note here that the nature of balance shown by passbook (in the books of bank) and cash book (in the books of customer) is quite different. The debit balance in the pass book represents the credit balance as per the cash book and vice-versa because the business enterprise treats the bank as a debtor/Trade receivable and bank treats the business enterprise as a creditor/Trade payable.

4. BANK RECONCILIATION STATEMENT

To reconcile means to identify or find out the difference between two different sources and eliminating that difference. Whenever we deposit or withdraws money from banks, it is always recorded at two places:-



The cash book is maintained by the person having the bank account whereas the bank statement is prepared by the bank. Therefore, the balance in both the books should be equal and opposite in nature. For eg:- if Mr. A deposited ₹ 1,00,000 in his bank account it will be recorded on the Dr. side of his cash book, but for the bank it's a receipt so it will be recorded as a Cr. Entry in the bank statement or the pass book.

But most of the times these two balances do not match. The reasons for difference in balances can be many and are explained later in this chapter. It is possible to eliminate this difference by matching all the facts and figures of the two statements. The process of eliminating this difference and bringing the two statements in line with each other is known as "Reconciliation", and the statement which reconciles the bank balance as per cash book with the balance as per the pass book by showing all the causes of difference is known as "BANK RECONCILIATION STATEMENT".

5. IMPORTANCE OF BANK RECONCILIATION STATEMENT

Bank reconciliation statement is a very important tool for internal control of cash flows. It helps in detecting errors, frauds and irregularities occurred, if any, at the time of passing entries in the cash book or in the pass book, whether intentionally or unintentionally. Since frauds can be detected on the preparation of bank reconciliation statement therefore accountants are careful while preparing and maintaining the records of the business enterprise. Hence it works as an important mechanism of internal control. Following are the salient features of bank reconciliation statement:

(i) The reconciliation will bring out any errors that may have been committed either in the cash book or in the pass book;

(ii) Any undue delay in the clearance of cheques will be shown up by the reconciliation;

(iii) A regular reconciliation discourages the accountant of the bank from embezzlement of funds. There have been many cases when the cashiers merely made entries in the cash book but never deposited the cash in the bank; they were able to get away with it only because of lack of reconciliation.

(iv) It helps in finding out the actual or true position of the bank balance by incorporating the effect of any uncleared funds as well.

(v) It will ensure accounting of all the financial transactions incurred by the company during a particular financial year.

CAUSES OF DIFFERENCE

The difference in the both balances (bank balance as per cash book and pass book) may arise because of the following reasons:-

1. **TIMING:-** Sometimes a transaction is recorded at two different times in cash book and the pass book. This may happen in the following cases:-

   - Mr. A has issued a cheque to PQR ltd., now it will be recorded in his cash book immediately but the bank will recognize this transaction only when the same cheque will be presented to it by PQR ltd.

   - Similarly for PQR Ltd , entry in the cash book will be made immediately as the cheque is received from Mr. A but the bank account will be credited when it collects money in respect of that cheque.

2. **TRANSACTIONS:-** There are various transactions which the bank carries out by itself without intimating the customer. For e.g.:- interest received on a savings bank account,

it will be credited by the bank immediately but the entry in the cash book will be made only when the customer comes to know about it, which is usually at a later stage. Similar is the case with Bank charges (which are debited from the customer account by bank).

3. **ERRORS:-** Mistakes or errors made in preparing the accounts either by the bank or the customer can also result in disagreement of the two statements. For e.g. omission of cheques issued. For this reason rectification of errors is required to be done in both the statements before preparing any Bank Reconciliation Statement.

SOME OF THE ITEMS THAT FREQUENTLY CAUSE A DIFFERENCE:-

When bank balance as per Cash Book > Pass Book	When bank balance as per Cash Book < Pass Book
i) Cheques deposited with the bank but not cleared	i) Cheques issued but not presented for payment
ii) Interest and expenses charged by the bank	ii) Interest allowed by bank
iii) Direct payments by the bank	iii) Interest and dividends collected by the bank
iv) Dishonour of a bill discounted with the bank	iv) Direct payment into the bank by a customer
	v) Bills collected by the bank on behalf of the customer

Above each scenario is explained in detail below along with examples:

(i) Cheques issued but not presented for payment: The entry in the cash book is made immediately on issue of cheque but naturally entry will be made by the bank only when the cheque is presented for payment. Thus there will be a gap of some days between the entry in the cash book and in the pass book.

Example 1: The balance as per Cash Book and Pass Book are ₹10,000. Cheque of ₹ 2,000 is issued but not presented for payment. Then the balances as per cash book and pass book will be as follows:

Cash book (bank column only)

Particulars	₹	Particulars	₹
To balance b/f	10,000	By Vendor A/c (to whom cheque is issued)	2,000
		By balance c/f	8,000
	10,000		10,000

Bank statement (pass book)

Date	Particulars	Dr. (withdrawn)	Cr. (deposited)	Balance
	Balance b/f			10,000(cr.)

On the issue of aforesaid cheque, the bank account in Cash Book is credited by ₹2,000 and so balance is reduced to ₹ 8,000. Whereas balance in the Pass Book remains ₹10,000 until the cheque is presented for payment.

(ii) Cheques deposited with the bank but not cleared: As soon as cheques are sent to the bank (i.e. deposited with bank), entries are made on the debit side of the bank column of the cash book. But usually banks credit the customer's account only when they have received the payment from the bank concerned- in other words, when the cheques have been cleared. Again, there will be some time gap between the deposit of the cheques and the credit given by the bank.

Example 2 : The balance as per Cash book and Pass Book are ₹ 12,000. Cheque of ₹ 3,000 is deposited but not cleared.

Cash book

Particulars	₹	Particulars	₹
To balance b/f	12,000	By balance c/f	15,000
To Vendor A/c	3,000		
	15,000		15,000

Bank statement (Pass Book)

Date	Particulars	Dr. (withdrawn)	Cr. (deposited)	Balance
	Balance b/f			12,000 (cr.)

When cheque is deposited into bank, the bank account in Cash Book is increased to ₹ 15,000, but the balance in the Pass Book remains ₹ 12,000 until the cheque is cleared.

(iii) Interest allowed by bank : If the bank has allowed interest to the customer, the entry will normally be made in the customer's account and later shown in the pass book. The customer usually comes to know the amount of the interest by pursuing the pass book and only then he makes relevant entry in the cash book.

Example 3: The balance as per Cash Book and Pass Book are ₹ 10,000. The bank has allowed ₹ 1,000 interest on saving account to customer.

Cash book

Particulars	**₹**	**Particulars**	**₹**
To balance b/f	10,000	By balance c/f	10,000
	10,000		10,000

Bank statement (Pass Book)

Date	**Particulars**	**Dr. (withdrawn)**	**Cr. (deposited)**	**Balance**
	Balance b/f			10,000 (cr.)
	Interest		1,000	11,000(cr.)

Because of such interest, balance of Pass Book is increased to ₹11,000. Whereas balance in the Cash Book remains ₹10,000 until information reaches to the customer and he records such transaction.

(iv) Interest and expenses charged by the bank: Like (iii) above, the interest charged by the bank and the amount of the bank charges are entered in the customer account and later in the pass book. The customer makes the required entries only after he sees the pass book or bank statement. These are debited to customer account by bank therefore till such entry is passed in cash book, bank balance as per pass book is less than bank balance as per cash book.

(v) Interest and dividends collected by the bank: Sometimes investments are left with the bank in the safe custody; the bank itself sees to it that the interest or the dividend is collected on the due dates. Entries are made as indicated in (iii) above.

Example 4: The balance as per Cash Book and Pass Book are ₹15,000. The bank has collected dividend of ₹ 2,000.

Cash book

Particulars	**₹**	**Particulars**	**₹**
To balance b/f	15,000	By balance c/f	15,000
	15,000		15,000

Bank statement (Pass Book)

Date	**Particulars**	**Dr. (withdrawn)**	**Cr. (deposited)**	**Balance**
	Balance b/f			15,000(cr.)
	Dividend		2,000(Cr.)	17,000(cr.)

On collection of dividend bank credits the amount to customer's account, so balance in Pass Book is increased to ₹ 17,000. Whereas balance in the Cash Book remains ₹ 15,000 until the information of such dividend collection reaches to the customer and he records such transaction.

(vi) Direct payments by the bank: The bank may be given standing instructions for certain payments such as insurance premium, equated monthly installments of loan (EMIs). In these cases also, the customer comes to know of the payment only after viewing the pass book or bank statement. The entries in the pass book and in the cash book may thus be on different dates.

Example 5: The balance as per Cash Book and Pass Book of Mr. X are ₹ 20,000. The bank has instruction to pay insurance premium of ₹ 1,500 directly to insurance company at the end of each month.

Cash book

Particulars	₹	Particulars	₹
To balance b/f	20,000	By balance c/f	20,000
	20,000		20,000

Bank statement (pass book)

Date	Particulars	Dr. (withdrawn)	Cr. (deposited)	Balance
	Balance b/f			20,000 (cr.)
	Insurance premium	1,500		18,500 (cr.)

On payment of insurance premium bank debits the customer's account by ₹ 1,500 so balance in Pass Book is decreased to ₹ 18,500. Whereas balance in the Cash Book remains ₹ 20,000 until the information of such payment reaches to the customer and he records such transaction.

(vii) Direct payment into the bank by a customer: If such a payment is received by the bank, it will be entered in the customer's account and also in the pass book; the account holder may come to know of the amount only when he sees the pass book. (e.g. Customers' these days prefers using banking facilities like NEFT, RTGS to transfer funds online)

(viii) Dishonour of a bill discounted with the bank: If the bank is not able to receive payment on promissory notes discounted by it, it will debit the customer's account together with the charges it may have incurred. The customer will naturally make the entry only when he sees the pass book.

Example 6: The balances as per Cash Book and Pass Book of Mr. X are ₹ 20,000. Mr. X deposited a cheque of ₹ 3,000 and debited to his bank account ₹ 3,000 immediately. But bank will credit X's account on realization of amount. Now the cheque is dishonoured for non-payment. Bank charges ₹ 100 in this connection.

Cash book

Particulars	₹	Particulars	₹
To balance b/f	20,000	By balance c/f	23,000
To bank a/c	3,000		
	23,000		23,000

Bank statement (Pass Book)

Date	Particulars	Dr. (withdrawn)	Cr. (deposited)	Balance
	Balance b/f			20,000 (cr.)
	Bank charges	100		19,900 (cr.)

Thus, balance of Mr. X's account in Pass Book stands ₹ 19,900 after this transaction while balance as per Cash Book stand ₹ 23,000. So Mr. X should deduct ₹ 3,000 the amount of dishonoured cheque, plus ₹ 100 the amount of bank charges for reconciliation.

(ix) Bills collected by the bank on behalf of the customer: If goods are sold, the documents may be sent through the bank. If the bank is able to collect the amount, it will credit the customer's account. The customer may make the entry only on receiving the pass book.

All these timing differences will lead to difference in balances as shown by the cash book and the pass book.

Following is the table summarising in brief the timings of different transactions:

Sl. No.	Transaction	Time of recording in cash book	Time of recording in pass book
1.	Payment done by the account holder through issuing a cheque	At the time of issuing the cheque	At the time of presenting the cheque to the bank for payment or clearing of funds.
2.	Receipt by the account holder through a cheque	At the time of depositing the cheque into the bank .	At the time of collection of amount from the account of the issuing party.

3.	Collection of bills/cheque directly on behalf of the account holder	When the entry posted in the pass book comes into notice.	When the amount is collected by the bank.
4.	Direct payment to the third party on behalf of the account holder	When the entry posted in the pass book comes into notice.	When the amount is paid by the bank
5.	Dishonour of cheque/bills receivable.	When the entry posted in the pass book comes into notice.	When the cheque is dishonoured.
6.	Bank charges levied by the bank	When the entry posted in the pass book comes into notice.	When charges are levied by the bank
7.	Interest and dividend credited by the bank	When the entry posted in the pass book comes into notice.	When interest or dividend is allowed or collected by the bank.
8.	Interest debited by the bank	When the entry is posted in the pass book comes into notice.	When interest is charged by the bank

To illustrate this, we give below an extract from a pass book and the bank column of the cash book in Illustration 1:

ILLUSTRATION 1

Messer's Tall & Short, Faiz Bazar, New Delhi-110002

in account with Punjab National Bank, Daryaganj, New Delhi-110002

PASS-BOOK

Date		**Particulars**	**Withdrawals ₹**	**Deposits ₹**	**Dr. or Cr.**	**Balance ₹**
2022						
Jan.	*2*	*By Cash*		*4,00,000*	*Cr.*	*4,00,000*
"	*4*	*To Furniture Dealers Ltd.*	*60,000*		*Cr.*	*3,40,000*
"	*4*	*To Das & Co.*	*1,25,000*		*Cr.*	*2,15,000*
"	*10*	*By J. Johnson & Co.'s cheque*		*35,000*	*Cr.*	*2,50,000*
"	*12*	*To Roy & James*	*1,00,000*		*Cr.*	*1,50,000*

"	15	By B. Babu & Co's cheque		76,000	Cr.	2,26,000
"	16	By Cash		30,000	Cr.	2,56,000
"	20	To Cash	50,000		Cr.	2,06,000
"	26	By J. Rai & Bros cheque		43,000	Cr.	2,49,000
"	31	To Premium paid as per standing instructions	25,000		Cr.	2,24,000
	31	To Bank Charges	1,000		Cr.	2,23,000
	31	By Interest collected on Government Securities		20,000	Cr.	2,43,000

CASH-BOOK (Bank column only)

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2022			2022		
Jan. 1	To Cash	4,00,000	Jan. 2	By Furniture	
Jan. 2	To J. Johnson & Co.	35,000		Dealers Ltd.	60,000
Jan. 8	To B. Babu& Co.	76,000	Jan. 2	By Roy & James	1,00,000
Jan. 10	To Cash	30,000	Jan. 2	By Das & Co.	1,25,000
Jan. 16	To J. Rai & Bros.	43,000	Jan. 4	By K. Nagpal & Co.	73,000
Jan. 20	To M. Mohan & Co.	1,05,000	Jan. 17	By Cash	50,000
Jan. 22	To N. Nandy & Sons	34,000	Jan. 20	By B. Babu & Co.	78,000
			Jan. 31	By Balance c/d	2,37,000
		7,23,000			7,23,000
Feb. 1	To Balance b/d	2,37,000			

It will be seen that whereas the pass book shows a credit balance of ₹ 2,43,000, the cash-book shows a debit balance of ₹ 2,37,000. We shall compare the two to establish the reasons for the difference. The reconciliation of the two statements can be done in two ways:-

1. *Arrive at pass book balance from cash book.*
2. *Arrive at cash book balance from pass book.*

Let us start with the pass book balance and arrive at the balance as per cash book.

***Step: 1**. Compare the debit side of cash book with the deposits column of pass book:-*

We find that the following cheques are recorded in the cash book but not in the pass book. Therefore if we enter these two cheques in the deposit side of the pass book the balance becomes:-

Existing balance	*2, 43,000*
Add:- M Mohan & Co.	*1,05,000*
N. Nandy & Sons	*34,000*
Total	***3,82,000***

***Step: 2** Compare the credit side of the cash book with the withdrawal column of the pass book*

We find that the following cheques are not recorded. Therefore, if we enter these two cheques on the withdrawal side of the pass book the balance becomes: -

Existing balance	*3,82,000*
Less:- K Nagpal & Co.	*(73,000)*
B Babu & Co.	*(78,000)*
Total	***2,31,000***

There is an item 'Interest on Government Securities' which appears on the deposit side of the pass book but not in the debit side of the cash book, so this item should be deducted from pass book balance:-

Existing balance	*2,31,000*
Less:- Interest on govt. securities	*(20,000)*
Total	***2,11,000***

Further, there are two items which appear on the withdrawal side of the pass book i.e. they have been deducted from the bank balance but not on the credit side of the cash book, so these items should be added in order to reconcile the balance:-

Existing balance:-	*2,11,000*
Add: Insurance premium	*25,000*
Add: Bank charges	*1,000*
Total	***2,37,000***

Therefore, we have arrived at the balance as per the cash book from the pass book.

This process shows that the difference between the two balance arise only because there are some entries made in the cash-book but not in the pass book and some entries which are made in the pass book but not in the cash book. A comparison of the two shows up such entries and then, on that basis, the reconciliation is prepared. To illustrate it again, let us proceed from the cash book balance of ₹ 2,37,000. Since cheques totalling ₹ 1,39,000 have not been entered in the pass book, let us assume that they are also omitted from the cash book, this will reduce the cash book balance to ₹ 98,000. Cheques totalling ₹ 1,51,000 have been entered on the credit side of the cash book but not in the pass book their omission from the cash book will increase the cash book balance to ₹ 2,49,000. Amounts totalling ₹ 26,000 have been entered in the withdrawals column of the pass book but not in the cash book; an entry on the credit side of the cash book for these amounts will reduce the balance to ₹ 2,23,000. The deposits column shows an entry of ₹ 20,000 not found on the debit side of the cash book; the entry made in the cash book will increase balance to ₹ 2,43,000 as shown in the pass book.

(x) **Errors:** While recording the entries errors can occur both in the cash book and in the pass book. A bank rarely makes an error but if it does, the balance in the pass book will naturally differ from cash book. Similarly if any error is committed in the cash book then it's balance will be different from that of the pass book.

Some of the errors include commission of entry, recording of an incorrect amount, recording of entry on the wrong side of the book, wrong totalling of the account or wrong balancing of the book and recording of transactions of other party.

Example 7: Mr. A's cash book shows following transactions:

CASH-BOOK (Bank column only)

Date	Particulars	Amount ₹	Date 2022	Particulars	Amount ₹
			Mar 31	By balance c/d	1,00,000
April 7	To Wayne Ltd.	60,000	Apr 1	By balance b/d	10,000
April 11	To Cash A/c	80,000	April 29	By Cash A/c	2,000
				By Balance c/d	1,28,000
		1,40,000			1,40,000

PASS-BOOK

Date		Particulars	Withdrawals ₹	Deposit ₹	Balance ₹ (cr.)
2022					
April	1	Balance b/d			1,00,000

April	7	By Wayne Ltd.		60,000	1,60,000
April	11	By Cash		80,000	2,40,000
April	13	To Vandy Ltd.	90,000		3,30,000
April	29	To Cash A/c	2,000		3,28,000

Here there are several errors made by accountant:

April 1: Balance should be have bought down in debit side as ₹ 1,00,000

April 13: Also a cheque issued to Vandy Ltd. has been omitted in the books of ₹ 90,000

So, on correcting these entries balance as per Cash Book will be:

Existing Balance		₹ 1,28,000
Add: Correct Opening Balance		₹ 1,00,000
Add: Incorrect Opening Balance (Since it was bought down on credit side it will be added back)		₹ 10,000
Less: Cheque issued not recorded		₹ 90,000
Closing Balance as per Cash Book		₹ 1,48,000
Balance as per Pass Book	3,28,000	
Less: Cheque to Vandy Ltd wrongly added to existing balance instead of being subtracted	1,80,000	₹ 1,48,000
Difference in balances between cash book and pass book		Nil

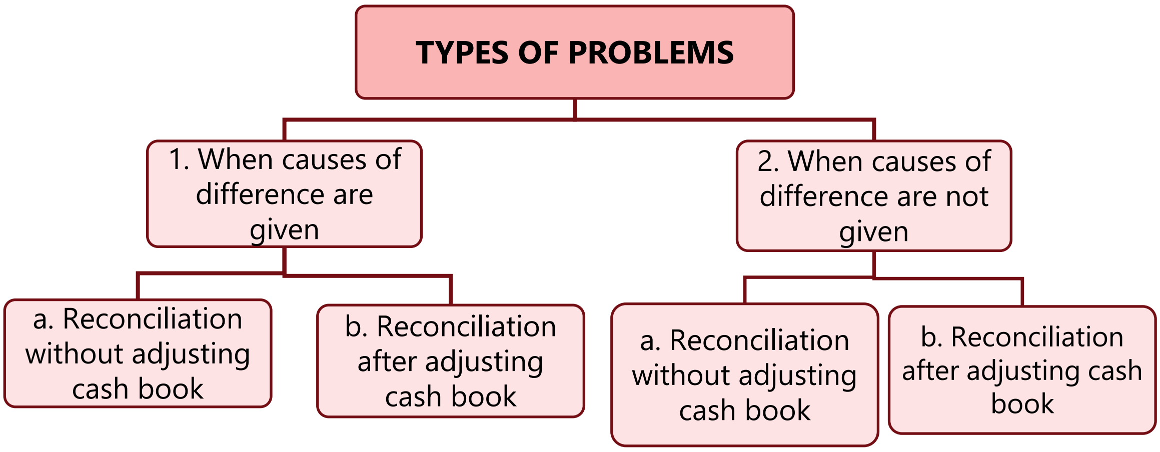
6. PROCEDURE FOR RECONCILING THE CASH BOOK BALANCE WITH THE PASS BOOK BALANCE

Before proceeding further, students must understand that 'Dr. balance as per cash book' means deposits in the bank or cash at bank or Cr. balance as per pass book. Similarly, 'Cr. balance as per cash book' means excess amount over deposits withdrawn by the account holder or overdraft balance or Dr. balance as per pass book.

It means that students can be required to start bank reconciliation from any of the following four balances as may be given in the question:

Dr. balance as per cash book	Cr. balance as per cash book	Dr. balance as per pass book	Cr. balance as per pass book

While doing reconciliation, the following types of problems can be given:-



When causes of differences are known then students can start reconciliation by taking any of the balance stated above and proceed further with the causes. Given the causes of disagreement, the balance of the other book can be either more or less on account of the said causes. If the balance of the other book is more on account of the said causes, then add the amount. If the balance of the other book is less on account of the said causes, then subtract the amount.

For example, if the reconciliation is initiated with Dr. balance as per the cash book and there is a cheque deposited in the bank but not yet cleared, then on account of non-clearance of the cheque, the Cr. balance of the pass book would be less. In this case, the amount of cheque should be subtracted from the cash book balance to arrive at the balance as per the pass book. Similarly, after making all the adjustments the balance as per the other book is obtained. It is necessary to note here that if a student starts from debit balance of cash book and after all adjustments the balance arrived is positive then it is known as Cr. balance as per the pass book and if the balance is negative then it is said to be Dr. balance as per the pass book and vice-versa.

But ***if causes of differences are not known*** then one has to compare the debit entries of cash book with the credit entries of the pass-book and vice-versa. The entries, which do not tally in the course, are the causes of difference in the balances of both the books. Once the causes are located their effects on both the books are analysed and then reconciliation statement is prepared to arrive at the actual bank balance.

In this procedure students, should also take into care that whether opening balance of both the books at particular point of time from where the books are compared, tallies or not. If opening balances are not same then unticked items are divided into two categories i.e., one relating to reconciliation of opening balance and other relating to reconciliation of closing balance.

Example 8: Jolly Ltd has following entries in its cash book and pass book:

CASH-BOOK (Bank column only)

Date 2022	Particulars	Amount ₹	Date 2022	Particulars	Amount ₹
May 1	To Balance b/d	70,000	May 15	By Richa Ltd.	20,000
May 9	To Avengers Ltd.	50,000			
May13	To Cash A/c	80,000			
			May 30	By Balance c/d	1,80,000
		2,00,000			2,00,000

PASS-BOOK

Date	Particulars	Withdrawals ₹	Deposits ₹	Dr. or Cr.	Balance ₹
2022					
May 1	Balance b/d			Cr.	1,00,000
May 7	To Mr. A	30,000		Cr.	70,000
May 12	By Avengers Ltd.		50,000	Cr.	1,20,000
May 13	By Cash A/c		80,000	Cr.	2,00,000
May 23	To Richa Ltd.	20,000		Cr.	1,80,000
May 29	Bank Charges	2,000		Cr.	1,78,000

Here when we compare Cash Book and Pass Book we found that following 2 entries remain unticked in pass book i.e. they don't appear in cash book:

Cheque to Mr. A	-	₹ 30,000
Bank Charges	-	₹ 2,000
Excess withdrawals as per pass book	-	₹ 32,000

However if we notice that difference between closing balances of two books is only ₹ 2,000 but at the same time there is a difference of ₹30,000 in opening balances as well. Thus, we need to bifurcate the unticked items as:

Regarding Opening Balance	Regarding Closing Balance
Cheque to Mr. A - ₹ 30,000 This is an item which must have been recorded in Cash book during previous month when cheque would have been issued and would have appeared as a reconciling item in BRS of that month. Since, it has been presented to bank by Mr. A in April, it has been recorded now by the bank.	Bank Charges - ₹ 2,000 These have been charged by the bank but not recorded in books.

7. METHODS OF BANK RECONCILIATION

There are following two methods of reconciling the bank balances:

7.1 Bank Reconciliation Statement without Preparation of adjusted Cash-Book

For reconciliation purposes students can take any of the four balances as the starting point and can proceed further with the causes of differences.

Based on the earlier explanation the following table has been prepared for student's ready reference when reconciliation is done on the basis of 'Balance' presentation. The final balance, which will come after addition and subtraction, will be the balance as per the other book (on the opposite side).

Causes of differences	Favourable balance (Dr.) as per cash- book	Unfavourable balance (Cr.) as per cash-book	Favourable balance (Cr.) as per pass-book	Unfavourable balance (Dr.) as per pass-book
Cheque deposited but not cleared	Subtract	Add	Add	Subtract
Cheque issued but not presented to bank	Add	Subtract	Subtract	Add
Cheque directly deposited in bank by a customer	Add	Subtract	Subtract	Add
Income (e.g., interest from UTI) directly received by bank	Add	Subtract	Subtract	Add
Expenses (e.g., telephone bills, Insurance charges) directly paid by bank on standing instructions	Subtract	Add	Add	Subtract
Bank charges levied by bank	Subtract	Add	Add	Subtract
Locker rent levied by bank	Subtract	Add	Add	Subtract
Wrong debit in the cash book	Subtract	Add	Add	Subtract
Wrong credit in the cash book	Add	Subtract	Subtract	Add

Wrong debit in the pass book	Subtract	Add	Add	Subtract
Wrong credit in pass book	Add	Subtract	Subtract	Add
Undercasting of Dr. side of bank account in the cash book	Add	Subtract	Subtract	Add
Overcasting of Dr. side of bank account in cash book	Subtract	Add	Add	Subtract
Undercasting of Cr. side of bank account in cash book	Subtract	Add	Add	Subtract
Overcasting of Cr. side of bank account in cash book	Add	Subtract	Subtract	Add
Bill receivable collected directly by bank	Add	Subtract	Subtract	Add
Interest on bank overdraft charged	Subtract	Add	Add	Subtract
Final Balance	If answer is ***positive*** then favourable balance (Cr.) as per pass-book and if negative then unfavourable balance (Dr.) as per pass-book.	If answer is ***positive*** then Unfavourable balance (Dr.) as per pass-book and if negative then Favourable balance (Cr.) as per pass-book	If answer is ***positive*** then favourable balance (Dr.) as per cash-book and if negative then unfavourable balance (Cr.) as per cash-book	If answer is ***positive*** then Unfavourable balance (Cr.) as per cash-book and if negative then Favourable balance (Dr.) as per cash-book

It is proper to prepare a neat statement showing the reconciliation of the two balances. Taking the example given in the illustration 1, the statement may be prepared as follows:

1. 'Balance' presentation.
2. 'Plus & Minus' presentation.

1. **As per Balance Presentation:**

Bank Reconciliation Statement as on 31st January, 2022

Particulars	Details(₹)	Amount(₹)
Balance as per Pass Book		2,43,000
Add: Cheques deposited but not yet credited:		
M. Mohan & Co.	1,05,000	
N. Nandy & Sons	34,000	1,39,000
Add: Premium paid and bank charges entered in the Pass Book but not yet entered in the Cash-Book		26,000
		4,08,000
Less: Cheques issued but not yet presented		
K. Nagpal & Co.	73,000	
B. Babu & Co.	78,000	1,51,000
		2,57,000
Less: Interest credited by bank but not yet entered in the Cash Book		20,000
Balance as per Cash Book		2,37,000
OR		
Balance as per Cash Book		2,37,000
Add: Cheques issued but not yet presented:		
K. Nagpal & Co.	73,000	
B. Babu & Co.	78,000	
		1,51,000
Add: Interest entered in the Pass Book, but not yet in the Cash Book		20,000
		4,08,000
Less: Cheques deposited but not yet credited:		
M. Mohan & Co.	1,05,000	
N. Nandy & Sons	34,000	1,39,000
		2,69,000
Less: Premium paid and bank charges entered in the Pass Book but not yet in the Cash Book		26,000
Balance as per Pass Book		2,43,000

2. As per Plus-Minus Presentation:

Bank Reconciliation Statement as on 31st January, 2022

Particulars	Plus Amount (₹)	Minus Amount (₹)
Balance as per Cash Book	2,37,000	
Cheques issued but not yet presented:		
K. Nagpal & Co.	73,000	
B. Babu & Co.	78,000	
Interest entered in pass book but not yet entered into cash book	20,000	
Cheques deposited but not yet credited:		
M. Mohan & Co.		1,05,000
N. Nandy & Sons		34,000
Premium paid and bank charges entered in pass book		26,000
Balance as per pass book		2,43,000
	4,08,000	4,08,000

ILLUSTRATION 2

From the following particulars, prepare a Bank Reconciliation Statement for Jindal offset Ltd.

(1) Balance as per cash book is ₹ 2,40,000

(2) Cheques issued but not presented in the bank amounts to ₹ 1,36,000.

(3) Cheques deposited in bank but not yet cleared amounts to ₹ 90,000.

(4) Bank charges amounts to ₹ 300.

(5) Interest credited by bank amounts to ₹ 1,250.

(6) The balance as per pass book is ₹ 2,86,950.

SOLUTION

Bank Reconciliation Statement

Particulars	Amount ₹
Balance as per Cash Book	2,40,000
Add: Cheque issued but not presented	1,36,000
Interest credited by bank	1,250
	3,77,250

Less : Cheque deposited but not yet cleared	(90,000)
Bank charges debited by bank	(300)
Balance as per Pass Book	2,86,950

ILLUSTRATION 3

On 31st March 2022, the Bank Pass Book of Namrata showed a balance of ₹ 1,50,000 to her credit while balance as per cash book was ₹ 1,12,050. On scrutiny of the two books, she ascertained the following causes of difference:

i) She has issued cheques amounting to ₹ 80,000 out of which only ₹ 32,000 were presented for payment.

ii) She received a cheque of ₹ 5,000 which she recorded in her cash book but forgot to deposit in the bank.

iii) A cheque of ₹ 22,000 deposited by her has not been cleared yet.

iv) Mr. Gupta deposited an amount of ₹ 15,700 in her bank which has not been recorded by her in Cash Book yet.

v) Bank has credited an interest of ₹ 1,500 while charging ₹ 250 as bank charges.

Prepare a bank reconciliation statement.

SOLUTION

Bank Reconciliation Statement as on 31st March, 2022

Particulars	Details (₹)	Amount (₹)
Balance as per Pass Book (Cr.)		1,50,000
Add: Cheque deposited but not yet cleared	22,000	
Add: Cheque recorded in Cash Book but not yet deposited	5,000	
Add: Bank Charges debited by bank	250	27,250
Less: Cheque issued but not yet presented	48,000	
Less: Amount deposited but not recorded in Cash Book	15,700	
Less: Interest allowed by bank	1,500	65,200
Balance as per Cash Book		1,12,050

ILLUSTRATION 4

From the following particulars ascertain the balance that would appear in the Bank Pass Book of A on 31st December, 2022.

(1) The bank overdraft as per Cash Book on 31st December, 2022 ₹ 6,340.

(2) Interest on overdraft for 6 months ending 31st December, 2022 ₹ 160 is entered in Pass Book.

(3) Bank charges of ₹ 400 are debited in the Pass Book only.

(4) Cheques issued but not cashed prior to 31st December, 2022, amounted to ₹ 11,68,000.

(5) Cheques paid into bank but not cleared before 31st December, 2022 were for ₹ 22,17,000.

(6) Interest on investments collected by the bank and credited in the Pass Book ₹ 12,00,000.

SOLUTION

Bank Reconciliation Statement

As on 31st December, 2022

Particulars	Amount ₹
Overdraft as per Cash Book	6,340
Add: Interest debited in the Pass Book but not yet entered in the Cash Book	160
Add: Bank charges debited in the Pass Book but not entered in the Cash Book	400
Add : Cheques deposited but not yet credited in the Pass Book	22,17,000
	22,23,900
Less: Cheques issued but not yet presented	(11,68,000)
Less: Interest collected and credited by bank but not yet entered in Cash Book	(12,00,000)
Balance as per Pass Book (Credit/Favourable balance)	(1,44,100)

The above illustration can also be presented with the column for "Plus" and "Minus."

Particulars	Plus Amount ₹	Minus Amount ₹
Overdraft as per Cash Book		6,340
Interest debited in Pass Book but not yet in Cash Book		160
Cheque issued but not yet presented	11,68,000	
Cheques paid in but not yet credited by the Bank		22,17,000

Bank charges		400
Interest collected and credited by the Bank in the Pass Book but not yet entered in Cash Book	12,00,000	
Balance as per Pass Book		1,44,100
Total	23,68,000	23,68,000

7.2 Bank Reconciliation Statement after the Preparation of adjusted Cash-Book

7.2.1 Meaning of adjusted cash book

When the balance in the cash book is first adjusted for certain adjustments before taking it to the bank reconciliation statement, then it is known as adjusted cash book balance. Adjusting the cash-book before preparing the bank reconciliation statement is completely optional, if reconciliation is done during different months. But if reconciliation is done at the end of the accounting year or financial year, the cash-book must be adjusted so as to reflect the correct bank balance in the balance sheet.

While adjusting the cash-book the following adjustments are considered:-

1. All the errors (like incorrect amount recorded in the cash-book, entry posted twice in the cash-book, over/undercasting of the balance etc.) and
2. Omissions (like bank charges recorded in the pass-book only, interest debited by the bank, direct receipt or payment by the bank, dishonour of cheques/bills etc.) by the cash-book are taken into care

Only above transactions are considered for adjusting cash book. Apart from this, any delay in recording in the pass-book due to difference in timing (like cheque issued but not presented for payment, cheque deposited but not cleared) is taken to bank reconciliation statement. This adjusted cash-book balance is taken to bank reconciliation statement.

Errors occurring in the pass-book are not to be adjusted in the cash book. All the adjustments considered in the adjusted cash-book are not carried again to the Bank Reconciliation Statement.

ILLUSTRATION 5

On 30th September, 2022, the bank account of X, according to the bank column of the Cash-Book, was overdrawn to the extent of ₹ 4,062. On the same date the bank statement showed a credit balance of ₹ 20,758 in favour of X. An examination of the Cash Book and Bank Statement reveals the following:

1. *A cheque for ₹ 13,14,000 deposited on 29th September, 2022 was credited by the bank only on 3rd October, 2022.*
2. *A payment by cheque for ₹ 16,000 has been entered twice in the Cash Book.*
3. *On 29th September, 2022, the bank credited an amount of ₹ 1,17,400 received from a customer of X, but the advice was not received by X until 1st October, 2022.*
4. *Bank charges amounting to ₹ 580 had not been entered in the Cash Book.*
5. *On 6th September, 2022, the bank credited ₹ 20,000 to X in error.*
6. *A bill of exchange for ₹ 1,40,000 was discounted by X with his bank. This bill was dishonoured on 28th September, 2022 but no entry had been made in the books of X.*
7. *Cheques issued upto 30th September, 2022 but not presented for payment upto that date totalled ₹ 13,26,000.*

You are required :

(a) to show the appropriate rectifications required in the Cash Book of X, to arrive at the correct balance on 30th September, 2022 and

(b) to prepare a bank reconciliation statement as on that date.

SOLUTION

(a) **Cash Book (Bank Column)**

Date 2022	Particulars	Amount ₹	Date 2022	Particulars	Amount ₹
Sept. 30	To Party A/c	16,000	Sept. 30	By Balance b/d	4,062
	To Customer A/c			By Bank charges	580
	(Direct deposit)	1,17,400		By Customer A/c	
	To Balance c/d	11,242		(B/R dishonoured)	1,40,000
		1,44,642			1,44,642

(b) **Bank Reconciliation Statement as on 30th September, 2022**

Particulars	Amount ₹
Overdraft as per Cash Book	11,242
Add: Cheque deposited but not collected upto 30th September, 2022	13,14,000
	13,25,242

Less: Cheques issued but not presented for payment upto 30th September, 2022	(13,26,000)
Credit by Bank erroneously on 6th September	(20,000)
Credit balance as per bank statement	20,758

Note: Bank has credited X by 20,000 in error on 6th September, 2022. If this mistake is rectified in the bank statement, then this will not be deducted in the above statement along with ₹ 13,26,000 resulting in credit balance of ₹ 758 as per pass-book.

ILLUSTRATION 6

On 30th December, 2022 the bank column of A. Philip's cash book showed a debit balance of ₹ 4,610. On examination of the cash book and bank statement you find that:

1. *Cheques amounting to ₹ 6,30,000 which were issued to trade payables and entered in the cash book before 30th December, 2022 were not presented for payment until that date.*
2. *Cheques amounting to ₹ 2,50,000 had been recorded in the cash book as having been paid into the bank on 30th December, 2022, but were entered in the bank statement on1st January, 2023.*
3. *A cheque received for ₹ 73,000 had been dishonoured prior to 30th December, 2022, but no record of this fact appeared in the cash book.*
4. *A dividend of ₹ 3,80,000, paid direct to the bank had not been recorded in the cash book.*
5. *Bank interest and charges amounting to ₹ 4,200 had been charged in the bank statement but not entered in the cash book.*
6. *No entry had been made in the cash book for a trade subscription of ₹ 10,000 paid vide banker's order in November, 2022.*
7. *A cheque for ₹ 27,000 drawn by B. Philip had been charged to A. Philip's bank account by mistake in December, 2022.*

You are required:

(a) *to make appropriate adjustments in the cash book bringing down the correct balance, and*

(b) *to prepare a statement reconciling the adjusted balance in the cash book with the balance shown in the bank statement.*

SOLUTION

(a) **A. Philip**

Dr. **Cash Book (Bank column)** **Cr.**

Date 2022	Particulars	Amount ₹	Date 2022	Particulars	Amount ₹
Dec. 30	To Balance b/d	4,610	Dec. 30	By Trade receivables- Cheque dishonoured	73,000
	To Dividend received	3,80,000		By Bank interest and charges	4,200
				By Trade Subscription	10,000
			Dec. 31	By Balance c/d	2,97,410
		3,84,610			3,84,610
2023 Jan. 1	To Balance b/d	2,97,410			

(b) **Bank Reconciliation Statement as at 30th December, 2022**

Particulars	Amount ₹
Balance per cash book	2,97,410
Add: Cheques not yet presented	6,30,000
	9,27,410
Less: Lodgement not yet recorded by bank	(2,50,000)
	6,77,410
Less: Cheque wrongly charged	(27,000)
Balance as per the bank statement	6,50,410

ILLUSTRATION 7

From the following information, prepare a Bank reconciliation statement as at 31st December, 2022 for Messrs New Steel Limited : ₹

(1)	*Bank overdraft as per Cash Book on 31st December, 2022*	22,45,900
(2)	*Interest debited by Bank on 26th December, 2022 but no advice received*	2,78,700
(3)	*Cheque issued before 31st December, 2022 but not yet presented to Bank*	6,60,000
(4)	*Transport subsidy received from the State Government directly by the Bank but not advised to the company*	14,25,000
(5)	*Draft deposited in the Bank, but not credited till 31st December, 2022*	13,50,000
(6)	*Bills for collection credited by the Bank till 31st December, 2022 but no advice received by the company*	8,36,000
(7)	*Amount wrongly debited to company account by the Bank, for which no details are available*	7,40,000

SOLUTION

M/s. New Steel Ltd.

Bank Reconciliation Statement as on 31st Dec, 2022

Particulars	Details ₹	Amount ₹
Overdraft as per Cash Book		22,45,900
Add : Interest charged by the bank	2,78,700	
Draft deposited in bank but not yet credited	13,50,000	
Wrong debit by the bank, under verification	7,40,000	23,68,700
		46,14,600
Less: Cheque issued but not yet presented	(6,60,000)	
Transport subsidy not yet recorded in the Cash Book	(14,25,000)	
Bills for collection credited in the bank not yet entered in the cash book	(8,36,000)	(29,21,000)
Overdraft as per bank statement		16,93,600

ILLUSTRATION 8

The Cash Book of Mr. Gadbadwala shows ₹ 8,36,400 as the balance at Bank as on 31st December, 2022, but you find that it does not agree with the balance as per the Bank Pass Book. On scrutiny, you find the following discrepancies:

(1) *On 15th December, 2022 the payment side of the Cash Book was undercast by ₹ 10,000.*

(2) *A cheque for ₹ 1,31,000 issued on 25th December, 2022 was not taken in the bank column.*

(3) *One deposit of ₹ 1,50,000 was recorded in the Cash Book as if there is no bank column therein.*

(4) *On 18th December, 2022 the debit balance of ₹ 15,260 as on the previous day, was brought forward as credit balance in the Cash book.*

(5) *Of the total cheques amounting to ₹ 11,514 drawn in the last week of December, 2022, cheques aggregating ₹ 7,815 were encashed in December.*

(6) *Dividends of ₹ 25,000 collected by the Bank and subscription of ₹ 1,000 paid by it were not recorded in the Cash Book.*

(7) *One out-going Cheque of ₹ 3,50,000 was recorded twice in the Cash Book. Prepare a Reconciliation Statement.*

SOLUTION

(If the books are not closed on 31st December, 2022)

Bank Reconciliation Statement of Mr. Gadbadwala as on 31st Dec., 2022

Particulars		**Details** ₹	**Amount** ₹
Balance as per the Cash Book			8,36,400
Add : Mistake in bringing forward ₹ 15,260 debit balance as credit balance on 18th Dec., 2022		30,520	
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		25,000	
Cheque recorded twice in the Cash Book		3,50,000	
Deposit not recorded in the Bank column		1,50,000	5,59,219
			13,95,619
Less : Wrong casting in the Cash Book on 15th Dec.		10,000	

Cheques issued but not entered in the Bank column		1,31,000	
Subscription paid by the bank directly not yet recorded in the Cash Book		1,000	(1,42,000)
Balance as per the Pass Book			12,53,619

If the books are to be closed on 31st December, then adjusted cash book will be prepared as given below:

Cash Book (Bank Column)

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	8,36,400	By wrong casting	10,000
To error for wrong posting	30,520	By cheques not entered	1,31,000
To dividends collected by bank	25,000	By subscription	1,000
To cheques recorded twice	3,50,000	By balance c/d	12,49,920
To deposit not recorded	1,50,000		
	13,91,920		13,91,920

Bank Reconciliation Statement

Particulars	₹
Balance as per the Cash Book (corrected)	12,49,920
Add: Cheques issued but not yet presented	3,699
Balance as per the Pass Book	12,53,619

ILLUSTRATION 9

The following are the Cash Book (bank column) and Pass Book of Jain for the months of March, 2022 and April, 2022:

Cash Book (Bank Column only)

Date	*Particulars*	*Amount Dr. ₹*	*Date*	*Particulars*	*Amount Cr. ₹*
01/3/2022	*To Balance b/d*	*60,000*	*03/3/2022*	*By Cash A/c*	*2,00,000*
06/3/2022	*To Sales A/c*	*3,00,000*	*07/3/2022*	*By Modi*	*60,000*
10/3/2022	*To Ram*	*65,000*	*12/3/2022*	*By Patil*	*30,000*
18/3/2022	*To Singhal*	*2,70,000*	*18/3/2022*	*By Suresh*	*40,000*

25/3/2022	*To Goyal*	*33,000*	*24/3/2022*	*By Ramesh*	*1,50,000*
31/3/2022	*To Patel*	*65,000*	*30/3/2022*	*By Balance c/d*	*3,13,000*
		7,93,000			*7,93,000*

Pass Book

Date	*Particulars*	*Amount Dr. ₹*	*Amount Cr. ₹*	*Dr. or Cr.*	*Balance ₹*
1/4/2022	*By Balance b/d*		*3,65,000*	*Cr.*	*3,65,000*
3/4/2022	*By Goyal*		*33,000*	*Cr.*	*3,98,000*
5/4/2022	*By Patel*		*65,000*	*Cr.*	*4,63,000*
7/4/2022	*To Naresh*	*2,80,000*		*Cr.*	*1,83,000*
12/4/2022	*To Ramesh*	*1,50,000*		*Cr.*	*33,000*
15/4/2022	*To Bank Charges*	*200*		*Cr.*	*32,800*
20/4/2022	*By Usha*		*17,000*	*Cr.*	*49,800*
25/4/2022	*By Kalpana*		*38,000*	*Cr.*	*87,800*
30/4/2022	*To Sunil*	*6,200*		*Cr.*	*81,600*

Reconcile the balance of cash book on 31/3/2022.

SOLUTION

1. On scrutiny of the debit side of the Cash Book of March 2022 and receipt side of the Pass Book of April, 2022 reveals that two cheques deposited in Bank (Goyal ₹ 33,000 and Patel ₹ 65,000) in March were not credited by the Bank till 31/3/2022.

2. On scrutiny of the credit side of the cash book and payment side of the Pass Book reveals that a cheque issued to Ramesh for ₹ 1,50,000 in March 2022, had not been presented for payment in Bank till 31/3/2022. Therefore the Bank Reconciliation statement on 31/3/2022 will appear as follows :

Bank Reconciliation Statement as on 31st March, 2022

Particulars	**Amount (₹)**
Balance as per the Cash Book	3,13,000
Add : Cheque issued but not presented for payment	1,50,000
	4,63,000
Less : Cheque deposited but not credited by Bank	(98,000)
Balance as per the Pass Book	3,65,000

ILLUSTRATION 10

When Nikki & Co. received a Bank Statement showing a favourable balance of ₹ 10,39,200 for the period ended on 30th June, 2022, this did not agree with the balance in the cash book.

An examination of the Cash Book and Bank Statement disclosed the following :

1. *A deposit of ₹ 3,09,200 paid on 29th June, 2022 had not been credited by the Bank until 1st July, 2022.*
2. *On 30th March, 2022 the company had entered into hire purchase agreement to pay by bank order a sum of ₹ 3,00,000 on the 10th of each month, commencing from April, 2022. No entries had been made in Cash Book.*
3. *A customer of the firm, who received a cash discount of 4% on his account of ₹ 4,00,000 paid the firm a cheque on 12th June. The cashier erroneously entered the gross amount in the bank column of the Cash Book.*
4. *Bank charges amounting to ₹ 3,000 had not been entered in Cash-Book.*
5. *On 28th June, a customer of the company directly deposited the amount in the bank ₹ 4,00,000, but no entry had been made in the Cash Book.*
6. *₹ 11,200 paid into the bank had been entered twice in the Cash Book.*
7. *A debit of ₹ 11,00,000 appeared in the Bank Statement for an unpaid cheque, which had been returned marked 'out of date'. The cheque had been re-dated by the customer and paid into Bank again on 5th July, 2022.*

Prepare Bank Reconciliation Statement on 30 June, 2022.

SOLUTION

Bank Reconciliation Statement on 30th June, 2022

Particulars	Details (₹)	Amount (₹)
Balance as per the Pass Book		10,39,200
Add: Deposited with bank but not credited	3,09,200	
Payment of Hire Purchase installments not entered in the Cash Book (₹ 3,00,000 x 3)	9,00,000	
Discount allowed wrongly entered in bank column	16,000	
Bank charges not entered in the Cash Book	3,000	
Deposit entered in the Cash Book twice	11,200	
Cheque returned 'out of date' entered in the Cash Book	11,00,000	23,39,400

		33,78,600
Less: Direct deposit by customer not entered in the Cash Book		(4,00,000)
Balance as per the Cash Book		29,78,600

ILLUSTRATION 11

Mr. Manoj is employed by Century Rayon and Carpets Pvt Ltd. as their cashier. The main responsibility of Mr. Manoj is to maintain the company's cash book and prepare a bank reconciliation statement at the end of each month. The cash book (only bank column) is set out below together with a copy of the bank statement for the month of February 2022.

You are required to :

a) Reconcile the cash book with the bank statement.

b) Make necessary entries to update the cash book.

c) Start with the balance as per cash book, list any unpresented cheques and sub-total on the reconcliation statement.

Century Rayon and Carpets Pvt Ltd

Cash Book (Bank Column only)

Date	***Particulars***	***Amount Dr. ₹***	***Date***	***Particulars***	***Amount Cr. ₹***
01/02/2022	*To Balance b/d*	*1,42,500*	*03/02/2022*	*By Bhagwandas*	1,980
01/02/2022	*To Blue and Co*	*1,570*	*07/02/2022*	*By Maruti Ltd (400460)*	*1,500*
04/02/2022	*To GM Ltd*	*2,430*	*12/02/2022*	*By Jackson Ltd (400461)*	*54,000*
08/02/2022	*To Robinson Ltd*	*910*	*18/02/2022*	*By PC computers (400462)*	*1,420*
13/02/2022	*To Donald*	*750*	*24/02/2022*	*By Shiv garage (400463)*	*49,000*
20/02/2022	*To Avenue Super mart*	*4,200*	*30/02/2022*	*By Petty cash (400465)*	*1,500*
28/02/2022	*To Sleep Well Ltd*	*940*		*By Shweta & Co (400464)*	*2,100*
				By AV Partners (400466)	*5,200*
				By Balance c/d	*36,600*
		1,53,300			1,53,300

Customer: Century Rayon and Carpets Pvt Ltd
Account No – xxxxx0439

Account Statement for the month of February 2022

Date	*Particulars*	*Amount Dr.*	*Amount Cr.*	*Dr. or Cr.*	*Balance ₹*
1/02/2022	*Balance b/d*				*1,42,500*
3/02/2022	*Cheques*		*1,570*	*Cr.*	*1,44,070*
5/02/2022	*Maruti Ltd*	*1,500*		*Dr.*	*1,42,570*
7/02/2022	*Bhagwandas*	*1,980*		*Dr.*	*1,40,590*
12/02/2022	*GM Ltd*		*2,430*	*Cr.*	*1,43,020*
15/02/2022	*Robinson Ltd*		*910*	*Cr.*	*1,43,930*
20/02/2022	*Premium of New India Insurance Ltd*	*3,800*		*Dr.*	*1,40,130*
14/02/2022	*Donald*		*750*	*Cr.*	*1,40,880*
14/02/2022	*400463*	*49,000*		*Dr.*	*91,880*
23/02/2022	*cheques*		*4,200*	*Cr.*	*96,080*
26/02/2022	*Savita*	*1,030*		*Dr.*	*95,050*
26/02/2022	*400465*	*1,500*		*Dr.*	*93,550*
27/02/2022	*Shreya*		*2,200*	*Cr.*	*95,750*
28/02/2022	*Bank charges*	*2,538*		*Dr.*	*93,212*

SOLUTION

In the books of Century Rayon and Carpets Pvt Ltd

a) Journal entries to be posted:

Bank A/c	Dr 2200	
To Shreya A/c		2200
Bank Charges A/c	Dr 2538	
Insurance premium A/c	Dr 3800	
Savita A/c	Dr 1030	
To Bank A/c		7368

After posting above entries, following will be the updated book of the company.

Cash Book (Bank Column)

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	36,600	By bank charges	2,538
To direct receipt in bank	2,200	By insurance premium	3,800
		By direct payment to Savita	1,030
		By balance c/d	31,432
	38,800		38,800

Bank Reconciliation Statement as on February 28, 2022

Particulars	Details	Amount ₹
Updated Balance as per Cash book		31,432
Add: Cheques issued but not yet presented for payment		
Jackson Ltd	54000	
P C Computers	1,420	
Shweta & Co	2,100	
A.V. Partners	5,200	62,720
		94,152
Less: Cheques deposited but not yet credited		
Sleep Well Ltd	940	940
Balance as per the bank statement		93,212

SUMMARY

- Bank pass book is merely a copy of the customer's account in the books of bank.
- Bank reconciliation statement is a statement which reconciles the balance as per cash book with the balance as per bank pass book by showing all causes of difference between the two.
- The salient features of bank reconciliation statement:
  - The reconciliation will bring out any errors that may have been committed either in the cash book or in the pass book;

- ✦ Any undue delay in the clearance of cheques will be shown up by the reconciliation;
- ✦ A regular reconciliation discourages the accountant of the bank from embezzlement. There have been many cases when the cashiers merely made entries in the cash book but never deposited the cash in the bank; they were able to get away with it only because of lack of reconciliation.
- ✦ It helps in finding out the actual position of the bank balance.

- The difference in the balances of both the books can be because of the following reasons:
  1. Timing differences,
  2. Transactions;
  3. Errors.
- Bank reconciliation can be started from any of the following four balances given in the question:
  1. Dr. balance as per cash book
  2. Cr. balance as per cash book
  3. Dr. balance as per pass book
  4. Cr. balance as per pass book
- There are two methods of reconciling the bank balances :
  1. Bank reconciliation statement without preparation of adjusted cash-book.
  2. Bank reconciliation statement after the preparation of adjusted cash-book.

TEST YOUR KNOWLEDGE

True or False

1. *Bank Reconciliation is the process of reconciling cash column of the cash book and bank column of the cash book.*
2. *There are 3 types of differences between cash book and pass book namely Timing, Transactions & Errors.*
3. *Adjusting the cash book for any errors and/or omissions before preparing bank reconciliation is optional when the reconciliation is done at the end of the financial year.*
4. *Debit balance in cash book is same as overdraft as per pass book.*

5. *Bank charges debited by the bank is an example of timing difference for the purposes of bank reconciliation.*

6. *Overcasting of the debit side of the cash book is an example of a difference that is due to error.*

7. *When we start bank reconciliation with a debit balance in cash book, then cheques issued but not yet presented should be added back to arrive at the balance as per pass book.*

8. *The bank charges charged by the bank should be deducted when bank reconciliation statement is being prepared starting from a credit balance of pass book.*

9. *When the causes of differences between pass book balance and cash book is not known, then the bank reconciliation statement can be prepared by matching the two books and identifying any unticked items in both sets.*

10. *While preparing the bank reconciliation statement starting with debit balance as per pass book or bank statement, the deposited cheques that are not yet cleared need not be adjusted.*

11. *Cash book shows a debit balance of ₹ 50,000 and the only difference from the balance as shown in pass book relates to cheques issued for ₹ 60,000 but not yet presented for payment. The balance as per pass book should be ₹ 1,10,000.*

12. *Overcasting of credit side of the cash book shall result in a higher bank balance in cash book when compared with pass book balance.*

13. *A cheque for ₹ 25,000 that was issued and was also presented for payment in same month but erroneously recorded on debit side of the cash book would cause a difference of ₹ 50,000 from the balance in pass book.*

14. *A direct debit by bank on account of any payment as may be instructed by customer should be recorded on credit side of cash book.*

15. *Bank Reconciliation Statement can be prepared in two formats – "Balance" presentation and "Plus & Minus" presentation.*

16. *The difference between cash book & pass book that relates to errors are those mostly made by Bank.*

17. *A cheque for ₹ 80,000 that was discounted from bank was dishonoured and the bank charged ₹ 1,600 as the charges on account of same. While starting with debit balance in cash book for preparing bank reconciliation statement, we need to deduct ₹ 78,400 to reconcile with pass book.*

18. *Interest on savings bank that is allowed or credited by bank is generally recorded in cash book prior to it being recorded by bank.*

19. *A regular bank reconciliation discourages the accountants to be involved in any kind of funds embezzlement.*

20. *Timing difference relates the transactions that are recorded in the same period in both cash book and also the bank pass book.*

Multiple Choice Questions

1. *When the balance as per Cash Book is the starting point, direct deposits by customers are:*

   (a) *Added*

   (b) *Subtracted*

   (c) *Not required to be adjusted.*

2. *A debit balance in the depositor's Cash Book will be shown as:*

   (a) *A debit balance in the Bank Statement.*

   (b) *A credit balance in the Bank Statement.*

   (c) *An overdrawn balance in the Bank Statement.*

3. *When balance as per Pass Book is the starting point, interest allowed by Bank is*

   (a) *Added*

   (b) *Subtracted*

   (c) *Not required to be adjusted*

4. *A Bank Reconciliation Statement is prepared with the help of:*

   (a) *Bank statement and bank column of the Cash Book.*

   (b) *Bank statement and cash column of the Cash Book*

   (c) *Bank column of the Cash Book and cash column of the Cash Book.*

5. *The cash book showed an overdraft of ₹ 1,50,000, but the pass book made up to the same date showed that cheques of ₹ 10,000, ₹ 5,000 and ₹ 12,500 respectively had not been presented for payments; and the cheque of ₹ 4,000 paid into account had not been cleared. The balance as per the pass book will be:*

   (a) *₹ 1,10,000*

   (b) *₹ 2,17,500*

   (c) *₹ 1,26,500*

6. *When drawing up a Bank Reconciliation Statement, if you start with a debit balance as per the Bank Statement, the unpresented cheques should be:*

   (a) *Added;*

   (b) *Deducted;*

   (c) *Not required to be adjusted.*

7. *When drawing up a BRS if you start with a Dr. Balance as per Bank Statement, the following are added:*

   1. *Cheque issued but not presented to bank*

   2. *B/R collected directly by bank*

   3. *Overcasting of the Dr. Side of bank A/c in the cash book.*

      (a) *only 1*

      (b) *only 1& 2*

      (c) *all of the above*

8. *A bank reconciliation statement is mainly prepared to:*

   (a) *Reconcile the cash balance of the cash book*

   (b) *Reconcile the difference between the bank balance shown by the cash book and bank passbook*

   (c) *both a & b*

Theory Questions

1. *Write short note on Bank reconciliation statement.*

2. *State the causes of difference between the balance shown by the pass book and the cash book.*

Practical Questions

1. *From the following particulars prepare a bank reconciliation statement as on 31st December 2022:*

   (i) *On 31st December, 2022 the cash-book of a firm showed a bank balance of ₹ 60,000 (debit balance).*

   (ii) *Cheques had been issued for ₹ 15,00,000, out of which cheques worth ₹ 4,00,000 only were presented for payment.*

(iii) *Cheques worth ₹ 11,40,000 were deposited in the bank on 28th December, 2022 but had not been credited by the bank. In addition to this, one cheque for ₹ 5,00,000 was entered in the cash book on 30th December, 2022 but was banked on 3rd January, 2023.*

(iv) *A cheque from Susan for ₹ 4,00,000 was deposited in the bank on 26th December 2022 but was dishonoured and the advice was received on 2nd January, 2023.*

(v) *Pass-book showed bank charges of ₹ 2000 debited by the bank.*

(vi) *One of the debtors deposited a sum of ₹ 5,00,000 in the bank account of the firm on 20th December, 2022 but the intimation in this respect was received from the bank on 2nd January, 2023.*

(vii) *Bank pass-book showed a debit balance of ₹ 3,82,000 on 31st December, 2022.*

2. *According to the cash-book of Gopi, there was a balance of ₹ 44,50,000 in his bank on 30th June, 2022. On investigation you find that:*

(i) *Cheques amounting to ₹ 6,00,000 issued to creditors have not been presented for payment till the date.*

(ii) *Cheques paid into bank amounting to ₹ 11,05,000 out of which cheques amounting to ₹ 5,50,000 only collected by the bank up to 30th June 2022.*

(iii) *A dividend of ₹ 40,000 and rent amounting to ₹ 6,00,000 received by the bank and entered in the pass-book but not recorded in the cash book.*

(iv) *Insurance premium (up to 31st December, 2022) paid by the bank ₹ 27,000 not entered in the cash book.*

(v) *The payment side of the cash book had been under casted by ₹ 5,000.*

(vi) *Bank charges ₹ 1,500 shown in the pass book had not been entered in the cash book.*

(vii) *A bill payable of ₹ 2,00,000 had been paid by the bank but was not entered in the cash book and bill receivable for ₹ 60,000 had been discounted with the bank at a cost of ₹ 1,000 which had also not been recorded in cash book.*

Required:

(a) *to make the appropriate adjustments in the cash book, and*

(b) *to prepare a statement reconciling it with the bank pass book.*

3. *Prepare a bank reconciliation statement as on 30th September, 2022 from the following particulars:*

Particulars	**₹**
Bank balance as per pass-book	*10,00,000*
Cheque deposited in the bank, but no entry was passed in the Cash-Book	*5,00,000*
Cheque received, but not sent to bank	*11,20,000*
Credit side of the bank column cast short	*2,000*
Insurance premium paid directly by the bank under the standing advice	*60,000*
Bank charges entered twice in the cash book	*2,000*
Cheque issued, but not presented to the bank for payment	*5,00,000*
Cheque received entered twice in the cash book	*10,000*
Bills discounted dishonoured not recorded in the cash book.	*5,00,000*

4. *Prepare a bank reconciliation statement from the following particulars on 31st March, 2022:*

Particulars	**₹**
Debit balance as per bank column of the cash book	*37,20,000*
Cheque issued to creditors but not yet presented to the bank for payment	*7,20,000*
Dividend received by the bank but not yet entered in the cash book	*5,00,000*
Interest allowed by the bank	*12,500*
Cheques deposited into bank for collection but not collected by bank up to this date.	*15,40,000*
Bank charges	*2,000*
A cheque deposited into bank was dishonoured, but no intimation received	*3,20,000*
Bank paid house tax on our behalf, but no information received from bank in this connection.	*3,50,000*

5. *Prepare a bank reconciliation statement from the following particulars on 31st March, 2022 and show the balance as per cash book:*

   i) Overdraft as per passbook on March 31, 2022, is ₹ 3,00,000.

   ii) Interest on bank overdraft not entered in the cash book Rs. 36,500 *iii)* *Insurance premium of Rs. 17,950 was due and paid by the bank but same has not been accounted in the books.*

iv) *Cheques drawn in the last week of March,2022, but not cleared till date for ₹ 13,000 and Rs. 23,500.*

v) *Cheques deposited into bank on February,2022, but yet to be credited on dated March 31, 2022 Rs. 56,000.*

vi) *Amount of Rs. 20,500 is wrongly debited by the bank*

vii) *Interest on Investment Rs. 83,800 collected and credited by bank but the same has not been entered in the Cash Book.*

ANSWERS/HINTS

True and False

1. False : Bank Reconciliation Statement reconciles bank column of cash book with the balance in the pass book i.e. customer account in the books of bank.

2. True : These are the three broad categories.

3. False : Adjusting the cash book is mandatory when bank reconciliation is done at the end of the financial year.

4. False : Debit balance as per cash book should be represented by credit or favourable balance in pass book.

5. False : Bank charges are example of the transactions that bank carries out by itself and the same has not been recorded in the cashbook until statement is obtained from the bank.

6. True : Overcasting is an example of an error.

7. True : Since the cheques issued would have been recorded as payments and bank balance was credited in cash book, we need to add it back as the same is not yet deducted from our bank balance.

8. False : Bank charges should be added when we start with credit or favourable balance in pass book as bank would have debited the charges.

9. True : Since, we don't know the causes of difference, matching the two statements is only efficient way to identify the difference.

10. False : Cheques deposited but not yet cleared should be subtracted from debit or unfavourable balance in pass book.

11. True : Cheques issued but not yet presented should be added back to a debit balance in cash book to arrive at pass book balance i.e. ₹ 50,000 + ₹ 60,000 = ₹ 1,10,000.

12. False : Overcasting of credit side means excessive payments are recorded and hence would lower the bank balance.

13. True: ₹ 25,000 payment is recorded as a receipt and hence it will have to be adjusted twice (once to nullify and then once to record actual payment) hence causing the difference of double amount.

14. True : It is an example of a payment instructed by customer to be directly debited by bank, and hence credited in the cash book.

15. True : Reconciliation statement can be prepared in either of the two formats.

16. False : Bank rarely makes mistakes, and hence differences that relate to errors are generally made in cash book.

17. False : We need to deduct ₹ 81,600 (i.e. both cheque returned & charges) from debit balance in cash book to arrive at balance as per pass book.

18. False : Interest allowed by bank is mostly recorded in cash book after the entry has been made in the pass book or bank statement.

19. True : In absence of any reconciliation, the accountants can mis-utilize the funds temporarily by recording the entry without actual depositing the cash.

20. False : Timing differences relate to the transactions that are recorded in cash book and pass book in two different periods.

Multiple Choice Questions

1.	(a)	**2.**	(b)	**3.**	(b)	**4.**	(a)	**5.**	(c)	**6.**	(a)
7.	(b)	**8.**	(b)								

Theoretical Questions

1. Bank reconciliation statement is prepared as on a particular date to reconcile and explain the causes of difference between the bank balance as per cash book and the same as per savings bank pass book or current account statement. At the end of each month, the bank balance as per cash book and that as per pass book /bank statement should be compared and, if there is disagreement, these balances should be reconciled stating exact reasons of disagreement. The reconciliation is made in a statement called the bank reconciliation statement.

2. The difference between the balance shown by the passbook and the cashbook may arise on account of the following:

(i) Cheques issued but not yet presented for payment.

(ii) Cheques deposited into the bank but not yet cleared.

(iii) Interest allowed by the bank.

(iv) Interest and expenses charged by the bank.

(v) Interest and dividends collected by the bank.

(vi) Direct payments by the bank.

(vii) Direct deposits into the bank by a customer.

(viii) Dishonour of a bill discounted with the bank.

(ix) Bills collected by the bank on behalf of the customer.

(x) An error committed in cash book or by the bank etc.

(xi) Undercasting or Overcasting in cashbook.

Practical Questions

1. **Bank Reconciliation Statement**

as on 31st December, 2022

	₹	₹
Bank balance (Dr.) as per cash book		60,000
Add: Cheques issued but not yet presented for payment	11,00,000	
Cheques directly deposited by a customer not yet recorded in cash book	5,00,000	16,00,000
		16,60,000
Less: Cheques deposited but not yet credited by bank	11,40,000	
Cheque received and recorded in cash book but not yet banked	5,00,000	
Cheque dishonoured by the bank; the dishonour entry not yet passed in cash book	4,00,000	
Bank charges not recorded in cash book	2,000	(20,42,000)
Bank balance (Dr.) as per pass book		(3,82,000)

2. **Cash Book (Bank Column)**

Receipts	₹	Payments	₹
To Balance b/d	44,50,000	By Insurance premium A/c	27,000
To Dividend A/c	40,000	By Correction of errors	5,000
To Rent A/c	6,00,000	By Bank charges	1,500
To Bill receivable A/c	59,000	By Bill payable	2,00,000
		By Balance c/d	49,15,500
	51,49,000		51,49,000

Bank Reconciliation Statement

as on 30th June, 2022

	₹
Adjusted balance as per cash book (Dr.)	49,15,500
Add: Cheques issued but not presented for payment till 30th June, 2022	6,00,000
Less: Cheques paid into bank for collection but not collected till 30th June, 2022	(5,55,000)
Balance as per pass book	49,60,500

3. **Bank Reconciliation Statement as on 30th September, 2022**

	₹	₹
Bank balance as per pass book		10,00,000
Add: Cheque received but not sent to the bank	11,20,000	
Credit side of the bank column cast short	2,000	
Insurance premium paid directly not recorded in the cash book	60,000	
Cheque received entered twice in the cash book	10,000	
Bills dishonoured not recorded in the cash book	5,00,000	16,92,000
		26,92,000
Less: Cheque deposited into the bank but no entry was passed in the cash book	5,00,000	
Bank charges recorded twice in the cash book	2,000	
Cheque issued but not presented to the bank	5,00,000	(10,02,000)
Bank balance as per cash book		16,90,000

4. **Bank Reconciliation Statement as on 31st March, 2022**

	₹	₹
Debit balance as per cash book		37,20,000
Add: Cheque issued but not yet presented to bank for payment	7,20,000	
Dividend received by bank not entered in cash book	5,00,000	
Interest allowed by bank	12,500	12,32,500
		49,52,500
Less: Cheques deposited into bank but not yet collected	15,40,000	
Bank charges	2,000	
A cheque deposited into bank was dishonoured	3,20,000	
House tax paid by bank	3,50,000	(22,12,000)
Credit balance as per pass book		27,40,500

5. **Bank Reconciliation Statement as on 31st March, 2022**

	₹	₹
Balance as per bank statement (Overdraft)		3,00,000
Add: Cheques drawn but not cleared	36,500	
Interest collected on investments directly credited by bank	83,800	1,20,300
		4,20,300
Less: Interest on bank overdraft not entered in the cash book	36,500	
Cheques deposited but not yet cleared	56,000	
Insurance premium paid by bank	17,950	
Amount wrongly debited by bank	20,500	1,30,950
Overdraft as per cash book		289,350

NOTES

CHAPTER 4

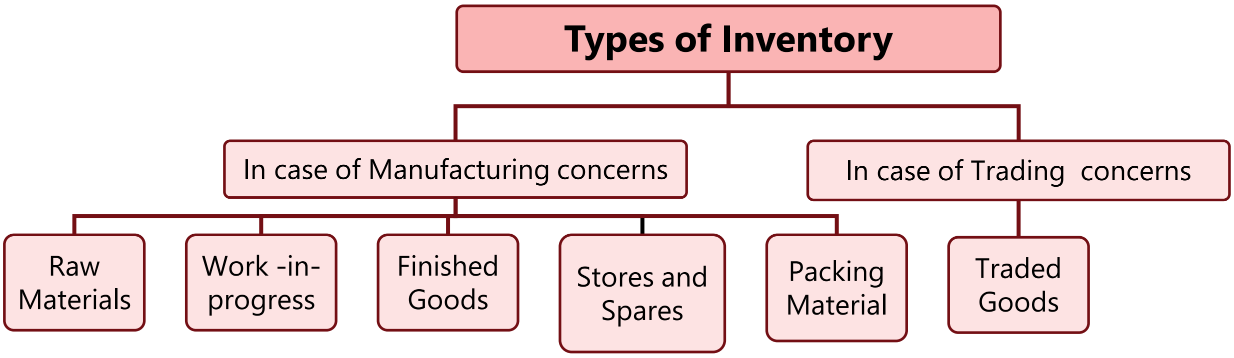
INVENTORIES

LEARNING OUTCOMES

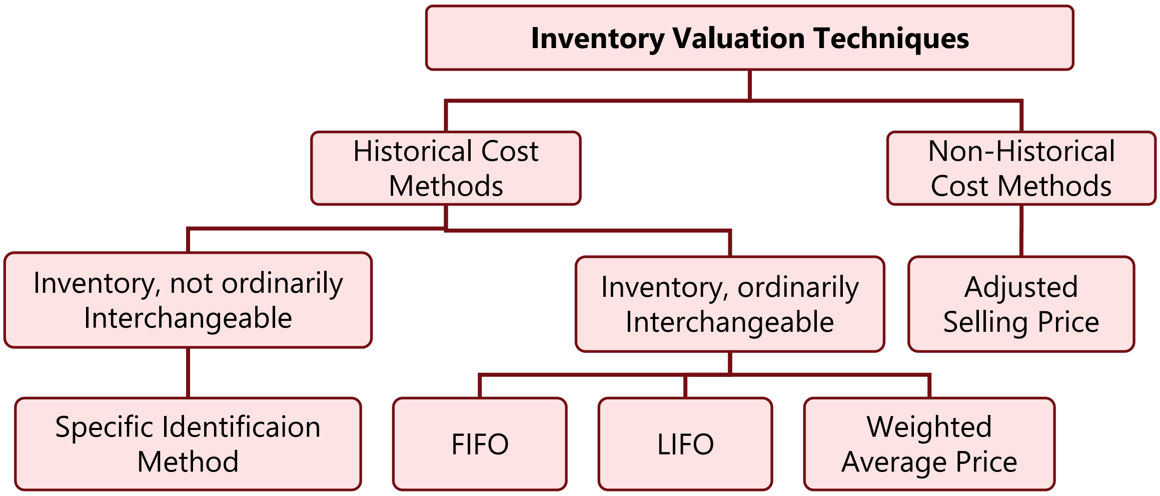
After studying this chapter, you will be able to:

- Understand the meaning of term 'Inventory'.
- Learn the technique of Specific Identification Method, FIFO, Average Price, Weighted Average Price and Adjusted Selling Price methods of inventory valuation.
- Understand the methods of inventory record keeping and comprehend the intricacies relating to Inventory taking.

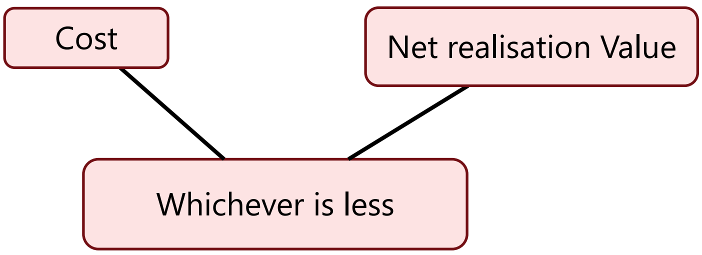
CHAPTER OVERVIEW



Formulae for Determining Cost of Inventory



Basis of Inventory Valuation



1. MEANING

Inventory can be defined as assets held

- for sale in the ordinary course of business, or
- in the process of production for such sale, or
- for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares, servicing equipment and standby equipment.

There can be different types of inventory based on nature of business of an enterprise. The inventories of a trading concern consist primarily of products purchased for resale in their existing form. It may also have an inventory of supplies such as wrapping paper, cartons, and stationery. The inventories of manufacturing concern consist of several types of inventories: raw material (which will become part of the goods to be produced), work-in-process (partially completed products in the factory) and finished products. In manufacturing concerns inventories will also include maintenance supplies, consumables, loose tools and spare parts. However, inventories do not include spare parts, servicing equipment and standby equipment which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are generally accounted for as fixed assets. Similarly, in an enterprise engaged in construction business, projects under construction are also considered as inventory.

At the year-end (or any period for which books are closed) every business entity needs to ascertain the closing balance of Inventory which comprise of Inventory of raw material, work-in-progress, finished goods and other consumable items. Value of closing Inventory is put at the credit side of the Trading Account and asset side of the Balance Sheet. So, before preparation of final accounts, the accountant should know the value of Inventory of the business entity. However, we shall restrict our discussion on inventory valuation of a manufacturing concern and goods of a trading concern.

2. INVENTORY VALUATION

A primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognized. Inventory is generally the most significant component of the current assets held by a trading or manufacturing enterprise. It is widely recognized that inventory is one of the major assets that affects efficiency of operations. Both excess of inventory and its shortage affects the production activity, and the profitability of the enterprise whether it is a manufacturing or a trading business. Proper valuation of inventory has a very significant bearing on the authenticity of the financial statements. The significance of inventory valuation arises due to various reasons as explained in the following points:

(i) Determination of Income

The valuation of inventory is necessary for determining the true income earned by a business entity during a particular period. To determine gross profit, cost of goods sold is matched with revenue of the accounting period. Cost of goods sold is calculated as follows:

Cost of goods sold = Opening inventory + Purchases + Direct expenses - Closing inventory.

Inventory valuation will have a major impact on the income determination if merchandise cost is large fraction of sales price. The effect of any over or under statement of inventory may be explained as:

If the value of......	Then net income will be.....
Closing inventory overstated ↑	Overstated ↑
Opening inventory overstated ↑	Understated ↓
Closing inventory understated ↓	Understated ↓
Opening inventory understated ↓	Overstated ↑

The effect of misstatement of inventory figure on the net income is always through cost of goods sold. Thus, proper calculation of cost of goods sold and for that matter, proper valuation of inventory is necessary for determination of correct income.

(ii) Ascertainment of Financial Position

Inventories are classified as **current assets**. The value of inventory on the date of balance sheet is required to determine the financial position of the business. In case the inventory is not properly valued, the balance sheet will not disclose the truthful financial position of the business.

Usually, slow-moving or non-moving inventory is the basic reason for poor financial performance as well as financial position of an enterprise. To identify such items, the first step is to value the inventory in the appropriate manner.

(iii) Liquidity Analysis

Inventory is classified as a current asset, it is one of the components of net working capital which reveals the liquidity position of the business. Current ratio which studies the relationship between current assets and current liabilities is significantly affected by the value of inventory. Bankers rely on the current ratio which is denoted as current assets divided by current liabilities. If inventory is a major part of the current assets then, naturally, the next set of questions that arise would be:

a) Whether the inventory is properly valued based on consistently applied principles?

b) Are there any items of inventory that are either slow-moving or non-moving ?

c) How often an external auditor has verified the inventories to make the valuation reliable?

Studies have shown that poor management of inventories, is one of the reasons of losses of small manufacturing enterprises which eventually leads to shutting down of such business units.

(iv) Statutory Compliance

Schedule III to the Companies Act, 2013 requires valuation of each class of goods i.e. raw material, work-in-progress and finished goods under broad head to be disclosed in the financial statements. As per the requirements of the Accounting Standards, the financial statements should disclose:

(a) the accounting policies adopted in measuring inventories, including the cost formula used, and

(b) the total carrying amount of inventories and its classification appropriate to the enterprise.

The common classification of inventories are raw materials; work-in-progress; finished goods; stores-in-trade (in respect of goods acquired for trading) and spares and loose tools.

3. BASIS OF INVENTORY VALUATION

Inventories should be generally **valued at the lower of cost or net realizable value**. This principle is governed by 'Principle of Conservative Accounting' under which any expenses or losses from transactions entered or event occurred are to be recognized immediately, however, any gains or profits are not recognized until it becomes due or are actually realized. Under the principle of 'lower of cost or net realizable value' any loss due to decrease in sales price of the inventory below its cost is recognized immediately as it is anticipated that the enterprise will make losses whenever it will sell.

Cost: As per **Accounting Standards,** Cost of inventories should comprise

1. all cost of purchase,
2. costs of conversion (primarily for finished goods and work - in progress) and
3. other costs incurred in bringing the inventories to their present location and condition.

Cost of purchase consist of purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining costs of purchase. In other words, cost includes any amount paid to the seller reduced by any discounts/rebates given by the seller. Similarly, any duties paid to the supplier will be part of cost of the inventory unless the enterprises can recover these taxes duties from the authorities.

For example- Raw material required for making a product is bought at ₹100 per unit plus GST at 18%. 100 units of raw material are bought.

So, the amount that needs to be paid is ₹100 x 100 units = ₹10,000+GST at 18% = ₹11,800/-

However, since the GST on purchase is available as credit, it won't be counted as the cost of purchase. Hence, the cost of purchase will be ₹10,000 only and not ₹11,800/-

Costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable overheads.

Continuing the above example – for the conversion of 100 units of raw material into finished goods, direct labour cost incurred is ₹3,000. Then, the cost of conversion will be ₹3,000 and thus the value of inventory at this stage is ₹13,000 (for 100 units)

Other Costs may include administrative overheads incurred to bring the inventory into present location and condition or any cost specifically incurred on inventory of a specified customer. Interest and other borrowing costs are generally not included in the cost of inventory. However, in some circumstances where production process is longer and it is required to carry inventory for a long period e.g. wine, rice and timber it may be appropriate to consider interest and other borrowing cost also part of cost of inventory.

In the same example let us assume that ₹200 is paid as unloading charges for the raw material from the truck to the storage place in the factory, in that case ₹200 shall NOT be accounted as unloading charges separately as expenses, but shall be accounted as other costs to bring the inventory to present location. And hence the cost of inventory of 100 units at this stage shall be ₹13,200/-

Exclusions from cost of inventories: Following expenses are generally not included in the costs of inventories:

(a) abnormal amounts of wasted materials, labour or other production overheads:

(b) storage costs, unless those costs are necessary in the production process prior to further production stage;

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) selling and distribution costs

Brief explanation about the exclusions from the cost of inventories:

(a) Normal wastage of material or labour cost is included in the cost of inventory. However, abnormal wastage is excluded for the reason that it occurs either due to inefficiency or abnormal factors that won't justify considering those wastages as part of inventory cost.

(b) Storage costs are normally the cost of doing business. For example, rent of warehouse or storage area is considered as overheads already and hence not considered as cost of inventory. However, if special storage is required as part of the production process, then such storage cost is considered as cost of inventory. For example, in wine making process, requires the raw material is stored in a particular condition for fermentation for a long time (usually years together), such cost of storage is accounted as cost of inventory.

(c) Administrative overheads do not usually add any specific value to inventories and hence excluded.

(d) Selling and distribution costs are part of selling and general administration costs and hence excluded.

Net realizable value: This is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. In case of finished goods and traded goods net realizable value will generally mean selling price which is reduced by selling and distribution expenses. In case of work in progress, expenses and overheads required to be incurred to convert work -in progress into finished goods and making it ready for sale will also be reduced from selling price. In case of raw materials, replacement cost is generally considered as net realizable value.

An assessment is made of as at each balance sheet date. Inventories are usually written down to net realizable value on an item-by-item basis. In some circumstances, however, it may be appropriate to group similar or related items e.g. in case of interchangeable items it may not be possible to identify cost and net realizable value of each item separately.

4. INVENTORY RECORD SYSTEMS

There are two principal systems of determining the physical quantities and monetary value of inventories sold and in hand. One system is known as 'Periodic Inventory System' and the other as the 'Perpetual Inventory System'. The periodic system is less expensive to use than the perpetual method. But the useful information obtained from perpetual system is more than cost incurred on it. These systems are distinguished on the basis of the actual records kept to ascertain the cost of goods sold and the closing inventory valuations.

4.1 PERIODIC INVENTORY SYSTEM

Periodic inventory system is a method of ascertaining inventory by taking an **actual physical count (or measure or weight)** of all the inventory items on hand at a **particular date** on which inventory is valued. It is because of actual physical count that the system is also called physical inventory system. The cost of goods sold is determined as shown below:

Opening inventory (known) + Purchases (known) − Closing inventory (physically counted) = Cost of goods sold

Periodic inventory system is simple and less expensive than the perpetual system. In this system, inventory account is adjusted at the end of the accounting period to determine cost of goods sold. This system suffers from various limitations:

(i) Physical inventory taking is required more than once a year for preparation of quarterly or half yearly financial statements thereby making this system more expensive.

(ii) Physical count of goods requires closure of normal operations of business.

(iii) As cost of goods sold is taken as residual figure, it is not possible to identify loss of goods due to pilferage, damage or even fraud.

(iv) Inventory control is not possible under this system.

(v) Books of accounts does not reflect inventory in hand and its value therefore, it is difficult to plan operations e.g. how much or when to order/manufacture.

This system is used by small enterprises where it is easy to control physical inventory. This system is not considered suitable for medium or larger enterprises which generally use Perpetual Inventory system.

4.2 PERPETUAL INVENTORY SYSTEM

Perpetual inventory system is a system of **recording inventory balances after each receipt and issue.** In order to ensure accuracy of perpetual inventory records, physical inventory should be checked and compared with recorded balances. Under this system, cost of goods issued is directly determined and inventory of goods is taken as residual figure with the help of inventory ledger in which flow of goods is recorded on continuous basis. The basic feature of this system is the maintenance of inventory ledger to have records of goods on continuous basis. Under perpetual inventory system, closing inventory is determined as follows:

opening inventory(known) + Purchases during the period (known) – Cost of Goods Sold (Known) = Closing Stock(bal ancing figure)

Perpetual inventory system helps to overcome the limitations of periodic system. As inventory is taken as residual figure, it includes loss of goods. However, the main limiting factor is the high cost of using this system.

4.3 DISTINCTION BETWEEN PERIODIC INVENTORY SYSTEM AND PERPETUAL INVENTORY SYSTEM

Both the systems - Periodic Inventory System and Perpetual Inventory System are not mutually exclusive and complementary in nature. Distinction between both the systems can be explained as follows:

S. No.	Periodic Inventory System	Perpetual Inventory System
1.	This system is based on physical verification.	It is based on book records.
2.	This system provides information about inventory and cost of goods sold at a particular date.	It provides continuous information about inventory and cost of sales.
3.	This system determines inventory and takes cost of goods sold as residual figure.	It directly determines cost of goods sold and computes inventory as balancing figure.

4.	Cost of goods sold includes loss of goods as goods not in inventory are assumed to be sold.	Closing inventory includes loss of goods as all unsold goods are assumed to be in Inventory.
5.	Under this method, inventory control is not possible.	Inventory control can be exercised under this system.
6.	This system is simple and less expensive.	It is costlier method.
7.	Periodic system requires closure of business for counting of inventory.	Inventory can be determined without affecting the operations of the business.

5. FORMULAE/METHODS TO DETERMINE COST OF INVENTORY

5.1 Historical Cost Methods

There is no unique formula for determination of historical cost of inventories. The different techniques for valuation of inventory have been discussed below:

(i) Specific Identification Method

Pricing under this method is based on actual physical flow of goods. It attributes specific costs to identified goods and requires keeping different lots purchased separately to identify the lot out of which units in inventories are left. The historical costs of such specific purpose inventories may be determined on the basis of their specific purchase price or production cost.

This method is generally used to ascertain the cost of inventories of items that are not ordinarily interchangeable and their value is high like expensive medical equipment, otherwise it requires the use of FIFO (First in first out) or weighted average price/average price formula.

ILLUSTRATION 1

Surekha Ltd deals in 3 products P, Q & R, which are neither similar nor interchangeable. At the end of a financial year, the Historical Cost and NRV of items of Closing Stock are given below. Determine the value of Closing Stock.

Items	*Historical Cost (in ₹ Lakhs)*	*Net Realisable Value (in ` Lakhs)*
P	*38*	*42*
Q	*29*	*29*
R	*17*	*14*

SOLUTION

Inventories are to be valued at the lower of cost and Net Realisable Value (NRV). Inventories are usually written down to NRV on an item-by-item basis. The Value of Closing Stocks is determined as under:

Items	Historical Cost (in ₹ Lakhs)	Net Realisable Value (in ₹ Lakhs)	Valuation = Least of Cost or NRV
P	38	42	38
Q	29	29	29
R	17	14	14
Total			81

(ii) FIFO (First in first out) Method

This method is based on the assumption that cost should be charged to revenue in the order in which they are incurred, that is, it is assumed that the issue of goods is usually from the earliest lot on hand. The inventory of goods on hand therefore, consists of the latest consignments. Thus, the closing inventory is valued at the price paid for such consignments.

The FIFO formula assumes that the items of inventories which were purchased or produced first are consumed or sold first and consequently items remaining in the inventory at the end of the period are those most recently purchased or produced. This assumption is in line with the good business practice to disposing goods in the order of their acquisition especially in the case of perishable goods and items with frequent technological changes. It must be kept in mind that this assumption of cost flow or goods flow need not be true as a physical fact i.e. not necessary goods are physically also sold or issued in the chronological order of their purchase or production. It relates only to the method of accounting and not to the actual physical movement of goods.

Now, let us take an example to understand the application of FIFO method.

ILLUSTRATION 2

A manufacturer has the following record of purchases of a condenser, which he uses while manufacturing radio sets:

Date	*Quantity (units)*	*Price per unit*
Dec. 4	*900*	*50*
Dec. 10	*400*	*55*

Dec. 11	*300*	*55*
Dec. 19	*200*	*60*
Dec. 28	*800*	*47*
	2,600	

1,600 units were issued during the month of December till 18th December. Calculate the value of closing inventory.

SOLUTION

The closing inventory is 1,000 units and would consist of:

800 units received on 28th December; and

200 units received on 19th December as per FIFO

	₹
The value of 800 units @ ₹ 47	37,600
The value of 200 units @ ₹ 60	12,000
Total	49,600

(iii) LIFO (Last in first out) Method

As the name suggests, the LIFO formula assigns to cost of goods sold, the cost of goods that have been purchased last though the actual issues may be made out of the earliest lot on hand to prevent unnecessary deterioration in value. The closing inventory then is assumed to consist of earlier consignments and its value is then calculated according to such consignments. Under this basis, goods issued are valued at the price paid for the latest lot of goods on hand which means inventory of goods in hand is valued at price paid for the earlier lot of goods. In the absence of details of issue, the price paid for the earliest consignments is used for valuing closing inventory. LIFO method is based on the principle of matching current cost with current revenue as cost of recently purchased or produced goods are charged to cost against each sale. The cost of goods sold under this method represents the cost of recent purchases resulting that there is better matching of current costs with current sales.

ILLUSTRATION 3

In the previous example assume that following issues were made during the month of December:

Record of issues

Date	*Quantity (units)*
Dec. 5	*500*
Dec. 20	*600*
Dec. 29	*500*
Total	*1,600*

SOLUTION

Computation of closing stock under perpetual inventory system

Using LIFO method, following will be stock ledger:

Date	Receipts			Issues			Balance inventory		
Dec.	Qty.	Rate	Amount	Qty	Rate	Amount	Qty.	Rate	Amount
4	900	50	45,000	-	-	-	900	50	45,000
5	-	-	-	500	50	25,000	400	50	20,000
10	400	55	22,000	-	-	-	400	50	20,000
							400	55	22,000
11	300	55	16,500	-	-	-	400	50	20,000
							400	55	22,000
							300	55	16,500
19	200	60	12,000	-	-	-	400	50	20,000
							400	55	22,000
							300	55	16,500
							200	60	12,000
20	-	-	-	200	60	12,000			
	-	-	-	300	55	16,500			
	-	-	-	100	55	5,500	400	50	20,000
							300	55	16,500
28	800	47	37,600	-	-	-	400	50	20,000
							300	55	16,500

28							800	47	37,600
29	-	-	-	500	47	23,500	400	50	20,000
							300	55	16,500
							300	47	14,100

Therefore, cost of closing inventory of 1,000 pcs will be ₹ 50,600.

Computation under periodic inventory system

In the above example, if the entity followed periodic inventory valuation, closing inventory of 1,000 pcs. will be valued as follows:

800 pcs. @ ₹ 47 each (purchased on Dec. 28th)	=	₹ 37,600
200 pcs. @ ₹ 60 each (purchased on Dec. 19th)	=	₹ 12,000
Total 1,000 pcs.	=	₹ 49,600

We can see that cost of closing inventory has changed following LIFO method based on perpetual inventory method and periodic inventory method.

"LIFO method is based on an irrational assumption that inventories entering last in the stores are issued or consumed first. However, the flow of goods which is generally observed in business entities is contradictory to this assumption. It should be noted that while applying LIFO, there will be difference in cost of goods sold and value of closing inventory, if the entity follows periodic as against perpetual method of inventory valuation. (Periodic and Perpetual methods have been explained later in this chapter). Therefore, LIFO method is no longer adopted for valuing inventories. Accounting Standards also does not permit the usage of LIFO Method. Generally, in practice, FIFO and Weighted Average Price Method are popular among the business entities and both these methods are also permitted by Accounting Standards."

(iv) Simple Average Price Method

Simple Average price for computing value of inventory is a very simple approach. All the different prices are added together and then divided by the number of prices. The closing inventory is then valued according to the price ascertained. This method is generally followed by the entities using periodic inventory method as it does not require efforts of identifying that closing inventory belongs to which consignments or lots.

ILLUSTRATION 4

In the same example of a manufacturer of radio sets given earlier, let us calculate the value of closing inventory using Average Price Method:

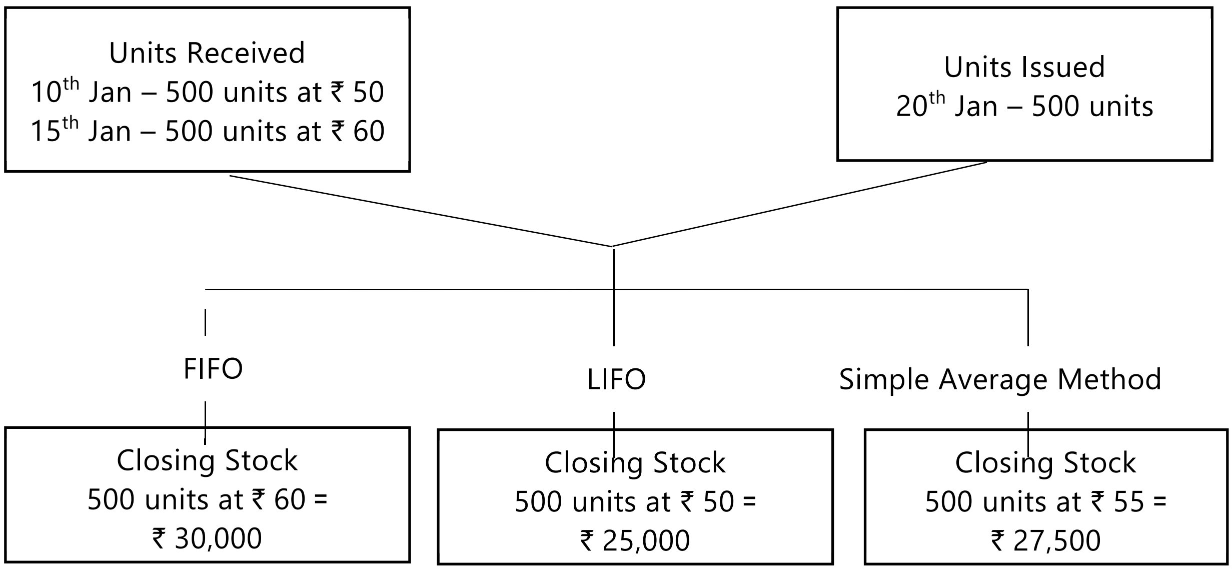
SOLUTION

The simple average in this question is:

[(50 + 55 + 55 + 60 + 47)/5] = 267/5 = ₹ 53.4

1,000 units valued at ₹ 53.4 would be ₹ 53,400

Let us try to analyse the impact of FIFO, LIFO and Simple Average Price Method with the help of the following chart:



Thus, we see that value of inventories changes based on different cost formula used.

(v) Weighted Average Price Method

Simple average price does not consider quantities purchased in various lots. However, it is more logical to compute weighted average price using the quantities purchased in a lot as weights. Under weighted average price method, cost of goods available for sale during the period is aggregated and then divided by number of units available for sale during the period to calculate weighted average price per unit. Thus

$$\text{Weighted average price per unit} = \frac{\text{Total cost of goods available for sale during the period}}{\text{Total number of units available for sale during the period}}$$

Closing inventory = No. of units in inventory × Weighted average price per unit

Cost of goods sold = No. of units sold × Weighted average price per unit.

ILLUSTRATION 5

On the basis of the data given in illustration 2 and 3, calculate the weighted average price and also the value of closing inventory by weighted average price method.

SOLUTION

The computation of weighted average price in the referred example is shown below:

A new average rate would be calculated on receiving a fresh consignment. Answer on that basis would be as under:

Date	Receipts			Issues			Balance inventory		
	Qty	Rate	Amount	Qty	Rate	Amount	Qty	Rate	Amount
Dec. 4	900	50	45,000	-	-	-	900	50	45,000
Dec. 5	-	-	-	500	50	25,000	400	50	20,000
Dec. 10	400	55	22,000	-	-	-	800	52.5	42,000
Dec. 11	300	55	16,500	-	-	-	1,100	53.18	58,500
Dec. 19	200	60	12,000	-	-	-	1,300	54.23	70,500
Dec. 20	-	-	-	600	54.23	32,538	700	54.23	37,962
Dec. 28	800	47	37,600	-	-	-	1,500	50.37	75,562
Dec. 29	-	-	-	500	50.37	25,185	1,000	50.37	50,377

Perpetual and Periodic Inventory System and Average Methods of Cost of Inventory

Both Simple Average Method and Weighted Average Method are applied differently in case the entity uses periodic inventory taking or Perpetual inventory taking. In case of periodic inventory, taking inventory available for sale during the period is considered together and an average rate is computed and closing inventory is valued using that rate. In case perpetual inventory records, average rate of inventory is computed on each new purchase and next issue is recorded using new average rate.

Illustration 5 above is an example of Weighted average method used in perpetual inventory recording system. In case the entity would have been using periodic inventory recording system, closing inventory would have been valued as below:

Details of purchases/receipt during the period

Date	Qty.	Rate	Value
Dec. 4	900	50	45,000
Dec. 10	400	55	22,000
Dec. 11	300	55	16,500
Dec. 19	200	60	12,000
Dec. 28	800	47	37,600
Total	2,600	51.19	133,100

Accordingly, closing stock of 1,000 pcs. would have been valued at 51,190 @ ₹ 51.19 per unit.

5.2 Non-Historical Cost Methods

Non-historical cost methods do not consider the historical cost incurred to acquire the goods. Non- historical cost methods include Adjusted Selling Price method and Standard Cost method. Adjusted Selling Price method can be explained as follows:

(i) Adjusted selling price method

This method is also called retail inventory method. It is used widely in retail business or in business where the inventory comprises of items, the individual costs of which are not readily ascertainable. The use of this method is appropriate for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory an appropriate percentage of gross margin. The percentage used takes into consideration inventory which has been marked below its original selling price. An average percentage for each retail department is often used. The calculation of the estimated gross margin of profit may be made for individual items or groups of items or by departments, as may be appropriate to the circumstances.

ILLUSTRATION 6

M/s X, Y and Z are in retail business, following information are obtained from their records for the year ended 31st March, 2022:

Goods received from suppliers		
(subject to trade discount and taxes)	₹	*15,75,500*
Trade discount 3% and GST 11%		
Packaging and transportation charges	₹	*87,500*
Sales during the year	₹	*22,45,500*
Sales price of closing inventories	₹	*2,35,000*

Find out the non-historical cost of inventories using adjusted selling price method.

SOLUTION

Determination of cost of purchases:

Goods received from suppliers	15,75,500
Less: Trade discount 3%	(47,265)
	15,28,235

Add: GST 11%	₹	1,68,106
	₹	16,96,341
Add: Packaging and transportation charges	₹	87,500
	₹	17,83,841

Determination of estimated gross profit margin:

Sales during the year	₹	22,45,500
Closing inventory at the selling price	₹	2,35,000
		24,80,500
Less: Purchases	₹	(17,83,841)
Gross profit	₹	6,96,659
Gross profit margin		28.09%
Inventory valuation:		
Selling price of closing inventories	₹	2,35,000
Less: Gross profit margin 28.09%	₹	(66,012)
	₹	1,68,988

ILLUSTRATION 7

From the following information, calculate the non historical cost of closing inventories using adjusted selling price method:

	₹
Sales during the year	*2,00,000*
Cost of purchases	*2,00,000*
Opening inventory	*Nil*
Closing inventory at selling price	*50,000*

SOLUTION

Calculation of gross margin of profit:

	₹
Sales	2,00,000
Add: Closing inventory (at selling price)	50,000
Selling price of goods available for sale:	2,50,000
Less: Cost of goods available for sale	2,00,000
Gross margin	50,000

Rate of gross margin = $\frac{50,000}{2,50,000} \times 100 = 20\%$

Cost of closing inventory = 50,000 less 20% on ₹ 50,000 = ₹ 40,000

(ii) **Standard cost method**

This method is used when there is frequent change in the price per unit of the goods and goods are purchased frequently by the business e.g. crude oil. Based on the experience a standard cost is determined on the basis of frequent changes in prices and inventory is valued on that price per unit.

6. INVENTORIES TAKING

Normally all operations are suspended for one or two days during the financial year and physical inventory is taken for everything in the godown or the store periodically. For the year-end inventory valuation, physical inventory taking is done during the last week of the financial year or during the first week of next financial year. If inventory taking is finished on 26th March, whereas accounting year ends on 31st March purchases and sales between 26th and 31st March are then separately adjusted. Later, a value is put on each item. The principle of cost or Net realizable value, whichever is lower, is applied either for the inventory as a whole or item by item.

Normally, enterprises prefer to perform inventory taking on the closing day, however, sometimes inventory taking cannot be carried out on the closing day. It is carried out a few days later or sometimes even a few days earlier. In such a case, the actual value of the inventory must be so adjusted as to relate it to the end of the year concerned. For doing so, it will be necessary to take into account the goods that have come in (purchases and sales returns) and those that have gone out (sales and purchase returns) during the interval between the close of the year and the date of actual inventory taking.

Further, the adjustment of all goods must be on the basis of cost or NRV whichever is lower. Suppose, a firm that closes its books on 31st December, carried out the inventory taking on the 7th January next year and actual inventory was of the cost of ₹ 7,85,000, during the period January 1 to 7 purchases were ₹ 1,53,000 and sales ₹ 2,50,000, the mark up being 25% on cost. The inventory on 31st December would be ₹ 8,32,000 as shown below:

	₹
Inventory ascertained on January 7	7,85,000
Less: Purchases during the period Jan. 1 to 7	1,53,000
	6,32,000

Add: Cost of goods sold during the period:	
2,50,000 × (100/125)	2,00,000
	8,32,000

ILLUSTRATION 8

From the following particulars ascertain the value of Inventories as on 31st March, 2022:

	₹
Inventory as on 1.4.2021	*1,42,500*
Purchases	*7,62,500*
Manufacturing Expenses	*1,50,000*
Selling Expenses	*60,500*
Administrative Expenses	*30,000*
Financial Charges	*21,500*
Sales	*12,45,000*

At the time of valuing inventory as on 31st March, 2021, a sum of ₹ 17,500 was written off on a particular item, which was originally purchased for ₹ 50,000 and was sold during the year for ₹ 45,000. Barring the transaction relating to this item, the gross profit earned during the year was 20 % on sales.

SOLUTION

Statement of Inventory in trade as on 31st March, 2022

	₹	₹
Inventory as on 1st April, 2021	1,42,500	
Less: Book value of abnormal inventory		
(₹ 50,000 - ₹ 17,500)	32,500	1,10,000
Add: Purchases		7,62,500
Manufacturing Expenses		1,50,000
		10,22,500
Less: Cost of goods sold:		
Sales as per books	12,45,000	
Less: Sales of abnormal item	45,000	
	12,00,000	
Less: Gross Profit @ 20%	2,40,000	9,60,000
Inventory in trade as on 31st March, 2022		62,500

ILLUSTRATION 9

A trader prepared his accounts on 31st March, each year. Due to some unavoidable reasons, no stock taking could be possible till 15th April, 2022 on which date total cost of goods in his godown came to ₹ 50,000. The following facts were established between 31st March and 15th April, 2022.

(i) Sales ₹ 41,000 (including cash sales ₹ 10,000).

(ii) Purchases ₹ 5,034 (including cash purchases ₹ 1,990).

(iii) Sales return ₹ 1,000.

(iv) On 15th March, goods of the sale value of ₹ 10,000 were sent on sale or return basis to a customer, the period of approval being four weeks. He returned 40% of the goods on 10th April, approving the rest; the customer was billed on 16th April.

(v) The trader had also received goods costing ₹ 8,000 in March, for sale on consignment basis. 20% of the goods had been sold by 31st March, and another 50% by the 15th April. These sales are not included in above sales.

Goods are sold by the trader at a profit of 20% on sales.

You are required to ascertain the value of inventory as on 31st March, 2022.

SOLUTION

Statement of Valuation of Stock on 31st March, 2022

	₹	₹
Value of stock as on 15th April, 2022		50,000
Add: Cost of sales during the period from 31st March, 2022 to 15th April, 2022:		
Sales (₹ 41,000-₹ 1,000)	40,000	
Less: Gross profit (20% of ₹ 40,000)	8,000	32,000
Cost of goods sent on approval basis (80% of ₹ 6,000)		4,800
		86,800
Less: Purchases during the period from 31st March, 2022 to 15th April, 2022	5,034	
Unsold stock out of goods received on consignment basis (30% of ₹ 8,000)	2,400	7,434
		79,366

ILLUSTRATION 10

Inventory taking for the year ended 31st March, 2022 was completed by 10th April 2022, the valuation of which showed a inventory figure of ₹ 16,75,000 at cost as on the completion date. After the end of the accounting year and till the date of completion of inventory taking, sales for the next year were made for ₹ 68,750, profit margin being 33.33 % on cost. Purchases for the next year included in the inventory amounted to ₹ 90,000 at cost less trade discount 10 %. During this period, goods were added to inventory at the mark up price of ₹ 3,000 in respect of sales returns. After inventory taking it was found that there were certain very old slow-moving items costing ₹ 11,250, which should be taken at ₹ 5,250 to ensure disposal to an interested customer. Due to heavy flood, certain goods costing ₹ 15,500 were received from the supplier beyond the delivery date of customer. As a result, the customer refused to take delivery and net realizable value of the goods was estimated to be ₹ 12,500 on 31st March. Compute the value of inventory for inclusion in the final accounts for the year ended 31st March, 2022.

SOLUTION

Statement showing the valuation of Inventory as on 31st March, 2022

	₹
Value of Inventory as on 10th April	16,75,000
Add: Cost of goods sold after 31st March till Inventory taking (₹ 68,750 – ₹ 17,190)	51,560
Less: Purchases for the next period (net)	(81,000)
Less: Cost of Sales Returns	(2,250)
Less: Loss on revaluation of slow-moving inventories	(6,000)
Less: Reduction in value on account of default	(3,000)
Value of Inventory on 31st March	16,34,310

Note: Profit margin of 33.33 % on cost means 25 % on sales price.

ILLUSTRATION 11

The following are the details of a spare part of Sriram mills:

1-1-2022	*Opening Inventory*	*Nil*
1-1-2022	*Purchases*	*100 units @ ₹ 30 per unit*
15-1-2022	*Issued for consumption*	*50 units*

1-2-2022	*Purchases*	*200 units @ ₹ 40 per unit*
15-2-2022	*Issued for consumption*	*100 units*
20-2-2022	*Issued for consumption*	*100 units*

Find out the value of Inventory as on 31-3-2022 if the company follows First in first out basis.

SOLUTION

First-in-First out basis

Sriram Mills
Calculation of the value of Inventory as on 31-3-2022

	Receipts			Issues			Balance		
Date	**Units**	**Rate**	**Amount**	**Units**	**Rate**	**Amount**	**Units**	**Rate**	**Amount**
		₹	₹		₹	₹		₹	₹
1-1-2022	Balance							Nil	
1-1-2022	100	30	3,000				100	30	3,000
15-1-2022				50	30	1,500	50	30	1,500
1-2-2022	200	40	8,000				50	30	1,500
							200	40	8,000
15-2-2022				50	30	1,500			
				50	40	2,000	150	40	6,000
20-2-2022				100	40	4,000	50	40	2,000

Therefore, the value of Inventory as on 31-3-2022: 50 units @ ₹ 40 = ₹ 2,000

ILLUSTRATION 12

Continuing with the information given in illustration 11, find out the value of Inventory as on 31-3-2022 if the company follows Weighted Average basis.

SOLUTION

Weighted Average basis

Sriram Mills
Calculation of the value of Inventory as on 31-3-2022

	Receipts			Issues			Balance		
Date	**Units**	**Rate**	**Amount**	**Units**	**Rate**	**Amount**	**Units**	**Rate**	**Amount**
		₹	₹		₹	₹		₹	₹
1-1-2022	Balance							Nil	
1-1-2022	100	30	3,000				100	30	3,000
15-1-2022				50	30	1,500	50	30	1,500

1-2-2022	200	40	8,000				250	38	9,500
15-2-2022				100	38	3,800	150	38	5,700
20-2-2022				100	38	3,800	50	38	1,900

Therefore, the value of Inventory as on 31-3-2022 = 50 units @ ₹ 38 = ₹ 1,900

SUMMARY

- Inventory can be defined as assets held for sale in the ordinary course of business, or in the process of production for such sale, or for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares.
- The inventories of manufacturing concern consist of several types of inventories: raw material (which will become part of the goods to be produced), parts and factory supplies, work-in-process (partially completed products in the factory) and, of course, finished products.
- Proper valuation of inventory has a very significant bearing on the authenticity of the financial statements.
- Cost of goods sold is calculated as follows:

  Cost of goods sold = Opening Inventory + Purchases + Direct expenses - Closing Inventory.
- Inventories should be generally valued at the lower of cost or net realizable value.
- Inventory Valuation Techniques:

  Historical Cost Methods

  ✓ Specific Identification Method

  ✓ FIFO (First in first out) Method

  ✓ LIFO (Last in first out) Method

  ✓ Average Price Method

  ✓ Weighted Average Price Method

  Non-Historical Cost Methods

  ✓ Adjusted selling price method

  ✓ Standard cost method

There are two principal systems of determining the physical quantities and monetary value of inventories sold and in hand. One system is known as 'Periodic Inventory System' and the other as the 'Perpetual Inventory System'.

TEST YOUR KNOWLEDGE

True and False

1. *Inventories are stocks of goods and materials that are maintained for mainly the purpose of revenue generation.*
2. *A building is considered inventory in a construction business.*
3. *Inventory is valued as carrying cost less percentage decreases.*
4. *Management has daily information about the quantity and valuation of closing stock under physical Inventory System.*
5. *Periodic Inventory System is more suitable for small enterprises.*
6. *When closing inventory is overstated, net income for the accounting period will be understated.*
7. *Closing inventory = Opening inventory + Purchases + Direct expenses + Cost of goods sold.*
8. *Cost of inventories should comprise all cost of purchase.*
9. *Inventory by-products, should be valued at net realisable value where cost of by products can be separately determined.*
10. *Abnormal amounts of wasted materials, labour or other production overheads expenses are included in the costs of inventories.*
11. *Perpetual system requires closure of business for counting of inventory.*
12. *Periodic inventory system is a method of ascertaining inventory by taking an actual physical count.*
13. *The value of closing inventory under simple average price method is realistic as compare to LIFO.*
14. *The value of stock is shown on the assets side of the balance-sheet as fixed assets.*
15. *Under inflationary conditions, FIFO will not show lowest value of cost of goods sold.*
16. *Under LIFO, valuation of inventory is based on the assumption that costs are charged against revenue in the order in which they occur.*
17. *Valuation of inventory, at cost or net realisable value, whichever less, is based on the principle of Conservatism.*
18. *Finished goods are normally valued at cost or market price whichever is higher.*

Multiple Choice Questions

1. *The amount of purchase if*

   Cost of goods sold is ₹ 80,700

   Opening Inventory ₹ 5,800

   Closing Inventory ₹ 6,000

   (a) ₹ 80,500

   (b) ₹ 74,900

   (c) ₹ 80,900.

2. *Average Inventory = ₹ 12,000. Closing Inventory is ₹ 3,000 more than opening Inventory. The value of closing Inventory = ______.*

   (a) ₹ 12,000

   (b) ₹ 24,000

   (c) ₹ 13,500.

3. *While finalizing the current year's profit, the company realized that there was an error in the valuation of closing Inventory of the previous year. In the previous year, closing Inventory was valued more by ₹ 50,000. As a result*

   (a) Previous year's profit is overstated and current year's profit is also overstated

   (b) Previous year's profit is overstated and current year's profit is understated

   (c) Previous year's profit is understated and current year's profit is also understated

4. *Consider the following for Q Co. for the year 2021-22:*

Cost of goods available for sale	*₹ 1,00,000*
Total sales	*₹ 80,000*
Opening inventory of goods	*₹ 20,000*
Gross profit margin on sales	*25%*

   Closing inventory of goods for the year 2021-22 as

   (a) ₹ 80,000

   (b) ₹ 60,000

   (c) ₹ 40,000

5. *If the profit is 25% of the cost price then it is*

   (a) *25% of the sales price*

   (b) *33% of the sales price*

   (c) *20% of the sales price*

6. *Goods purchased ₹ 1,00,000. Sales ₹ 90,000. Margin 20% on cost. Closing Inventory =?*

   (a) *₹ 20,000*

   (b) *₹ 10,000*

   (c) *₹ 25,000*

7. *A company is following weighted average cost method for valuing its inventory. The details of its purchase and issue of raw-materials during the week are as follows:*

   1.12.2022 opening Inventory 50 units value ₹ 2,200.

   2.12.2022 purchased 100 units @ ₹47.

   4.12.2022 issued 50 units.

   5.12.2022 purchased 200 units @ ₹ 48.

   The value of inventory at the end of the week and the unit weighted average costs is

   (a) *₹ 14,200 – ₹ 47.33*

   (b) *₹ 14,300 – ₹ 47.67*

   (c) *₹ 14,000 – ₹ 46.66*

8. *The cost of sales is equal to*

   (a) *Opening stock plus purchases*

   (b) *Purchases minus Closing stock*

   (c) *Opening stock plus purchases minus closing stock*

9. *Inventory is disclosed in financial statements under:*

   (a) *Fixed Assets*

   (b) *Current Assets*

   (c) *Current Liabilities*

10. *Accounting Standards do not permit following method of inventory valuation*

   (a) *FIFO*

(b) *Average cost*

(c) *LIFO*

11. *Which inventory costing formula calculates value of closing inventory considering that inventory most recently purchased has not been sold?*

(a) *FIFO*

(b) *LIFO*

(c) *Weighted average cost*

12. *Valuing inventory at cost or net releasable value is based on which principle*

(a) *Consistency*

(b) *Conservatism*

(c) *Going concern*

13. *Under inflationary trend, which of the methods will show highest value of inventory?*

(a) *FIFO*

(b) *Weighted average*

(c) *LIFO*

14. *Which of the following methods does not consider historical cost of inventory?*

(a) *Weighted average*

(b) *FIFO*

(c) *Retail price method*

Theory Questions

1. *Write short notes on:*

(i) *Adjusted Selling Price method of determining cost of stock.*

(ii) *Principal methods of ascertainment of cost of inventory.*

2. *Distinguish between:*

(i) *LIFO and FIFO basis of costing of stock.*

(ii) *FIFO and weighted average price method of stock costing.*

3. *Define inventory. Explain the importance of proper valuation of inventory in the preparation of statements of the business entity.*

Practical Questions

1. *X who was closing his books on 31.3.2022 failed to take the actual stock which he did only on 9th April, 2022, when it was ascertained by him to be worth ₹ 2,50,000.*

   It was found that sales are entered in the sales book on the same day of dispatch and return inwards in the returns book as and when the goods are received back. Purchases are entered in the purchases day book once the invoices are received.

   It was found that sales between 31.3.2022 and 9.4.2022 as per the sales day book are ₹ 17,200. Purchases between 31.3.2022 and 9.4.2022 as per purchases day book are ₹ 1,200, out of these goods amounting to ₹ 500 were not received until after the stock was taken.

   Goods invoiced during the month of March, 2022 but goods received only on 4th April, 2022 amounted to ₹ 1,000. Rate of gross profit is 33-1/3% on cost.

   Ascertain the value of physical stock as on 31.3.2022.

2. *From the following information, ascertain the value of stock as on 31.3.2022:*

	₹
Value of stock on 1.4.2021	*7,00,000*
Purchases during the period from 1.4.2021 to 31.3.2022	*34,60,000*
Manufacturing expenses during the above period	*7,00,000*
Sales during the same period	*52,20,000*

   At the time of valuing stock on 31.3.2021 a sum of ₹ 60,000 was written off a particular item which was originally purchased for ₹ 2,00,000 and was sold for ₹ 1,60,000. But for the above transaction the gross profit earned during the year was 25% on cost.

3. *The Profit and loss account of Hanuman showed a net profit of ₹ 6,00,000, after considering the closing stock of ₹ 3,75,000 on 31st March, 2022. Subsequently the following information was obtained from scrutiny of the books:*

   (i) Purchases for the year included ₹ 15,000 paid for new electric fittings for the shop.

   (ii) Hanuman gave away goods valued at ₹ 40,000 as free samples for which no entry was made in the books of accounts.

   (iii) Invoices for goods amounting to ₹ 2,50,000 have been entered on 27th March, 2022, but the goods were not included in stock.

   (iv) In March, 2022 goods of ₹ 2,00,000 sold and delivered were taken in the sales for April, 2022.

(v) Goods costing ₹ 75,000 were sent on sale or return in March, 2022 at a margin of profit of 33-1/3% on cost. Though approval was given in April, 2022 these were taken as sales for March, 2022.

Calculate the value of stock on 31st March, 2022 and the adjusted net profit for the year ended on that date.

4. *Physical verification of stock in a business was done on 23rd June, 2022. The value of the stock was ₹ 48,00,000. The following transactions took place between 23rd June to 30th June, 2022:*

   (i) Out of the goods sent on consignment, goods at cost worth ₹ 2,40,000 were unsold.

   (ii) Purchases of ₹ 4,00,000 were made out of which goods worth ₹ 1,60,000 were delivered on 5th July, 2022.

   (iii) Sales were ₹ 13,60,000, which include goods worth ₹ 3,20,000 sent on approval. Half of these goods were returned before 30th June, 2022.

   (iv) Goods are sold at cost plus 25%. However, goods costing ₹ 2,40,000 had been sold for ₹ 1,20,000.

   Determine the value of stock on 30th June, 2022.

ANSWERS / HINTS

True and False

1. True: Inventories refers to stocks of goods and materials that are maintained in business for revenue generation.

2. True: For a construction business, a building under construction will be inventory. The building is being built in the normal course of business and will eventually be sold as inventory.

3. False: Inventory is valued at lower of cost or net realizable value.

4. False: Under Perpetual Inventory System management have daily information of closing stock.

5. True: A periodic inventory system is suitable to small and micro enterprises, where physical counting of inventory is not a tedious process.

6. False: When closing inventory is overstated, net income for the accounting period will be overstated.

7. False: Closing stock = Cost of goods sold - (Opening inventory + Purchases + Direct expenses).

8. False: Cost of inventories should comprise all cost of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

9. False: Inventory by-products, should be valued at net realisable value where cost of by products cannot be separately determined. .

10. False: Abnormal amounts of wasted materials, labour or other production overheads expenses are generally not included in the costs of inventories.

11. False: Periodic system requires closure of business for counting of inventory.

12. True: Under Periodic inventory system actual physical count of inventory is taken of all the inventory on hand at a particular date.

13. True: Value of Closing stock as per average method is more realistic then LIFO.

14. False: The value of stock is shown on the assets side of the balance-sheet as current assets. As it is realisable within 12 months.

15. False: Under inflationary conditions, LIFO and weighted average will not show lowest value of cost of goods sold.

16. False: Under FIFO, valuation of inventory is based on the assumption that costs are charged against revenue in the order in which they occur.

17. True: The conservatism concept states that one shall not account for anticipated profits but shall provide all prospective losses. Valuing inventory at cost or net realisable value whichever is less, therefore is based on principle of Conservatism.

18. False: Finished goods are normally valued at cost or market price whichever is lower.

Multiple Choice Questions

1.	**(c)**	2.	**(c)**	3.	**(b)**	4.	**(c)**	5.	**(c)**	6.	**(c)**
7.	**(a)**	8.	**(c)**	9.	**(b)**	10.	**(c)**	11.	**(a)**	12.	**(b)**
13.	**(a)**	14.	**(c)**								

Theoretical Questions

1 **(i)** Adjusted selling method is also called retail inventory method. It is used widely in retail business or in business where the inventory comprises of items, the individual costs of which are not readily ascertainable. The historical cost of inventory is estimated by calculating it in the first instance at selling price and then deducting an amount equal to the estimated gross margin of profit on such stocks.

(ii) The specific identification method, First-In–First-Out (FIFO) and weighted average cost formulae are the principal methods of ascertaining the cost of inventory. The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs under the specific identification method.

2. **(i)** Under FIFO method of inventory valuation, inventories purchased first are issued first. The closing inventories are valued at latest purchase prices and inventory issues are valued at corresponding old purchase prices. In other words, under FIFO method, costs are assigned to the units issued in the same order as the costs entered in the inventory. During periods of rising prices, cost of goods sold are valued at older and lower prices if FIFO is followed and consequently reported profits rise due to lower cost of goods sold.

On the other hand, under LIFO method of inventory valuation, units of inventories issued should be valued at the prices paid for the latest purchases and closing inventories should be valued at the prices paid for earlier purchases. In other words, closing inventories are valued at old purchase prices and issues are valued at corresponding latest purchase prices.

(ii) Under the First-In-First-Out (FIFO) method of valuation of stock, the actual issue of goods is usually the earliest lot on hand. Hence, the stock in hand will therefore consist of the latest consignments. The closing stock is valued at the price paid for such consignments.

The weighted average price method is not a simple average price method. Under this method of valuation of stock, a stock ledger is maintained, recording receipts and issues on daily basis. A new average would be calculated on receiving fresh consignment. The average price thus calculated after considering arrival of new consignment with the previous value of stock and dividing the preceding stock value and the cost of new arrival with the total units of preceding and new arrival will give the weighted average price.

3. Inventory can be defined as assets held

- for sale in the ordinary course of business, or
- in the process of production for such sale, or
- for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares.

The significance of inventory valuation arises due to the following reasons:

(i) Determination of Income

(ii) Ascertainment of Financial Position

(iii) Liquidity Analysis

(iv) Statutory Compliance

Practical Questions

1. Statement of Valuation of Physical Stock as on 31st March, 2022

		₹
Value of stock as on 9th April, 2022		2,50,000
Add: Cost of sales during the intervening period		
Sales made between 31.3.2022 and 9.4.2022	17,200	
Less: Gross profit @25% on sales	(4,300)	12,900
		2,62,900
Less: Purchases actually received during the intervening period:		
Purchases from 1.4.2022 to 9.4.2022	1,200	
Less: Goods not received upto 9.4.2022	(500)	700
		2,62,200
Less: Purchases during March, 2022 received on 4.4.2022		1,000
Value of physical stock as on 31.3.2022		2,61,200

2. **Statement of Valuation of Stock as on 31st March, 2022**

			₹
Value of stock as on 1st April, 2021			7,00,000
Add:	Purchases during the period from 1.4.2021 to 31.3.2022		34,60,000
Add:	Manufacturing expenses during the above period		7,00,000
			48,60,000
Less:	Cost of sales during the period:		
	Sales	52,20,000	
Less:	Gross profit	10,32,000	41,88,000
Value of stock as on 31.3.2022			6,72,000

Working Note:

	₹
Calculation of gross profit:	
Gross profit on normal sales 20/100 x (52,20,000 -1,60,000)	10,12,000
Gross profit on the particular (abnormal) item 1,60,000 - (2,00,000 - 60,000)	20,000
	10,32,000

Note: The value of closing stock on 31st March, 2022 may, alternatively, be found out by preparing Trading Account for the year ended 31st March, 2022.

3. Profit and Loss Adjustment Account

Particulars	₹	Particulars	₹
To Advertisement (samples)	40,000	By Net profit	6,00,000
To Sales (goods approved in April to be taken as April sales: (75,000 + 25,000)	1,00,000	By Electric fittings	15,000
To Adjusted net profit	10,40,000	By Samples	40,000
		By Stock (purchases of March not included in stock)	2,50,000
		By Sales (goods sold in March wrongly taken as April sales)	2,00,000

		By Stock (goods sent on approval basis not included in stock)	75,000
	11,80,000		11,80,000

Calculation of value of inventory on 31st March, 2022

	₹
Stock on 31st March, 2022 (given)	3,75,000
Add: Purchases of March, 2022 not included in the stock	2,50,000
Goods lying with customers on approval basis	75,000
	7,00,000

4. Statement of Valuation of Stock on 30th June, 2022

		₹
Value of stock as on 23rd June, 2022		48,00,000
Add: Unsold stock out of the goods sent on consignment	2,40,000	
Purchases during the period from 23rd June, 2022 to 30th June, 2022	2,40,000	
Goods in transit on 30th June, 2022	1,60,000	
Cost of goods sent on approval basis (80% of ₹ 1,60,000)	1,28,000	7,68,000
		55,68,000
Less: Cost of sales during the period from 23rd June, 2022 to 30th June, 2022		
Sales (₹ 13,60,000 - ₹ 1,60,000)	12,00,000	
Less: Gross profit	96,000	
		11,04,000
Value of stock as on 30th June, 2022		44,64,000

Working Notes:

1. Calculation of normal sales:		
Actual sales		13,60,000
Less: Abnormal sales	1,20,000	
Return of goods sent on approval	1,60,000	2,80,000
		10,80,000
2. Calculation of gross profit:		
Gross profit or normal sales 20/100 x ₹ 10,80,000		2,16,000
Less: Loss on sale of particular (abnormal) goods (₹ 2,40,000-₹ 1,20,000)		1,20,000
Gross profit		96,000

NOTES

CHAPTER 5

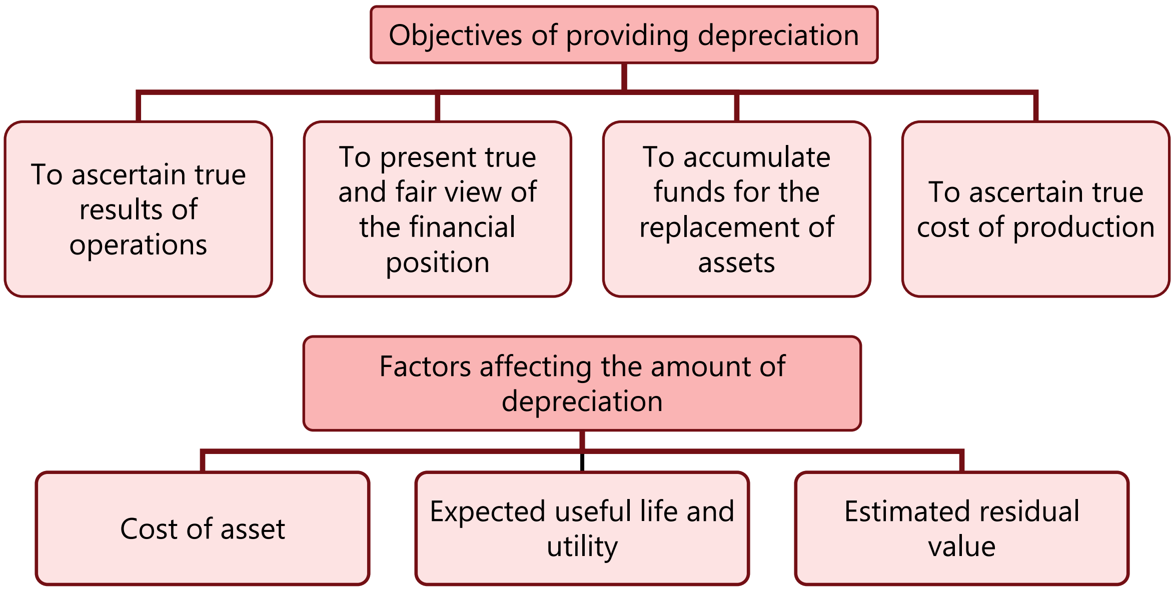
DEPRECIATION AND AMORTISATION

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the meaning and nature of depreciation.
- Understand how to determine the amount of depreciation from the total value of Property, Plant and Equipment and its useful life.
- Understand various methods of depreciation and learn advantages and disadvantages of such methods.
- Understand how to calculate the amount of profit or loss resulting from the sale/disposal of Property, Plant and Equipment.
- Familiarize with the accounting treatment for change in the method of depreciation from Straight Line Method to Reducing Balance method.
- Familiarize with the accounting treatment for change in estimated useful life and residual value of property, plant and equipment.
- Understand the meaning and nature of intangible assets and its amortisation.

CHAPTER OVERVIEW



1. INTRODUCTION

1.1 Concept of Depreciation

Tangible Assets are assets that have a physical substance i.e., they can be seen and touched, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Useful life of tangible asset is based on expected usage.

Property, plant and equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than a period of twelve months.

These are also called fixed assets in common parlance. When a fixed asset is purchased, it is recorded in books of account at its original or acquisition/purchase cost. However fixed assets are used to earn revenues or save costs for several accounting periods in future with the same acquisition cost until the concerned fixed asset is sold or discarded. For example, acquisition of a machinery expected to be in use for 10 years in the production of finished goods will earn revenues over the next 10 years. Similarly, an ATM machine installed by a bank will result in cost savings over the expected life of such ATM machines for the bank in terms of not requiring to employ personnel to dispense cash for customers. Since the life of such assets exceeds one year, it is therefore necessary that a part of the acquisition cost of such fixed assets be treated or allocated as an expense in each of the accounting period in which the asset is utilized. The amount or value of fixed assets allocated in such manner to respective accounting period is called depreciation. Value of such assets decreases with passage of time mainly due to following reasons.

1. Wear and tear due to its use in business
2. Efflux of time (even when it is not being used)
3. Obsolescence due to technological or other changes
4. Decrease in market value
5. Depletion mainly in case of mines and other natural reserves

It is important to account for value of portion of property, plant and equipment utilized for generating revenue during an accounting year to ascertain true income. In other words, against the income/cost savings generated during a period, it is essential to book a portion of the cost of the asset utilized in generating such income/cost savings. This portion of cost of Property, Plant & Equipment allocated to an accounting year is called depreciation.

As per Schedule II under the Companies Act, 2013, Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset is the cost of an asset or other amount substituted for cost (i.e., in case of revaluation of assets, such revalued amount), less its residual value. The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity.

Thus, there are 3 important factors for computing depreciation:

- Estimated useful life of the asset
- Cost of the asset
- Residual value of the asset at the end of the of its estimated useful life

Depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Thus it is not necessary that an asset must be used to be depreciated. There is decrease in value of assets due to normal wear and tear or obsolescence even when these are not physically used. Accordingly, value of such wear and tear should be estimated and accounted for.

Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation for a period helps to charge that portion of the cost of the asset against the revenues earned, which is expired for that period and hence follows matching principle. In other words the total cost of the asset is reflected in form of a) Expired cost (depreciation) and b) Unexpired Cost which shall be the written down value of the asset being reflected in balance sheet. Also, charging depreciation every year reduces the distributable profits thereby ensuring the availability of funds whenever the replacement is required.

The depreciation is a type of loss in the value of assets employed for carrying on a business. Being an essential element of business expenditure, it is necessary to calculate the amount of such loss and to make a provision, and therefore, arrive at the amount of profit or loss made by the business.

Basically, the cost of an asset used for purpose of business has to be written off over its economic (not physical) life which must be estimated. A point to remember is that usually, at the end of the economic life, an asset has some value as scrap or otherwise. The amount to be written off in each year should be as such which will reduce the book value of the asset, at the end of its economic life, to its estimated scrap value.

1.2 Depreciation on components of an assets

It may be noted that Accounting Standards as well as the Companies Act, 2013 requires depreciation to be charged on a component basis. Each part of an item of Property, Plant and Equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately. An enterprise should allocate the amount initially recognised in respect of an item of property, plant and equipment to its significant parts/components and should depreciate each such part separately based on the useful life and residual value of each particular component. For Example- Aircraft is a classic example of such an asset. The airframe (i.e. the body of the aircraft), the engines and the interiors have different individual useful lives. If the life of the airframe (being the longest of the individual lives of the three major types of components) is taken as the life of the aircraft, it is important that other two major components i.e. engine and interiors are depreciated over their respective useful life and not over the life of airframe. Other components (usually small and low value) which will require replacement very frequently may be depreciated over the useful life of airframe and their frequent replacement cost may be charged to expense as and when it is incurred.

Here it is important to note that a part of Property, Plant & Equipment to be identified as a separate component should have both

(a) significant cost when compared to overall cost of item of property, plant and equipment and

(b) an estimated useful life or depreciation method different from rest of the parts of the property plant and equipment.

A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

1.3 Objectives for Providing Depreciation

Prime objectives for providing depreciation are:

(1) *Correct income measurement:* Depreciation should be charged for proper estimation of periodic profit or loss. In case an enterprise does not account for depreciation on Property, Plant & Equipment, it will not be considering loss in value of property, plant & equipment due to their use in production or operations of the enterprise and will not result in true profit or loss for the period.

(2) *True position statement:* Value of the Property, Plant & Equipment should be adjusted for depreciation charged in order to depict the actual financial position. In case depreciation is not accounted for appropriately, the property, plant and equipment would be disclosed in financial statements at a value higher than their true value. We should always present the same at its unexpired cost which is after charging the expired cost as depreciation.

(3) *Funds for replacement:* Generation of adequate funds in the hands of the business for replacement of the asset at the end of its useful life. Depreciation is a good indication of the amount an enterprise should set aside to replace a fixed asset after its economic useful life is over. However, the replacement cost of a fixed asset may additionally be impacted by inflation or other technological changes.

(4) *Ascertainment of true cost of production:* For ascertaining the cost of the production, it is necessary to charge depreciation as an item of cost of production.

Further depreciation is a non-cash expense and unlike other normal expenditure (e.g. wages, rent, etc.) does not result in any cash outflow. Further depreciation by itself does not create funds it merely draws attention to the fact that out of gross revenue receipts, a certain amount should be retained for replacement of assets used for carrying on operation which is achieved by charging depreciation that reduces the distributable profits.

2. FACTORS IN THE MEASUREMENT OF DEPRECIATION

Estimation of exact amount of depreciation is not easy as it involves lot of estimation. Generally following factors are taken into consideration for calculation of depreciation.

1. Cost of asset including expenses for installation, commissioning, trial run etc.

2. Estimated useful life of the asset (both in terms of time & also utility/units).

3. Estimated scrap value (if any) at the end of useful life of the asset.

The above mentioned factors can be explained, in detail, as follows:

Historical — Cost of Asset

Cost of a depreciable asset represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to or improvement thereof for the purpose of increase in efficiency. We have discussed this in more detail in coming paragraphs.

Estimated — Useful life of the Asset

'Useful Life' is either (i) the period over which a depreciable asset is expected to be used by the enterprise or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise. Determination of the useful life is a matter of estimation and is normally based on various factors including experience with similar type of assets. Several other factors like estimated working hours, production capacity, repairs and renewals, etc. are also taken into consideration on demanding situation.

Estimated — Scrap (residual value)

Determination of the residual value is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the other hand, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of asset.

Depreciable Amount

Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements (for example- revalued amount), less the estimated residual value.

For example, a machinery is purchased for ` 1,10,000. The residual value is estimated at ` 10,000. It is estimated that the machinery will work for 5 years. The cost to be allocated as depreciation in the accounting periods will be calculated as:

	₹
Acquisition cost	1,10,000
Less: Residual value	(10,000)
Depreciable amount	1,00,000
Estimated useful life of the asset	5 years

$$\text{Depreciation} = \frac{\text{Depreciable amount}}{\text{Estimated useful life}} \text{ i.e. ₹ } 1{,}00{,}000/5 = \text{₹ } 20{,}000 \text{ per year}$$

Cost of Property, Plant and Equipment comprises:

(a) its purchase price, including non-refundable import duties and purchase taxes, after deducting trade discounts and rebates.

(b) any cost directly attributable to bring the asset to the location and condition necessary for it to be capable of operating in a manner intended by the enterprise.

(c) the initial estimate of the costs of dismantling, removing, the item and restoring the site on which an asset is located.

Examples of directly attributable costs are:

(a) cost of employee benefits arising directly from acquisition or construction of an item of property, plant and equipment.

(b) cost of site preparation

(c) initial delivery and handling costs

(d) installation and assembly costs

(e) cost of testing whether the asset is functioning properly, after deducting the net proceeds from selling the items produced while testing (such as samples produced while testing)

(f) professional fees e.g. engineers hired for helping in installation of a machine

Thus, all the expenses which are necessary for the asset to bring it in condition and location of desired use will become part of cost of the asset. However, following expenses should not become part of cost of asset:

(a) costs of opening new facility or business, such as inauguration costs;

(b) cost of introducing new product or service (for example cost of advertisement or promotional activities).

(c) cost of conducting business in a new location or with a new class of customer (including cost of staff training); and

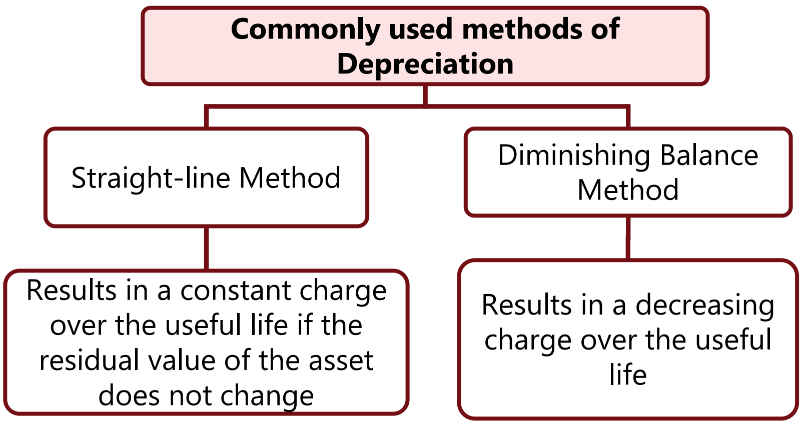
(d) administration and other general overhead costs.

Once an asset has been brought to its intended condition and location of use, no cost should be recognized as part of cost of the asset unless there is major repair or addition which increases the useful life of the asset or improves the production capacity of the asset. Accordingly, cost incurred while an item is capable of operating in intended manner but it is not yet put to use or is used at less than full capacity should not be capitalized as part of cost of the asset. Similarly, cost of relocation of an asset should not be capitalized.

Any additions made to a particular item of property, plant and equipment after it is initially put to use are depreciated over the remaining useful life of the asset. Any addition or extension which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately. Therefore, it is important to maintain an asset register capturing asset wise details of cost, rate of depreciation, date of capitalization etc. All these details need to be captured for any additions to existing assets as well. In the absence of the adequate information, it will be very difficult to compute depreciation expense year on year. Also, at the time of disposal or discard of a particular asset, it will not be possible to compute gain or loss on such disposal/discard.

3. METHODS FOR PROVIDING DEPRECIATION

Generally, methods for providing depreciation are based on formula, developed on a study of the behavior of the assets over a period of years for readily computing the amount of depreciation suffered by different forms of assets. Each of the methods, however, should be applied only after carefully considering nature of the asset and the conditions under which it is being used.



The Income Tax Rules, however, prescribe the Diminishing Balance Method except in the case of assets of an undertaking engaged in generation and distribution of power.

3.1 Straight Line Method

According to this method, an equal amount is written off every year during the working life of an asset so as to reduce the cost of the asset to nil or its residual value at the end of its useful life. The advantage of this method is that it is simple to apply and gives accurate results especially in case of leases, and also in case of plant and machinery. This method is also known as Fixed Instalment Method.

$$\text{Straight Line Depreciation} = \frac{\text{Cost of Asset} - \text{Scrap Value}}{\text{Useful life}}$$

$$\text{Straight Line Depreciation Rate} = \frac{\text{Straight Line Depreciation}}{\text{Cost of Asset}} \times 100$$

The underlying assumption of this method is that the particular tangible asset generates equal utility during its lifetime. But this cannot be true under all circumstances. The expenditure incurred on repairs and maintenance will be low in earlier years, whereas the same will be high as the asset becomes old. Apart from this the asset may also have varying capacities over the years, indicating logic for unequal depreciation provision. However, many assets have insignificant repairs and maintenance expenditures for which straight line method can be applied.

While using this method the period of use of an asset in a particular year should also be considered. In the year of purchase of an asset it may have been available for use for part of the year only, accordingly depreciation should be proportioned to reflect the period for which it was available for use. For example, if an asset was purchased on March 1, 2022 and the enterprise prepares financial statements for the year ending on March 31, 2022 depreciation will be provided for a period of 1 month only. Similar situation will arise in the year in which an asset is retired from its intended used or is sold.

3.2 Reducing or Diminishing Balance Method or Written Down Value (WDV) Method

Under this system, a fixed percentage of the diminishing value of the asset is written off each year so as to reduce the asset to its residual value at the end of its life. Repairs and small renewals are charged to revenue. This method is commonly used for plant, fixtures, etc. Under this method, the annual charge for depreciation decreases from year to year, so that the earlier years suffer to the benefit of the later years. Also, under this method, the value of asset can never be completely extinguished, which happens in the earlier explained Straight Line Method. This method is based on the assumption that cost of repairs will increase as the asset gets old, therefore, depreciation in earlier years should be high when the repair cost is expected to be low and depreciation in later years should be low when the repair cost is expected to be high. Therefore, this method will result in almost equal burden in all the years of use of the asset as depreciation will reduce with increase in repair costs will increase with every passing year. On the other hand, under the Straight Line Method, the charge for depreciation is constant, while repairs tend to increase with the life of the asset. Among the disadvantages of this method is the danger that too low a percentage may be adopted as depreciation with the result that over the life of the asset full depreciation may not be provided; also if assets are grouped in such a way that individual assets are difficult to identify, the residue of an asset may lie in the asset account even after the asset has been scrapped. The last mentioned difficulty could be, however, over come if a Plant register is maintained.

The rate of depreciation under this method may be determined by the following formula:

$$1-\sqrt[n]{\frac{\text{Residual Value}}{\text{Cost of Assets}}}\text{x}\,100$$

where, n = useful life

Similar to straight line method, in this method also period of use in a particular year e.g. year of purchase or sale an item of property plant and equipment needs to be considered while computing the depreciation amount.

Accounting Entries under Straight Line and Reducing Balance Methods:

There are two alternative approaches for recording accounting entries for depreciation.

First Alternative

A provision for depreciation or Accumulated Depreciation account is opened to accumulate the balance of depreciation and the assets are carried at historical cost. This method is preferred by most of the organizations as it presents both the gross investment and the current value of the assets.

Accounting entry

Depreciation Account	Dr.
To Provision for Depreciation Account or Accumulated Depreciation	
Profit and Loss Account	Dr.
To Depreciation Account	

Second Alternative

Amount of Depreciation is credited to the Asset Account every year and the Asset Account is carried at historical cost less depreciation.

Accounting entries:

Depreciation Account	Dr.
To Asset Account	
Profit and Loss Account	Dr.
To Depreciation Account	

ILLUSTRATION 1

Jain Bros. acquired a machine on 1st July, 2021 at a cost of ₹ 14,00,000 and spent ₹ 1,00,000 on its installation. The firm writes off depreciation at 10% p.a. of the original cost every year. The books are closed on 31st December every year.

Required

Show the Machinery Account and Depreciation Account for the year 2021 and 2022.

Machinery Account

Date	Particulars	₹	Date	Particulars	₹
2021			2021		
July 1	To Bank A/c	14,00,000	Dec. 31	By Depreciation A/c	
July 1	To Bank A/c - Installation Expenses	1,00,000		10% on ₹ 15,00,000 for 6 months	75,000
			Dec. 31	By Balance c/d	14,25,000
		15,00,000			15,00,000
2022			2022		
Jan. 1	To Balance b/d	14,25,000	Dec. 31	By Depreciation A/c	
				10% on ₹ 15,00,000	1,50,000
			Dec. 31	By Balance c/d	12,75,000
		14,25,000			14,25,000

Depreciation Account

Date	Particulars	₹	Date	Particulars	₹
2021			2021		
Dec. 31	To Machinery A/c	75,000	Dec. 31	By Profit & Loss A/c	75,000
2022			2022		
Dec. 31	To Machinery A/c	1,50,000	Dec. 31	By Profit & Loss A/c	1,50,000

ILLUSTRATION 2

Jain Bros. acquired a machine on 1st July, 2021 at a cost of ₹ 14,00,000 and spent ₹ 1,00,000 on its installation. The firm writes off depreciation at 10% p.a. every year. The books are closed on 31st December every year.

Required

Show the Machinery Account on diminishing balance method for the year 2021 and 2022.

SOLUTION

As per Reducing Balance Method

Machinery Account

Date	Particulars	₹	Date	Particulars	₹
2021			2021		
July 1	To Bank A/c	14,00,000	Dec. 31	By Depreciation A/c (₹ 15,00,000 x 10% x 6/12) for 6 months	75,000
July 1	To Bank A/c -	1,00,000			
			Dec. 31	By Balance c/d	14,25,000
		15,00,000			15,00,000
2022			2022		
Jan. 1	To Balance b/d	14,25,000	Dec. 31	By Depreciation A/c (₹ 14,25,000 x 10%)	1,42,500
			Dec. 31	By Balance c/d	12,82,500
		14,25,000			14,25,000

3.3 Sum of Years of Digits Method

It is a variation of the "Reducing Balance Method". In this case, the annual depreciation is calculated by multiplying the original cost of the asset less its estimated scrap value by the fraction represented by:

$$\frac{\text{The number of years (including the present year) of remaining life of the asset}}{\text{Total of all digits of the life of the asset (in years)}}$$

Suppose the estimated life of an asset is 10 years; the total of all the digits from 1 to 10 is 55 i.e.,10 + 9 + 8 + 7 + 6 + 5 + 4 + 3 + 2 + 1, or by the formula:

$$\frac{n(n+1)}{2} = \frac{10 \times 11}{2} = 55$$

The depreciation to be written off in the first year will be 10/55 of the cost of the asset less estimated scrap value; and the depreciation for the second year will be 9/55 of the cost of asset less estimated scrap value and so on.

The method is not yet in vogue; and its advantages are the same as those of the Reducing Balance Method.

ILLUSTRATION 3

M/s Akash & Co. purchased a machine for ₹ 10,00,000. Estimated useful life and scrap value were 10 years and ₹ 1,20,000 respectively. The machine was put to use on 1.1.2017.

Required

Show Machinery Account and Depreciation Account in their books for 2022 by using sum of years digits method.

SOLUTION

In the books of M/s Raj & Co.

Machinery Account

Date	Particulars	₹	Date	Particulars	₹
2022			2022		
Jan. 1	To Balance b/d (w.n.2)	3,60,000	Dec. 31	By Depreciation A/c (w.n.3)	80,000
			Dec. 31	By Balance c/d	2,80,000
		3,60,000			3,60,000
2023					
Jan.1	To Balance b/d	2,80,000			

Depreciation Account

		₹			₹
2022			2022		
Dec. 31	To Machinery A/c	80,000	Dec. 31	By Profit and Loss A/c	80,000
		80,000			80,000

Working Notes:

(1) **Total of sum of digit of depreciation for 2017-21**

$$= (₹\ 10,00,000 - ₹\ 1,20,000) \times \frac{10+9+8+7+6}{\frac{10\,(10+1)}{2}} = ₹\ 8,80,000 \times \frac{40}{55} = ₹\ 6,40,000$$

(2) **Written down value as on 1-1-2022**

₹ 10,00,000 – ₹ 6,40,000 = ₹ 3,60,000

(3) **Depreciation for 2022**

$$(₹\ 10,00,000 - ₹\ 1,20,000) \times \frac{5}{55} = ₹\ 80,000.$$

3.4 Machine Hour Method

Where it is practicable to keep a record of the actual running hours of each machine, depreciation may be calculated on the basis of hours that the concerned machine worked. The machine hour rate of the depreciation, is calculated after estimating the total number of hours that machine would work during its whole life; however, it may have to be varied from time to time, on a consideration of the changes in the economic and technological conditions which might take place, to ensure that the amount provided for depreciation corresponds to that considered appropriate in the changed circumstances. It would be observed that the method is a variation of the Straight Line Method under which depreciation is calculated per year. Under this method it is calculated for each hour the machine works.

Schedule II to the Companies Act 2013 which prescribes estimated useful life of different assets for companies also recognizes this method to some extent. It prescribes that depreciation should be charged using estimated useful life suggested in it; however, in certain category of plant and machinery it prescribes charging higher amount of depreciation if these assets are used for 2 shifts or 3 shifts. In a way, schedule II combines straight line method and machine hour method.

ILLUSTRATION 4

A machine was purchased for ₹ 30,00,000 having an estimated total working of 24,000 hours. The scrap value is expected to be ₹ 2,00,000 and anticipated pattern of distribution of effective hours is as follows :

Year

1 – 3 3,000 hours per year

4 - 6 2,600 hours per year

7 - 10 1,800 hours per year

Required

Determine Annual Depreciation under Machine Hour Rate Method.

SOLUTION

Statement of Annual Depreciation under Machine Hours Rate Method

Year	Annual Depreciation
1 - 3	$\frac{3,000}{24,000} \times$ (₹ 30,00,000 - ₹ 2,00,000) = ₹ 3,50,000

4 - 6	$\frac{2,600}{24,000}$ × (₹ 30,00,000 - ₹ 2,00,000) = ₹ 3,03,333
7 - 10	$\frac{1,800}{24,000}$ × (₹ 30,00,000 - ₹ 2,00,000) = ₹ 2,10,000

3.5 Production Units Method

Under this method depreciation of the asset is determined by comparing the annual production with the estimated total production. The amount of depreciation is computed by the use of following method:

$$\text{Depreciable Amount} \times \frac{\text{Production during the period}}{\text{Estimated total production}}$$

The method is applicable to machines producing product of uniform specifications.

ILLUSTRATION 5

A machine is purchased for ₹ 20,00,000. Its estimated useful life is 10 years with a residual value of ₹ 2,00,000. The machine is expected to produce 1.5 lakh units during its life time. Expected distribution pattern of production is as follows:

Year	*Production*
1-3	*20,000 units per year*
4-7	*15,000 units per year*
8-10	*10,000 units per year*

Required

Determine the value of depreciation for each year using production units method.

SOLUTION

Statement showing Depreciation under Production Units Method

Year	Annual Depreciation
1-3	$\frac{20,000}{1,50,000}$ × (₹ 20,00,000 - ₹ 2,00,000) = ₹ 2,40,000
4-7	$\frac{15,000}{1,50,000}$ × (₹ 20,00,000 - ₹ 2,00,000) = ₹ 1,80,000
8-10	$\frac{10,000}{1,50,000}$ × (₹ 20,00,000 - ₹ 2,00,000) = ₹ 1,20,000

3.6 Depletion Method

Depletion is the allocation of the cost of wasting natural resources such as oil, gas, timber, and minerals to the production process. This method is used in case of mines, quarries etc. containing only a certain quantity of product. The depreciation rate is calculated by dividing the cost of the asset by the estimated quantity of product likely to be available to be extracted. Annual depreciation will be the quantity extracted multiplied by the rate per unit.

ILLUSTRATION 6

M/s Surya & Co. took lease of a quarry on 1-1-2019 for ₹ 1,00,00,000. As per technical estimate the total quantity of mineral deposit is 2,00,000 tonnes. Depreciation was charged on the basis of depletion method. Extraction pattern is given in the following table:

Year	***Quantity of Mineral extracted***
2019	*2,000 tonnes*
2020	*10,000 tonnes*
2021	*15,000 tonnes*

Required

Show the Quarry Lease Account and Depreciation Account for each year from 2019 to 2021.

SOLUTION

Quarry Lease Account

		₹			₹
2019			2019		
Jan.	To Bank A/c	1,00,00,000	Dec. 31	By Depreciation A/c	1,00,000
				[(2,000/2,00,000)×₹1,00,00,000]	
			Dec. 31	By Balance c/d	99,00,000
		1,00,00,000			1,00,00,000
2020			2020		
Jan. 1	To Balance b/d	99,00,000	Dec. 31	By Depreciation A/c	5,00,000
			Dec. 31	By Balance c/d	94,00,000
		99,00,000			99,00,000
2021			2021		
Jan. 1	To Balance b/d	94,00,000	Dec. 31	By Depreciation A/c	7,50,000
			Dec. 31	By Balance c/d	86,50,000
		94,00,000			94,00,000

Depreciation Account

		₹			₹
2019			2019		
Dec. 31	To Quarry lease A/c	1,00,000	Dec. 31	By Profit & Loss A/c	1,00,000
		1,00,000			1,00,000
2020			2020		
Dec. 31	To Quarry lease A/c	5,00,000	Dec. 31	By Profit & Loss A/c	5,00,000
		5,00,000			5,00,000
2021			2021		
Dec. 31	To Quarry lease A/c	7,50,000	Dec. 31	By Profit & Loss A/c	7,50,000
		7,50,000			7,50,000

4. PROFIT OR LOSS ON THE SALE/DISPOSAL OF PROPERTY, PLANT AND EQUIPMENT

Whenever any depreciable asset is sold during the year, depreciation is charged on it for the period it has been used in the sale year. The written down value after charging such depreciation is used for calculating the profit or loss on the sale of that asset. The resulting profit or loss on sale of the asset is ultimately transferred to profit and loss account. Thus, all entries related to sale and profit or loss on sale of asset are posted in the respective asset account. Alternatively, a new account titled Asset disposal Account may also be opened in the ledger for the purpose of calculating profit or loss on sale of asset. In that case the book value of the asset will be transferred from the asset account to the asset disposal account and all entries related to sale like sale proceeds and calculation of profit or loss on sale will be posted in the Asset disposal account.

For example: The book value of the asset as on 1st January, 2022 is ₹ 50,00,000. Depreciation is charged on the asset @10%. On 1st July 2022, the asset is sold for ₹ 32,00,000. In such a situation, profit or loss on the sale will be calculated as follows:

	₹
Book value as on 1st Jan., 2022	50,00,000
Less: Depreciation for 6 months @10% (from 1st Jan., 2022 to 30th June, 2022)	(2,50,000)
Written down value as on 1st July, 2022	47,50,000

Less: Sale proceeds as on 1st July, 2022	(32,00,000)
Loss on sale of the asset	15,50,000

ILLUSTRATION 7

A firm purchased on 1st January, 2020 certain machinery for ₹ 5,82,000 and spent ₹ 18,000 on its erection. On July 1, 2020 another machinery for ₹ 2,00,000 was acquired. On 1st July, 2021 the machinery purchased on 1st January, 2020 having become obsolete was auctioned for ₹ 3,86,000 and on the same date fresh machinery was purchased at a cost of ₹ 4,00,000.

Depreciation was provided for annually on 31st December at the rate of 10 per cent p.a. on written down value.

Required

Prepare machinery account.

SOLUTION

Machinery Account

Date	Particulars	₹	Date	Particulars	₹
2020			2020		
Jan. 1	To Bank A/c	5,82,000	Dec. 31	By Depreciation A/c	70,000
Jan. 1	To Bank A/c – erection charges	18,000		By Balance c/d	7,30,000
July 1	To Bank A/c	2,00,000			
		8,00,000			8,00,000
2021			2021		
Jan. 1	To Balance b/d	7,30,000	July 1	By Depreciation on sold machine	27,000
July 1	To Bank A/c	4,00,000		By Bank A/c	3,86,000
				By Profit and Loss A/c	1,27,000
			Dec. 31	By Depreciation A/c	39,000
				By Balance c/d	5,51,000
		11,30,000			11,30,000

Working Note:

Book Value of Machines

	Machine I ₹	Machine II ₹	Machine III ₹
Cost	6,00,000	2,00,000	4,00,000
Depreciation for 2020	(60,000)	(10,000)	
Written down value	5,40,000	1,90,000	
Depreciation for 2021	(27,000)	(19,000)	(20,000)
Written down value	5,13,000	1,71,000	3,80,000
Sale Proceeds	(3,86,000)		
Loss on Sale	1,27,000		

ILLUSTRATION 8

On April 1, 2019 Shubra Ltd. purchased a machinery for ₹ 12,00,000. On Oct 1, 2021, a part of the machinery purchased on April 1, 2019 for ₹ 80,000 was sold for ₹ 45,000 and a new machinery at a cost of ₹ 1,58,000 was purchased and installed on the same date. The company has adopted the method of providing 10% p.a. depreciation on the written down value of the machinery.

Required : *Show the necessary ledger accounts for the years ended 31st March, 2020 to 2022 assuming that (a) 'Provision for Depreciation Account' is not maintained (b) Provision for Depreciation Account is maintained.*

SOLUTION

(a) When 'Provision for Depreciation Account' is not maintained.

Dr. **Machinery Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
01.04.2019	To Bank A/c	12,00,000	31.03.2020	By Depreciation A/c	1,20,000
				By Balance c/d	10,80,000
		12,00,000			12,00,000
01.04.2020	To Balance b/d	10,80,000	31.03.2021	By Depreciation A/c	1,08,000
				By Balance c/d	9,72,000
		10,80,000			10,80,000

01.04.2021	To Balance b/d	9,72,000	01.10.2021	By bank A/c	45,000
01.10.2021	To Bank A/c	1,58,000		By Profit & Loss A/c	16,560
				By Depreciation A/c	3,240
			31.3.2021	By Depreciation A/c (7,900+ 90,720)	98,620
				By Balance c/d (8,16,480 + 1,50,100)	9,66,580
		11,30,000			11,30,000

(b) When 'Provision for Depreciation Account' is maintained

Dr. **Machinery Account (at original cost)** Cr.

Date	Particulars	₹	Date	Particulars	₹
01.04.2019	To Bank A/c	12,00,000	31.03.2020	By Balance c/d	12,00,000
01.04.2020	To Balance b/d	12,00,000	31.03.2021	By Balance c/d	12,00,000
01.04.2021	To Balance b/d	12,00,000	01.10.2021	By Machinery Disposal A/c	80,000
01.10.2021	To Bank A/c	1,58,000	31.03.2022	By Balance c/d	12,78,000
		13,58,000			13,58,000

Dr. **Provision for Depreciation Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
31.03.2020	To Balance c/d	1,20,000	31.03.2020	By Depreciation A/c	1,20,000
31.03.2021	To Balance c/d	2,28,000	1.04.2020	By Balance b/d	1,20,000
			31.03.2021	By Depreciation A/c	1,08,000
		2,28,000			2,28,000
01.10.2021	To Machinery Disposal A/c	18,440	01.04.2021	By Balance b/d	2,28,000
31.03.2022	To Balance c/d	3,11,420	01.10.2021	By Depreciation A/c	3,240
			31.03.2022	By Depreciation A/c	98,620
		3,29,860			3,29,860

Dr. Machinery Disposal Account Cr.

Date	Particulars	₹	Date	Particulars	₹
01.10.2021	To Machinery Disposal A/c	80,000	01.10.2021	By Provision for Depreciation A/c	18,440
				By Bank A/c	45,000
				By Profit and Loss A/c	16,560
		80,000			80,000

Working Notes:

(1) Calculation of Profit/Loss on Sale of Machinery

Particulars	₹
A. Original Cost	80,000
B. *Less* : Depreciation @ 10% WDV p.a. for 2 ½ years	18,440
C. Book Value as on date of Sale (A – B)	61,560
D. *Less* : Sale proceeds	45,000
E. Loss on Sale (C – D)	16,560

(2) Calculation of Depreciation for Current Year on Machines (other than sold)

Particulars	₹
A. On Old Machines of ₹ 9,07,200 for 1 year (10% WDV)	90,720
B. On New Machine of ₹ 1,58,000 for ½ year	7,900
	98,620

ILLUSTRATION 9

A firm purchased second hand machinery on 1st January, 2019 for ₹ 3,00,000, subsequent to which ₹ 60,000 and ₹ 40,000 were spent on its repairs and installation, respectively. On 1st July, 2020 another machinery was purchased for ₹ 2,60,000. On 1st July, 2021, the first machinery having become outdated was auctioned for ₹ 3,20,000 and on the same date, another machinery was purchased for ₹ 2,50,000.

On 1st July, 2022, the second machinery was also sold off and it fetched ₹ 2,30,000.

Depreciation was provided on machinery @ 10% on the original cost annually on 31st December, under the straight line method.

Required

Prepare the following accounts in the books of the company: (i) Machinery Account for the years ending Dec. 31, 2019 to 2022 and (ii) Machinery Disposal Account.

SOLUTION

Dr. **Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.2019	To Bank A/c (A) – Cost	3,00,000	31.12.2019	By Depreciation (A)	40,000
	- Repairs	60,000		By Balance c/d (A)	3,60,000
	- Installation	40,000			
		4,00,000			4,00,000
01.01.2020	To Balance b/d	3,60,000	31.12.2020	By Depreciation	
				(A) 40,000	
				(B) <u>13,000</u>	53,000
01.07.2020	To Bank A/c (B)	2,60,000		By Balance c/d	
				(A) 3,20,000	
				(B) <u>2,47,000</u>	5,67,000
		6,20,000			6,20,000
01.01.2021	To Balance b/d	5,67,000	01.07.2021	By Machinery Disposal A/c (A)	3,00,000
01.07.2021	To Bank A/c (C)	2,50,000		By Depreciation A/c	
				(A) 20,000	
				(B) 26,000	
				(C) <u>12,500</u>	58,500
				By Balance c/d	
				(B) 2,21,000	
				(C) <u>2,37,500</u>	4,58,500
		8,17,000			8,17,000
01.01.2022	To Balance b/d	4,58,500	01.07.2022	By Machinery Disposal A/c (B)	2,08,000
				By Depreciation A/c	
				(B) 13,000	
				(C) <u>25,000</u>	38,000
				By Balance c/d	2,12,500
		4,58,500			4,58,500

Machinery Disposal Account

Date	Particulars	₹	Date	Particulars	₹
01.07.2021	To Machinery A/c (A)	3,00,000	01.07.2021	By Bank A/c	3,20,000
	To Profit Loss A/c (Profit)	20,000			
		3,20,000			3,20,000
01.07.2022	To Machinery A/c (B)	2,08,000	01.07.2022	By Bank A/c	2,30,000
	To P & L A/c (Profit)	22,000			
		2,30,000			2,30,000

5. CHANGE IN THE METHOD OF DEPRECIATION

The depreciation method applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern. Whenever any change in depreciation method is made, such change in method is treated as change in accounting estimate as per Accounting Standards. Its effect needs to be quantified and disclosed separately. A change in an accounting estimate may affect the current period only or both the current period and future periods.

Example:

Cost of Machine	₹ 10,50,000
Residual Value	₹ 50,000
Useful life	10 years.

The company charges depreciation on straight line method for the first two years and thereafter decides to adopt written down value method by charging depreciation @ 25%. (calculated based on useful life). You are required to calculate depreciation for the 3rd year.

Depreciation already charged for the first 2 years as per straight line method is ₹ 2,00,000. Therefore, WDV for 2nd year is ₹ 8,50,000

Therefore, in the profit and loss account of the 3rd year, the depreciation of ₹ 2,12,500 (25% of ₹ 850,000) should be debited. In case the entity would have continued with Straight Line Method, depreciation for 3rd year would have been ₹ 1,00,000.

ILLUSTRATION 10

M/s Anshul & Co. commenced business on 1st January 2017, when they purchased plant and equipment for ₹ 7,00,000. They adopted a policy of charging depreciation at 15% per annum on diminishing balance basis and over the years, their purchases of plant have been:

Date	***Amount ₹***
1-1-2018	*1,50,000*
1-1-2021	*2,00,000*

On 1-1-2021 it was decided to change the method and rate of depreciation to straight line basis. On this date remaining useful life was assessed as 6 years for all the assets purchased before 1.1.2021 with no scrap value and 10 years for the asset purchased on 1.1.2021.

Required

Calculate the difference in depreciation to be adjusted in the Plant and Equipment Account for the year ending 31st December, 2021.

SOLUTION

Depreciation on written down value basis

		Purchased on Jan. 1, 2017 ₹	**Purchased on Jan. 1, 2018** ₹	**Total Depreciation** ₹
2017	Cost	7,00,000		
	Depreciation	(1,05,000)		1,05,000
	Written Down Value (WDV)	5,95,000		
2018	Cost	-	1,50,000	
	Depreciation	(89,250)	(22,500)	1,11,750
	W.D.V.	5,05,750	1,27,500	
2019				
	Depreciation	(75,863)	(19,125)	94,988
	W.D.V.	4,29,887	1,08,375	

2020				
	Depreciation	(64,483)	(16,256)	80,739
	W.D.V.	3,65,404	92,119	
2021				
	Depreciation	(60,900)	(15,353)	76,253
		3,04,504	76,766	

Plant and Equipment Account

		₹			₹
2021			2021		
Jan. 1	To Balance b/d	4,57,523	Dec. 31	By Depreciation	96,253
	To Bank	2,00,000		(60,900+15,353+20,000)	
				By Balance c/d	5,61,270
		6,57,523			6,57,523
2022					
Jan. 1	To Balance b/d	5,61,270			

6. REVISION OF THE ESTIMATED USEFUL LIFE OF PROPERTY, PLANT AND EQUIPMENT

The residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with Accounting Standards.

Whenever there is a revision in the estimated useful life of the asset, the written down value or the balance depreciable amount should be charged over the revised remaining estimated useful life of the asset.

ILLUSTRATION 11

A Machine costing ₹ 6,00,000 is depreciated on straight line basis, assuming 10 years working life and Nil residual value, for three years. The estimate of remaining useful life after third year was reassessed at 5 years.

Required

Calculate depreciation for the fourth year.

SOLUTION

Depreciation per year = ₹ 6,00,000 / 10 = ₹ 60,000

Depreciation on SLM charged for three years = ₹ 60,000 x 3 years = ₹ 1,80,000

Book value of the computer at the end of third year = ₹ 6,00,000 – ₹ 1,80,000 = ₹ 4,20,000.

Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 5 years

Depreciation from the fourth year onwards = ₹ 4,20,000 / 5 = ₹ 84,000 per annum

7. REVALUATION OF PROPERTY, PLANT AND EQUIPMENT

After recognizing an asset initially, the asset whose fair value could be reliably measured could be carried at the revalued amount, being the fair value at revaluation date and reduced by successively accumulated depreciation and successive accumulated impairment losses (permanent decline in value) (if any). If an entity opts for revaluation:

(a) Revaluations must be made at adequate intervals (say yearly) for ensuring that carrying amount doesn't differ substantially from that which would be determined if fair value at end of the reporting period is used

(b) In case an item of PPE is revalued, whole class of such PPE to which such asset belongs should be revalued

(c) In case the carrying amount of an asset increases due to revaluation, such increase should be credited to revaluation surplus and should be accumulated in equity. However, such increase should be recognized in Profit and Loss statement to the extent of reversal of a previous decrease of that asset that was recognized in the Profit and Loss statement.

(d) In case the carrying amount of an asset is decreased due to revaluation, such decrease should be recognized in the Profit and Loss account. However, such decrease should be debited to the revaluation surplus to the extent of reversal of a previous increase that was recognized in revaluation surplus for that asset.

(e) The Revaluation Surplus may be transferred directly to retained earnings when the asset is derecognized. This may involve transferring the whole of the surplus when the asset is retired or disposed of. Such transfer from Revaluation Surplus to Retained Earnings cannot be made through the Profit or Loss.

(f) Alternatively, where there is an upward revaluation, the excess depreciation on account of such upward revaluation may be transferred from Revaluation Surplus to Retained Earnings. Such transfer from Revaluation Surplus to Retained Earnings cannot be made through the Profit or Loss.

It may be pertinent to note that revaluation of Property, Plant and Equipment is an accounting policy choice, and not mandatory under the accounting standards or the Companies Act, 2013.

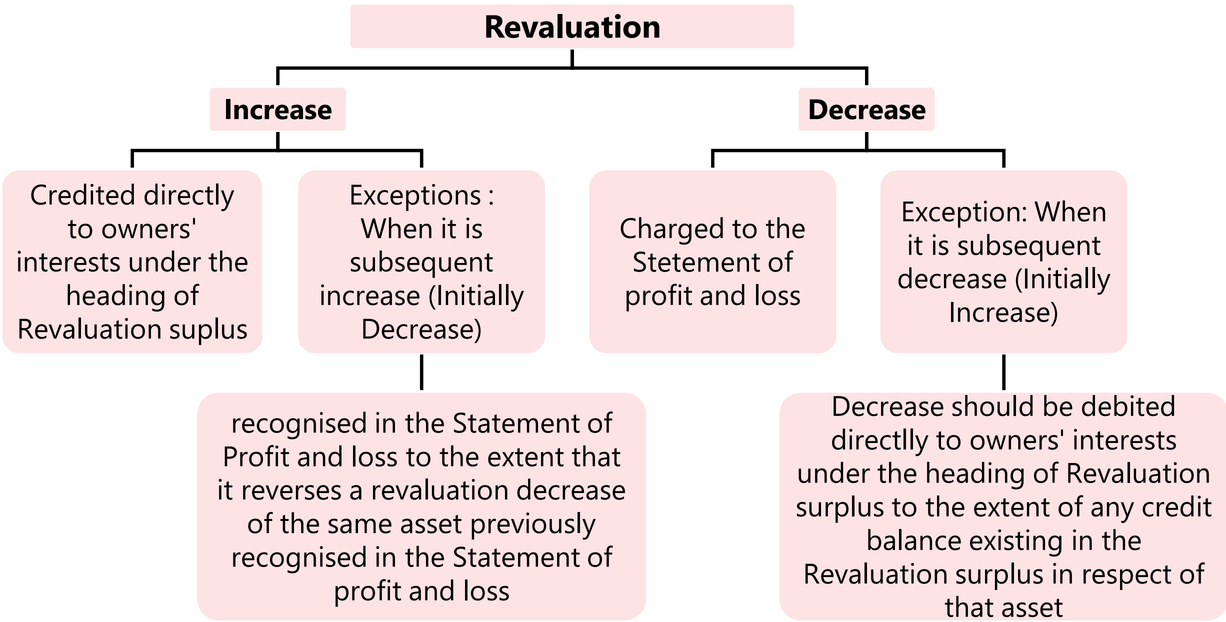


ILLUSTRATION 12

A machine of cost ₹ 12,00,000 is depreciated straight-line assuming 10 year working life and zero residual value for three years. At the end of third year, the machine was revalued upwards by ₹ 60,000 the remaining useful life was reassessed at 9 years.

Required

Calculate depreciation for the fourth year.

SOLUTION

Depreciation per year charged for three years = ₹ 12,00,000 / 10 = ₹ 1,20,000

WDV of the machine at the end of third year = ₹ 12,00,000 – ₹ 1,20,000 × 3 = ₹ 8,40,000.

Depreciable amount after revaluation = ₹ 8,40,000 + ₹ 60,000 = ₹ 9,00,000

Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 9 years

Depreciation for the fourth year onwards = ₹ 9,00,000 / 9 = ₹1,00,000.

8. INTANGIBLE ASSETS

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Examples of intangible assets include:

(a) Streaming rights of movies / TV shows / web series on platforms like Netflix, Disney Hot Star, Amazon Prime / Sony LIV etc.

(b) Broadcasting rights of events such as the Cricket World Cup, the Indian Premier League, the Pro Kabaddi League etc.

(c) Landing rights / time slots at airports which permit aircrafts to land or take-off during a particular time frame

(d) Patents

(e) Trademarks

(f) Copyrights

(g) Distribution rights for motion pictures in theatres

(h) Long-term customer contracts

(i) Customer data collected by the entities such as customer contact numbers / email IDs and spending data at stores like Pantaloons, Westside etc. could be a major intangible asset for these entities.

(j) Goodwill (purchased)

(k) Computer Software

Intangible assets comprise a major portion of the balance sheet. It may be noted that it can also be the case that intangible assets could make the entities far more valuable than the tangible assets. For instance, a multi-year customer contract guaranteeing more than 75% of the revenue for the company is a major asset, which on occasions could be more valuable than the tangible assets themselves. Similarly, when Air India was up for acquisition, the tangible assets comprised of several old planes which needed overhauling and maintenance. However, one of the major reasons that made Air India a desirable target was the prime landing slots (intangible asset) that it had at airports across the world

Intangible assets can be recognized in the financial statements provided they meet the following conditions:

(i) The intangible asset is **identifiable**. Being identifiable means the entity could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

(ii) The enterprise can **exercise control** over such intangible asset. Control means the power available with the enterprise to obtain economic benefits from the asset and at the same time, can restrict access of others to those benefits.

(iii) It is probable that the future economic benefits attributable to the asset will flow to the enterprise; and

(iv) The cost of the intangible asset can be measured reliably.

An intangible asset acquired separately usually measured at cost, as cost can be measured reliably in such cases. The cost of the intangible asset would comprise of:

- Purchase price
- Any import duties and taxes (other than those subsequently recoverable by the enterprise from the tax authorities)
- Any directly attributable expenditure on making the asset ready for its intended use e.g., professional fees towards legal services. Any trade discounts and rebates are deducted in arriving at the cost.

As can be seen above, the cost of an intangible asset is similar to the manner in which the cost of a tangible asset is determined.

Intangible assets acquired as part of acquisition, government grants, internally generated goodwill / intangible assets, or on exchange of assets are dealt separately at the intermediate level.

An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

Difference between Tangible and Intangible Assets

Tangible Assets	Intangible Assets
These are assets that have a physical substance i.e., they can be seen and touched, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.	These are identifiable assets that do NOT have a physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Tangible Assets have a finite life based on expected usage.	Intangible Assets have a finite life based on contractual terms. In some cases, intangible assets could also have an indefinite life e.g. purchased goodwill.
Useful life is based on expected usage, with no presumption laid down for the same.	Useful life of Intangible Assets is presumed not to exceed 10 years unless evidence exists to the contrary.
Tangible Assets are depreciated over the useful life. In other words, writing off the value of tangible assets on an annual basis is known as depreciation.	Intangible Assets are amortised over the useful life. In other words, writing off the value of intangible assets on an annual basis is known as amortisation.
Examples include Property, Machinery, Vehicles etc.	Examples include software, streaming rights, landing rights, trademarks, patents etc.

9. AMORTISATION

The concept of amortisation in case of intangible assets is similar to the concept of depreciation in case of tangible assets. In other words, 'depreciation of an intangible asset' is called **AMORTISATION**.

Amortisation can be defined as 'the systematic allocation of the depreciable amount of an intangible asset over its useful life'. Depreciable amount is the cost of an asset less its residual value.

Useful life is either:

(a) the period of time over which an asset is expected to be used by the enterprise; or

(b) the number of production or similar units expected to be obtained from the asset by the enterprise.

Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. Amortisation should commence when the asset is available for use. It is presumed that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use unless evidence exists to the contrary. For instance, given the rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that their useful life will be short. Similarly, intangible assets with contractual rights for a period exceeding ten years, will be amortised over such extended period rather than the presumed period of ten years.

Similar to depreciation, the amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expense unless permitted or required to be included in the carrying amount of another asset.

Given the nature of intangible assets, the residual value of an intangible asset should be assumed to be zero unless:

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) there is an active market for the asset and:

  (i) residual value can be determined by reference to that market; and

  (ii) it is probable that such a market will exist at the end of the asset's useful life.

The amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern.

ILLUSTRATION 13

Kumar R&D Co. registered a patent (the patent meets the criteria of an intangible asset) on 1st July, 2021 developed at a cost of ₹ 28,00,000 and spent ₹ 2,00,000 towards legal fees and registration. The patent is granted for a period of 10 years. The books are closed on 31st December every year.

Required

Show the Patent Account and Amortisation Account for the year 2021 and 2022.

SOLUTION

Useful Life: 10 years from 1 July, 2021

Residual Value: NIL

Value of patent = ₹ 30,00,000 (₹ 28,00,000 cost + ₹ 2,00,000 legal expenses and registration fees)

Therefore, annual depreciation: ₹ 30,00,000 ÷ 10 years = ₹ 3,00,000

Patent Account

		₹			₹
2021			2021		
July 1	To Bank A/c	28,00,000	Dec. 31	By Amortisation A/c:	
July 1	To Bank A/c - Legal & Reg. Exp.	2,00,000		₹ 3,00,000 x 6/12	1,50,000
			Dec. 31	By Balance c/d	28,50,000
		30,00,000			30,00,000
2022			2022		
Jan. 1	To Balance b/d	28,50,000	Dec. 31	By Amortisation A/c	3,00,000
			Dec. 31	By Balance c/d	25,50,000
		28,50,000			28,50,000

Amortisation Account

		₹			₹
2021			2021		
Dec. 31	To Patent A/c	1,50,000	Dec. 31	By Profit & Loss A/c	1,50,000
2022			2022		
Dec. 31	To Patent A/c	3,00,000	Dec. 31	By Profit & Loss A/c	3,00,000

ILLUSTRATION 14

Prime Streaming Co. acquired the streaming rights of a movie for ₹ 18,00,000 with the contracted duration of the streaming period being 10 years. At the beginning of the fourth year, based on the decline in viewership, Prime Streaming Co. decided to stream the movie only for the next 5 years.

Required

Calculate amortisation for the fourth year.

SOLUTION

Amortisation per year = ₹ 18,00,000 / 10 = ₹ 1,80,000

Amortisation on SLM charged for three years = ₹ 1,80,000 x 3 years = ₹ 5,40,000

Carrying Amount of the Streaming Rights at the end of third year = ₹ 18,00,000 – ₹ 5,40,000 = ₹ 12,60,000.

Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 5 years

Amortisation from the fourth year onwards = ₹ 12,60,000 / 5 = ₹ 2,52,000 per annum

SUMMARY

- Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.
- Objectives for providing depreciation are:
  - Correct income measurement by matching the charge for the year
  - True financial position statement by showing PP&E at their current value
  - Funds for replacement
  - Ascertainment of true cost of production.
- Factors in the measurement of depreciation:
  - Cost of asset
  - Estimated useful life of the asset
  - Estimated scrap value (if any) at the end of useful life of the asset.
- Methods for providing depreciation:
  - Straight line method
  - Reducing balance method
  - Sum of years of digits method
  - Machine hour method
  - Production units' method
  - Depletion method
- The resulting profit or loss on sale of the tangible asset is ultimately transferred to profit and loss account.
- The depreciation method residual value & useful life applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, on account of the above, they should be changed to reflect the changed pattern.

- Whenever there is a revision in the estimated useful life of the asset, the balance depreciable amount should be charged to the asset over the revised remaining estimated useful life of the asset.
- Whenever the depreciable asset is revalued, the depreciation should be charged on the revalued amount on the basis of the remaining estimated useful life of the asset.
- An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.
- Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

TEST YOUR KNOWLEDGE

True and False

1. *Increase in market value of a fixed asset is one of the reasons for depreciation being charged.*
2. *Depreciation is a cash expenditure like other normal expenses..*
3. *Cost of property, plant and equipment includes purchase price, refundable taxes & import duties after deducting any discount or rebate.*
4. *Cost of fixed asset should also include cost of opening a new facility such as inauguration costs.*
5. *Depreciation is charged with a constant amount under straight line method and charged with a constant percentage under diminishing balance method.*
6. *In case an item of Property, Plant & Equipment is revalued, whole class of assets to which that asset being revalued belongs should be revalued.*
7. *In case the carrying amount of an asset is decreased due to revaluation, such decrease should always be recognized in the Profit and Loss account.*
8. *Akash purchased a machine for ₹ 12,00,000. Estimated useful life is 10 years and scrap value is ₹ 1,00,000. Depreciation for the first year using sum of the years digit method shall be ₹ 2,00,000.*
9. *Depreciation cannot be provided in case of loss, in a financial year.*
10. *Providing for depreciation also helps in providing for accumulation of funds to facilitate the replacement at the end of its useful life.*

11. *If the equipment account has a balance of ₹ 12,50,000 and the accumulated depreciation account has a balance of ₹ 4,00,000, the written down value of same shall be ₹ 16,50,000.*

12. *Sum of the years digit method is an example of accelerated method of charging depreciation.*

13. *Over the life of an asset subject to depreciation, the accelerated method will result in less Depreciation Expense in early years and more depreciation in later years of its life.*

14. *While depreciating land cost, Straight line method shall give more depreciation than the written down value.*

15. *Provision for depreciation account is debited at the time of recording the depreciation on an asset.*

16. *If adequate maintenance expenditure is incurred with relation to running repairs of an asset, we need not charge any depreciation.*

17. *When a property, plant or equipment is sold then provision for depreciation account is debited, asset account is credited and any gain or loss is recorded to profit and loss account.*

18. *While calculating the depreciation as per diminishing balance method, the salvage value of the asset at the end of its life is reduced from its cost.*

19. *Any change in the estimated useful life of an asset should be accounted for as a change in an accounting estimate in accordance with Accounting Standards.*

20. *An intangible asset is a non identifiable, non monetary asset.*

Multiple Choice Questions

1. *Original cost = ₹ 12,60,000; Salvage value = Nil; Useful life = 6 years. Depreciation for the first year under sum of years digits method will be*

   (a) ₹ 3,60,000

   (b) ₹ 1,20,000

   (c) ₹ 1,80,000

2. *Obsolescence of a depreciable asset may be caused by:*

   I. Technological changes.

   II. Improvement in production method.

III. Change in market demand for the product or service output.

IV. Legal or other restrictions.

(a) Only (I) above

(b) Both (I) and (II) above

(c) All (I), (II), (III) and (IV) above

3. The number of production of similar units expected to be obtained from the use of an asset by an enterprise is called as

(a) Unit life

(b) Useful life

(c) Production life

4. If a concern proposes to discontinue its business from March 2018 and decides to dispose of all its plants within a period of 4 months, the Balance Sheet as on March 31, 2018 should indicate the plants at their

(a) Historical cost

(b) Net realizable value

(c) Cost less depreciation

5. In the case of downward revaluation of a plant which is for the first time revalued, the account to be debited is

(a) Plant account

(b) Revaluation Reserve

(c) Profit & Loss account

6. The portion of the acquisition cost of the tangible asset, yet to be allocated is known as

(a) Written down value

(b) Accumulated value

(c) Realisable value

7. The main objective of providing depreciation is to

(a) Create secret reserve

(b) Reduce the book value of assets

(c) Allocate cost of the assets

8. *Original cost of a machine was ₹ 25,20,000 salvage value was ₹ 1,20,000, useful life was 6 years. Annual depreciation under Straight Line Method*

   (a) ₹ 4,20,000

   (b) ₹ 4,00,000

   (c) ₹ 3,00,000

9. *The cost of a machine is ₹ 20,00,000. Two years later the book value is ₹ 10,00,000. The Straight-line percentage depreciation is*

   (a) 50%

   (b) 33-1/3%

   (c) 25%

10. *A machinery with original cost of ₹ 10,00,000 and Nil Salvage value acquired on 1st April 2019 with 4 years useful life was depreciated using Straight Line Method. It was decided to sell the machinery on 1st October 2021 for ₹ 1,20,000. What shall be the gain or (loss) on the sale of Machinery?*

    (a) Loss of ₹ 1,30,000

    (b) Gain of ₹ 1,20,000

    (c) Loss of ₹ 5,000

11. *Which of the following assets does not depreciate?*

    (a) Machinery and equipment

    (b) Patents

    (c) Land

12. *A company purchased a machinery on April 01, 2017, for ₹ 15,00,000. It is estimated that the machinery will have a useful life of 5 years after which it will have no salvage value. The depreciation charged during the year 2021-22 was*

    (a) ₹ 5,00,000

    (b) ₹ 4,00,000

    (c) ₹ 3,00,000

13. *If the equipment account has a balance of ₹ 22,50,000 and the accumulated depreciation account has a balance of ₹ 14,00,000, the book value of the equipment is*

    (a) ₹ 36,50,000

(b) ₹ 8,50,000

(c) ₹ 14,00,000

14. *A plant with original cost of ₹ 50,00,000 was revalued after 2 years resulting in credit to Revaluation Surplus account of ₹ 4,00,000. Towards the year end of 2019-20, due to COVID-19 the plan value had gone down by ₹ 5,00,000 and accordingly management decided to revalue the same. What shall be the impact of this downwards revaluation on the Profit & Loss Account ?*

(a) Debit of ₹ 5,00,000

(b) Debit of ₹ 1,00,000

(c) Credit of ₹ 5,00,000

15. *In respect of intangible assets, there is a presumption that the useful life of an intangible asset will not exceed*

(a) 2 years

(b) 3 years

(c) 10 years

16. *A company developed a technology to enhance the battery life of mobile phones. The cost of development have been capitalized as an intangible asset at ₹ 5,00,000. The company estimates the life of the technology developed to be 3 years. The company has forecasted that 50% of sales will be in year 1, 35% in year 2 and 15% in year 3. What should be the amortisation charge in third year?*

(a) ₹ 2,50,000

(b) ₹ 75,000

(c) ₹ 1,75,000

17. *An intangible asset is an asset*

(a) with no physical existence

(b) generated internally by the business

(c) cannot be sold

Theory Questions

1. *Distinguish between Straight line method of depreciation and Written down value method of depreciation.*

2. *Write short note on Depletion method of depreciation.*

3. *What factors are considered for calculation of depreciation of a plant?*

4. *What are intangible assets. Explain with the help of examples.*

Practical Questions

1. *A firm's plant and machinery account at 31st December, 2021 and the corresponding depreciation provision account, broken down by year of purchase are as follows:*

Year of Purchase	Plant and Machinery at cost ₹	Depreciation Provision ₹
2005	2,00,000	2,00,000
2011	3,00,000	3,00,000
2012	10,00,000	9,50,000
2013	7,00,000	5,95,000
2020	5,00,000	75,000
2021	3,00,000	15,000
	30,00,000	21,35,000

Depreciation is at the rate of 10% per annum on cost. It is the Company's policy to assume that all purchases, sales or disposal of plant occurred on 30th June in the relevant year for the purpose of calculating depreciation, irrespective of the precise date on which these events occurred.

During 2022 the following transactions took place:

1. *Purchase of plant and machinery amounted to ₹ 15,00,000*
2. *Plant that had been bought in 2011 for ₹ 170,000 was scrapped.*
3. *Plant that had been bought in 2012 for ₹ 90,000 was sold for ₹ 5,000.*
4. *Plant that had been bought in 2013 for ₹ 2,40,000 was sold for ₹ 15,000.*

You are required to:

Calculate the provision for depreciation of plant and machinery for the year ended 31st December, 2022. In calculating this provision you should bear in mind that it is the company's policy to show any profit or loss on the sale or disposal of plant as a completely separate item in the Profit and Loss Account. You are also required to prepare the following ledger accounts during 2022.

(i) *Plant and machinery at cost;*

(ii) Depreciation provision;

(iii) Sales or disposal of plant and machinery.

2. *The Machinery Account of a Factory showed a balance of ₹ 19,00,000 on 1st January, 2022. Its accounts were made up on 31st December each year and depreciation is written off at 10% p.a. under the Diminishing Balance Method.*

   On 1st June 2022, a new machinery was acquired at a cost of ₹ 2,80,000 and installation charges incurred in erecting the machine works out to ₹ 8,920 on the same date. On 1st June, 2022 a machine which had cost ₹ 4,37,400 on 1st January 2020 was sold for ₹ 75,000. Another machine which had cost ₹ 4,37,000 on 1st January, 2021 was scrapped on the same date and it realised nothing.

   Write a machinery account for the year 2022, allowing the same rate of depreciation as in the past, calculating depreciation to the nearest multiple of a Rupee.

3. *The LG Transport company purchased 10 trucks at ₹ 45,00,000 each on 1st April 2019. On October 1st, 2021, one of the trucks is involved in an accident and is completely destroyed and ₹ 27,00,000 is received from the insurance in full settlement. On the same date another truck is purchased by the company for the sum of ₹ 50,00,000. The company write off 20% on the original cost per annum. The company observe the calendar year as its financial year.*

   Give the motor truck account for two year ending 31 Dec, 2022.

4. *A Machinery costing ₹ 20,00,000 is depreciated on straight line assuming 10 years working life and nil salvage value for four years. At the end of the fourth year, the machinery was revalued upwards by ₹ 80,000. The remaining useful life of the machinery was also reassessed as 8 years at the end of the fourth year. Calculate the depreciation for 5th Year.*

5. *Amazing group had Property, Plant & Equipment (PP&E) with a book value of ₹ 35,00,000 on 31st December, 2022. The balance in Revaluation Surplus on that date was ₹ 3,00,000. As part of their practice of revaluing the assets on yearly basis, another revaluation was carried out on 31st December, 2022. Evaluate the impact of Revaluation if the Fair Value as a result of Revaluation done on 31st December, 2022 was (a) ₹ 37,00,000 (b) ₹ 33,00,000 and (c) ₹ 31,00,000. Also, give the journal entries.*

6. *On April 1, 2019 a firm purchased a machinery for ₹ 2,00,000. On 1st October in the same accounting year, additional machinery costing ₹ 1,00,000 was purchased. On 1st October, 2020, the machinery purchased on 1st April 2019, having become obsolete was sold off for ₹ 90,000. On October 1, 2021, new machinery was purchased for ₹ 2,50,000 while the machinery purchased on 1st October 2019 was sold for ₹ 85,000 on*

the same day. The firm provides depreciation on its machinery @ 10% per annum on original cost on 31st March every year. Show Machinery Account, Provision for Depreciation Account and Depreciation Account for the period of three accounting years ending March 31, 2022.

ANSWERS/HINTS

True and False

1. False : It is the decrease in market value as one of the reasons for depreciation. Increase in market value may result in Revaluation.
2. False: Depreciation is not a cash expenditure like other normal expenses as it does not result in any cash outflow.
3. False : Non refundable taxes & duties form part of the cost.
4. False : Inauguration costs shouldn't be part of cost.
5. True : SLM method results in same amount and diminishing method involves same rate of depreciation.
6. True : Revaluation should be done for the whole class of the asset.
7. False : Any decrease in value of asset on account of revaluation should be first debited to Revaluation Reserve, if any, and then to Profit & Loss account.
8. True : Sum of years digit method depreciation is calculated as 10/55 x (12,00,000 – 1,00,000) = 2,00,000
9. False**:** Depreciation is a charge against profit and not an appropriation of profit. Therefore, depreciation has to be provided for, even in case of loss in a financial year.
10. True : Depreciation being non cash expense reduces the distributable profits and hence facilitates replacement of asset when required.
11. False : WDV = ₹ 12,50,000 - ₹ 4,00,000 = ₹ 8,50,000
12. True : Higher depreciation is charged in earlier years under sum of the years digit method.
13. False : It is vice versa as under diminishing balance method; higher depreciation is charged in beginning.
14. False : Land is not depreciated.
15. False : Provision for Depreciation account is credited while charging the depreciation.

16. False : Depreciation is allocation of the cost of an asset over its useful life. Regular repairs may be required during its life are expensed and depreciation has to be charged anyways.

17. True : At the time of sale of an asset, respective asset account is credited with provision for depreciation account being debited and any resulting gain or loss being charged to profit & loss account.

18. False: Under diminishing balance method, salvage value is not considered initially as it assumes that at the end of the asset's life the remaining value shall be its salvage value.

19. True : Any change in useful life of an asset is accounted for as a change in estimate.

20. False : An intangible asset is an identifiable non-monetary asset, held for use in production and supply of goods and services.

Multiple Choice Questions

1.	(a)	**2.**	(c)	**3.**	(b)	**4.**	(b)	**5.**	(c)	**6.**	(a)
7.	(c)	**8.**	(b)	**9.**	(c)	**10.**	(c)	**11.**	(c)	**12.**	(c)
13.	(b)	**14.**	(b)	**15.**	(c)	**16.**	(b)	**17.**	(a)		

Theoretical Questions

1. Under straight line method an equal amount is written off each year throughout the working life of the depreciable tangible asset so as to reduce the cost of the asset to nil or to its scarp value at the end. Under reducing balance method, a fixed percentage is charged on the diminishing balance of the asset each year so as to reduce the value of the asset to its scarp value at the end of useful life. The basic distinction between these two methods are as follows:

Under straight line method, annual depreciation charge is equal throughout the life of the asset; but under reducing balance method, depreciation charge is reduced over the years as the asset grows old.

Under straight-line method, the asset can be fully depreciated but under reducing balance method asset can never be fully depreciated.

Under straight line method the charge for depreciation is constant while repair charges increase with the life of the asset, so the total charge throughout the life of the asset will not be uniform. To the contrary, under reducing balance method, depreciation charges become high in the initial years but generally repair remains low. As the asset grows old depreciation charge reduces but repair expenses increase. Thus under reducing balance method depreciation and repairs are more or less evenly distributed throughout the life of the asset.

2. Natural resources include physical assets like mineral deposits, oil and gas resources and timber. These natural resources exhaust by exploitation.

Depletion per unit is calculated as

$$\frac{\text{Acquisition cost-Residual Value}}{\text{Estimate life in terms of production units}}$$

3. The factors considered for calculation of depreciation are as: (i)Cost of asset including expenses for installation, commissioning, trial run etc. (ii) Estimated useful life of the asset and (iii) Estimated scrap value (if any) at the end of useful life of the asset.

4. Refer para 8

Practical Questions

1. Calculation of provision for depreciation of plant and machinery for the year ended 31st December, 2022.

Plant purchased in:		₹	₹
2005		nil	
2011		nil	
2012			50,000
2013	1/2 year at 10% on ₹ 2,40,000	12,000	
	1 year at 10% on ₹ 4,60,000	46,000	58,000
2020	10% on ₹ 5,00,000		50,000
2021	10% on ₹ 3,00,000		30,000
2022	1/2 year at 10% on ₹ 15,00,000		75,000
			2,63,000

Plant and Machinery Account (for 2022) at Cost

	₹		₹
To Balance b/d	30,00,000	By Disposals account:	
To Bank A/c	15,00,000	Scrapped	1,70,000
		Sold	3,30,000

		By Balance c/d	40,00,000
	45,00,000		45,00,000

Depreciation Provision Account (for 2022)

		₹		₹
To Disposal Account :			By Balance b/d	21,35,000
Scrapped - 2011 assets	1,70,000		By Profit and Loss Account	2,63,000
Sold - 2012 assets	90,000			
Sold - 2013 assets	2,16,000	4,76,000		
To Balance c/d		19,22,000		
		23,98,000		23,98,000

Sale or disposal of Plant and Machinery Account (for 2022)

		₹		₹
To Plant and Machinery :			By Provision for Depreciation	4,76,000
Scrapped		1,70,000	By Cash-Sales Proceeds	20,000
Sold		3,30,000	By Loss on sales	4,000
		5,00,000		5,00,000

2.

Plant and Machinery Account

		₹			₹
2022			2022		
Jan. 1	To Balance b/d	19,00,000	June 1	By Bank (Sales)	75,000
June. 1	To Bank (2,80,000 + 8,920)	2,88,920		By Depreciation (on sold machine)	14,762
				By Loss on sale	2,64,532
				By Loss on scrapping the machine	3,76,912
				By Depreciation (on scrapped machinery)	16,388
				By Depreciation (Note iii)	1,32,094
				By Balance c/d	13,09,232
		21,88,920			21,88,920

Working Note :

(i)	**Calculation of loss on sale of machine on 1-6-2022**		₹
	Cost on 1-1-2020		4,37,400
	Less : Depreciation @ 10% on ₹ 4,37,400		(43,740)
	W.D.V. on 31-12-2020		3,93,660
	Less : Depreciation @ 10% on ₹ 3,93,660		(39,366)
	W.D.V. on 31-12-2021		3,54,294
	Less : Depreciation @ 10% on ₹ 3,54,294 for 5 months		(14,762)
			3,39,532
	Less : Sale proceeds on 1-6-2022		(75,000)
	Loss		2,64,532
(ii)	**Calculation of loss on scrapped machine**		₹
	Cost on 1-1-2021		4,37,000
	Less : Depreciation @ 10% on ₹ 4,37,000		(43,700)
	W.D.V. on 1-1-2022		3,93,300
	Less : Depreciation @ 10% on ₹ 3,93,300 for 5 months		(16,388)
	Loss		3,76,912
(iii)	**Depreciation**		
	Balance of machinery account on 1-1-2022		19,00,000
	Less : W.D.V of machinery sold	3,54,294	
	W.D.V. of machinery scrapped	3,93,300	(7,47,594)
	W.D.V. of other machinery on 1-1-2022		11,52,406
	Depreciation @ 10% on ₹ 11,52,406 for 12 months		1,15,240
	Depreciation @ 10% on ₹ 2,88,920 for 7 months		16,854
			1,32,094

3.

Date	Particulars	Amount	Date	Particulars	Amount
2021			2021		
Jan-01	To balance b/d	2,92,50,000	Oct-01	By bank A/c	27,00,000
Oct-01	To Profit & Loss A/c		Oct-01	By Depreciation on lost assets	6,75,000

	(Profit on settlement of Truck)	4,50,000	Dec-31	By Depreciation A/c	83,50,000
Oct-01	To Bank A/c	50,00,000	Dec-31	By balance c/d	2,29,75,000
		3,47,00,000			3,47,00,000
2022			2022		
Jan-01	To balance b/d	2,29,75,000	Dec-31	By Depreciation A/c	91,00,000
			Dec-31	By balance c/d	1,38,75,000
		2,29,75,000			2,29,75,000

Working Note:

1. Profit on settlement of truck

	₹
Original cost as on 1.4.2019	45,00,000
Less: Depreciation for 2019	(6,75,000)
	38,25,000
Less: Depreciation for 2020	(9,00,000)
	29,25,000
Less: Depreciation for 2021 (9 months)	(6,75,000)
	22,50,000
Less: Amount received from Insurance company	(27,00,000)
	4,50,000

4. Depreciation per year for first 4 years = ₹ 20,00,000 / 10 = ₹ 2,00,000

Thus, WDV of the Machinery at end of the 4th year = ₹ 20,00,000 – (₹ 2,00,000 x 4) = ₹ 12,00,000

Revalued Amount i.e. New Depreciable Amount shall be = ₹ 12,00,000 + ₹ 80,000 = ₹ 12,80,000

Original remining useful life is (10-4) = 6 Years whereas it is reassessed as 8 Years.

Hence, depreciation for 5th Year = ₹ 12,80,000 / 8 = ₹ 1,60,000

5. **(a)** Fair Value: ₹ 37,00,000

Since this is an upward revaluation and the group had a balance in revaluation surplus (i.e. there was an upward movement earlier), hence this will result in an additional credit of ₹ 2,00,000 to Revaluation Surplus and hence the total

Revaluation Surplus balance (part of other comprehensive income in Equity) shall increase to ₹ 5,00,000. The Accounting journal entry shall be:

Property, Plant & Equipment A/c	Dr	2,00,000	
To Revaluation Surplus A/c			2,00,000

(b) Fair Value : ₹ 33,00,000

Since this is a downward revaluation and the group had a balance in revaluation surplus (i.e. there was an upward movement earlier), hence this will result in a reduction or a debit to Revaluation Surplus to the extent of balance therein and any excess shall be debited to Profit & Loss A/c. In this case, there is a reduction in fair value of ₹ 2,00,000 (35,00,000 – 33,00,000) and hence the entire amount shall be debited to Revaluation Surplus. Hence, the total Revaluation Surplus balance (part of other comprehensive income in Equity) shall decrease to ₹ 1,00,000. The Accounting journal entry shall be:

Revaluation Surplus A/c	Dr	2,00,000	
To Property, Plant & Equipment A/c			2,00,000

(c) Fair Value : ₹ 31,00,000

Since this is also a downward revaluation and the group had a balance in revaluation surplus (i.e. there was an upward movement earlier), hence this will result in a reduction or a debit to Revaluation Surplus to the extent of balance therein and any excess shall be debited to Profit & Loss A/c. In this case, there is a reduction in fair value of ₹ 4,00,000 (35,00,000 – 31,00,000) and hence the Revaluation Surplus A/c shall be debited by ₹ 3,00,000 and the balance ₹ 1,00,000 shall be debited to Profit & Loss A/c. Hence, the total Revaluation Surplus balance (part of other comprehensive income in Equity) shall become Nil. The Accounting journal entry shall be:

Revaluation Surplus A/c	Dr	3,00,000	
Profit & Loss A/c	Dr	1,00,000	
To Property, Plant & Equipment A/c			4,00,000

6. Dr. **Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.04.2019	To Bank A/c	2,00,000	31.03.2020	By Balance c/d	3,00,000
01.10.2019	To Bank A/c	1,00,000			
		3,00,000			3,00,000

01.04.2020	To Balance b/d	3,00,000	01.10.2020	By Bank A/c	90,000
				By Provision for Depreciation A/c	30,000
				By Profit and Loss A/c	80,000
			31.3.2021	By Balance c/d	1,00,000
		3,00,000			3,00,000
01.04.2021	To Balance b/d	1,00,000	01.10.2021	By Bank A/c	85,000
01.10.2021	To Bank A/c	2,50,000		By Provision for Depreciation A/c	20,000
	To Profit and Loss A/c	5,000	31.3.2022	By Balance c/d	2,50,000
		3,55,000			3,55,000

Depreciation Account

Date	Particulars	₹	Date	Particulars	₹
31.03.2020	To provision for Depreciation A/c	25,000	31.03.2020	By Profit and Loss A/c	25,000
		25,000			25,000
01.10.2020	To Provision for Depreciation A/c	10,000	31.03.2021	By Profit and Loss A/c	20,000
31.03.2021	To Provision for Depreciation A/c	10,000			
		20,000			20,000
01.10.2021	To Provision for Depreciation A/c	5,000	31.03.2022	By Profit and Loss A/c	17,500
31.03.2022	To Provision for Depreciation A/c	12,500			
		17,500			17,500

Dr. **Provision for Depreciation Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
31.03.2020	To Balance c/d	25,000	31.03.2020	By Depreciation A/c (₹ 20,000 + ₹ 5,000)	25,000
		25,000			25,000
01.12.2020	To Machinery A/c (₹ 20,000 + ₹ 10,000)	30,000	01.04.2020	By Balance b/d	25,000

31.03.2021	To Balance c/d	15,000	01.10.2020	By Depreciation A/c	10,000
			31.03.2021	By Depreciation A/c	10,000
		45,000			45,000
01.10.2021	To Machinery A/c (₹ 5,000 + ₹ 10,000+ ₹ 5,000)	20,000	01.04.2021	By Balance b/d	15,000
31.03.2022	To Balance c/d	12,500	01.10.2021	By Depreciation A/c	5,000
			31.03.2022	By Depreciation A/c	12,500
		32,500			32,500

NOTES

CHAPTER 6

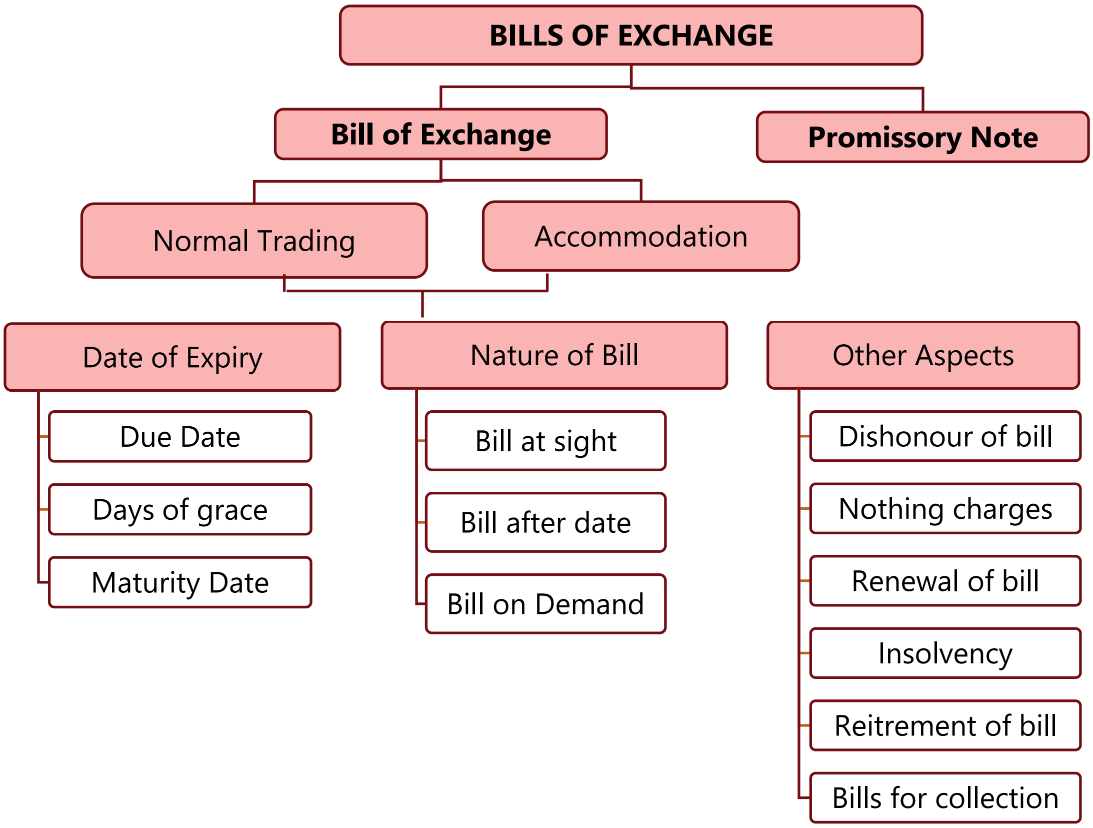
BILLS OF EXCHANGE AND PROMISSORY NOTES

LEARNING OUTCOMES

After studying this chapter, you would be able to:

- Understand the meaning of Bills of Exchange and Promissory Notes and also try to grasp their underlying features.
- Understand the accounting treatments relating to issue, acceptance, discounting, maturity and endorsement of bills in the books of drawer and drawee.
- Learn the technique of accounting relating to accommodation bills.
- Learn the special treatment needed in case of insolvency as well as early retirement of bill.

CHAPTER OVERVIEW



1. BILLS OF EXCHANGE

It is general practice that when goods are sold or services are provided, the seller extends a credit period to buyer. Sometimes, the seller may not be in a position to offer credit period and the purchase is not in a position to pay immediately. In such circumstances the seller would like that the purchaser should give a definite promise in writing to pay the amount of the goods on a certain date which he can use to generate immediate funds. Commercial practice has developed to treat these written promises into valuable instruments of credit that when a written promise is made in proper form and is properly stamped, it is expected that the buyer discharges his debt and the seller receives payment. This is because written promises are often accepted by banks and money is advanced against them. Also, they can be endorsed, i.e., passed on from person to person. The written promise is either in the form of a Bill of Exchange or in the form of a promissory note.

A Bill of Exchange has been defined as an "instrument in writing containing an unconditional order signed by the maker directing 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". When such an order is accepted in writing on the face of the order itself, it becomes a valid bill of exchange. Suppose A orders B to pay ₹50,000 for three months after date and B accepts this order by signing his name, then it will be a bill of exchange.

A Bill of Exchange has the following characteristics:

1. It must be in writing.
2. It must be dated.
3. It must contain an order to pay a certain sum of money.
4. The promise to pay must be unconditional.
5. The money must be payable to a definite person or to his order to the bearer.
6. The draft must be accepted for payment by the party to whom the order is made.
7. It should be properly stamped (except in case of bills payable ''on demand")
8. Payment must be in legal currency of the country.

The party which makes the order is known as the ***drawer***. The party which accepts the order is known as the ***acceptor*** and the party to whom the amount has to be paid is known as the ***payee***. The drawer and the payee can be the same.

A Bill of Exchange can be passed on to another person by endorsement. Endorsement on a bill of exchange is made exactly as it is done in the case of a cheque. The primary liability on a bill of exchange is that of the acceptor. If he does not pay, a holder can recover the amount from any of the previous endorsers or the drawee.

Sometimes, it may happen that a bill of exchange is drawn for foreign trade operations. Such a bill is known as "***Foreign Bill of Exchange***". A foreign bill of exchange is one which is drawn in one country and is payable in another. It is generally drawn up in triplicate wherein each copy is sent by separate post so that at least one copy reaches the intended party. Payment will be made only on one of the copies and when such payment is made the other copies become useless. Section 12 of the Negotiable Instruments Act provides that all instruments, which are not inland instrument, are foreign.

A specimen of foreign bill of exchange is given below:

₹ 11,50,000
New Delhi
July, 2022

Ninety days after date of this First Bill of Exchange (Second and Third of the same tenure and date being unpaid) Pay to the order of M/s Vencent John & Associates, London the sum of Rupees Eleven lakh Fifty thousand only, value received.

To,

Wallis Sons	Accepted	
M/a IONX	(Wallis Sons)	Stamp
Birmingham, UK		

Drawee

The following are examples of foreign bills:

1. A bill drawn in India on a person resident outside India and made payable outside India.
2. A bill drawn outside India on a person resident outside India.
3. A bill drawn outside India and made payable in India.
4. A bill drawn outside India and made payable outside India.

2. PROMISSORY NOTES

A promissory note is an instrument in writing, not being a bank note or currency note containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or to the order of a certain person. Under Section 31(2) of the Reserve Bank of India Act a promissory note cannot be made payable to bearer.

A promissory note has the following characteristics:

1. It must be in writing.
2. It must contain a clear promise to pay. Mere acknowledgement of a debt is not a promissory note.

3. The promise to pay must be unconditional."I promise to pay `50,000 as soon as I can" is not an unconditional promise.
4. The promiser or maker must sign the promissory note.
5. The maker must be a certain person.
6. The payee (the person to whom the payment is promised) must also be certain.
7. The sum payable must be certain. "I promise to pay `50,000 plus all fine" is not certain.
8. Payment must be in legal currency of the country.
9. It should not be made payable to the bearer.
10. It should be properly stamped.
11. It does not require any acceptance.

Specimen of promissory note :

Specimen of a Promissory Note

₹ 10,00,000/- only

Rohan
77, Sector-12, Ghaziabad
March 01, 2022

Three months after date I promise to pay Priya or his order the sum of ₹ Ten lakh only, for value received.

To,
Priya
S-11, Rohini, Delhi.

Stamp

(Rohan)

Payee

Maker

3 DIFFERENCES - BILL OF EXCHANGE AND PROMISSORY NOTE

Bill of Exchange	**Promissory Note**
A bill contains an order to pay	A promissory note contains only a promise to pay certain sum of money
There are generally 3 parties (Drawer, Drawee and Payee) in bill of exchange	There are 2 parties (Maker and Payee) in promissory note

A bill is paid by acceptor	A promissory note is paid by maker
A bill is drawn by creditor	A promissory note is made by debtor
The drawer and payee may be same person in case of bill of exchange	In promissory note maker and payee cannot be same person
In a bill of exchange the liability of drawer is secondary and conditional. He will be liable only in case the acceptor does not honour the bill.	In a promissory note the liability of a maker is primary and absolute.
A bill of exchange can be accepted conditionally	A promissory note cannot be made conditionally
In a bill of exchange, notice of dishonour must be given	Notice of dishonour is not required in case of promissory note
In case of dishonour, a bill of exchange must be noted and protested	Noting and protest is not required in case of dishonour of a promissory note.

4. RECORD OF BILLS OF EXCHANGE AND PROMISSORY NOTES

A party which receives a Promissory Note or receives an accepted Bill of Exchange will treat it as a new asset under the name of Bills receivable. A party which issues a Promissory Note or accepts a Bill of Exchange will treat it as new liability under the heading of Bills Payable. We shall first deal with the entries in the books of the party which receives promissory notes or bills. (When we talk of bills, we include promissory notes also).

On receipt of Bill, the payee makes the following entry in his books of accounts:

Bills Receivable Account Dr.

To Drawee/Maker of the note

(1) A accepts a Bill of exchange drawn on him by B. In the books of B the entry will be :

Bills Receivable Account Dr.

To A

(2) A sends to B the acceptance of D. In this case also, the entry in the books of B will be:

Bills Receivable Account Dr.

To A

The person who receives the bill has three options. These are:

(i) He can hold the bill till maturity. (Naturally in this case no further entry is passed until the date of maturity arrives).

(ii) The bill can be endorsed in favour of another party say Z. In this case, the entry will be to debit the party which now receives the bill and to credit the Bills Receivable Account.

Z Dr.

To Bills Receivable Account

(iii) The Bill of Exchange can be discounted with bank. The bank will deduct a small sum of money as discount and pay rest of the money.

Bank Account Dr. (with the amount actually received)

Discount Account Dr. (with the amount of loss or discount)

To Bills Receivable Account

On the date of maturity there will be two possibilities:

(a) The first is that the bill will be paid, that is to say, *met* or *honoured*. The entries for this will depend upon what was done to the bill during the period of maturity. If the bill was kept, the cash will be received by the party which originally received the bill. In his books, therefore, the entry will be :

Bank Account Dr.

To Bills Receivable Account

But if he has already endorsed the bill in *favour* of his creditor or if the bill has been discounted with the bank he will not get the amount; it will be the creditor or the bank which will receive the money. Therefore, in these two cases, no entry will be made in the books of the party which originally received the bill.

(b) The second possibility is that the bill will be *dishonoured*, that is to say, the bill will not be paid. If the bill is *dishonoured*, the bill becomes useless and the party from whom the bill was received will be liable to pay the amount (and also the expenses incurred by the party).

Therefore, the following entries will be made :

1. If the bill was kept till maturity then :

Drawee / Maker Account Dr.

To Bills Receivable Account

2. If the bill was endorsed in favour of a creditor, the entry is :

Drawee / Maker Account	Dr.
To Creditor Account	

3. If the bill was discounted with the bank :

Drawee / Maker Account	Dr.
To Bank Account	

Thus, it will be seen that in case of dishonour, the party which gave the bill has to be debited (because he has become liable to pay the amount). The credit entry is in Bills Receivable Account (if it was retained) or the Creditor or the bank (if it was endorsed/discounted in their favour).

5. TERM OF A BILL

The term of bill of exchange may be of any duration. Usually the term does not exceed 90 days from the date of the bill.

- When a bill is drawn ***after sight***, the term of the bill begins to run from the date of 'sighting', i.e., when the bill is accepted.
- When a bill is drawn ***after date***, the term of the bill begins to run from the date of drawing the bill.

6. EXPIRY / DUE DATE OF A BILL

The date on which the term of the bill terminates is called as 'Expiry/Due Date of the bill'.

7. DAYS OF GRACE

Every instrument payable otherwise than on demand is entitled to three days of grace.

8. DATE OF MATURITY OF BILL

The date which comes after adding three days of grace to the expiry/due date of a bill, is called the date of maturity.

The maturity of a promissory note or bill of exchange is the date at which it falls due. Every promissory note or bill of exchange gets matured on the third day after the day on which it is expressed to be payable, except when it is expressed to be payable:

(i) on demand,

(ii) at sight, or

(iii) on presentment

9. BILL AT SIGHT

Bill at Sight means the instruments in which no time for payment is mentioned. A cheque is always payable on demand. A promissory note or bill of exchange is payable on demand-

(a) when no time for payment is specified, or

(b) when it is expressed to be payable on demand, or at sight or on presentment.

Notes:

(i) "At sight" and "presentment" means on demand.

(ii) An instrument payable on demand may be presented for payment at any time.

(iii) Days of grace is not to be added to calculate maturity for such types of bill.

10. BILL AFTER DATE

Bill after date means the instrument in which time for payment is mentioned. A promissory note or bill of exchange is a time instrument when it is expressed to be payable-

(a) after a specified period.

(b) on a specific day

(c) after sight

(d) on the happening of event which is certain to happen

Notes:

(i) The expression 'after sight' means-

(a) in a promissory note, after presentment for sight

(b) in a bill of exchange, after acceptance or noting for non-acceptance or protest for non-acceptance.

(ii) A cheque cannot be a time instrument because the cheque is always payable on demand. Though a cheque can be post dated and which can be presented on or after such date. A cheque has validity of 90 days from its date after that it becomes void, normally termed as 'Stale Cheque' as bank will not honour such cheque.

11. HOW TO CALCULATE DUE DATE OF A BILL

The due date of each bill is calculated as follows:

Case	Due Date
(a) When the bill is made payable on a specific date.	(a) That specific date will be the due date.
(b) When the bill is made payable at a stated number of months(s) after date.	(b) That date on which the term of the bill shall expire will be the due date. **Note:** The term shall expire on that day of the month which corresponds with the day on which the bill is dated. If the month in which the period terminates has no corresponding day, the period shall be deemed to expire on the last day of such a month. For example a bill signed on January 31st payable after 3 months will be due on May 3rd.
(c) When the bill is made payable at a stated number of days after date.	(c) That date which comes after adding stated number of days to the date of bill, shall be the due date. **Note:** The date of Bill is excluded.
(d) When the due date is a public holiday.	(d) The preceding business day will be the due date.
(e) When the due date is an emergency/ unforeseen holiday.	(e) The next following day will be the date.

Note: The term of a **Bill after sigh**t commences from the date of acceptance of the bill whereas the term of a **Bill after date** commences from the date of drawing of bill.

12. NOTING CHARGES

It is necessary that the fact of dishonour and the causes of dishonour should be established. If the acceptor can prove that the bill was not properly presented to him for payment, he may escape liability. Therefore, if there is dishonour, or fear of dishonour, the bill will be given to a public official known as "***Notary Public***". These officials present the bill for payment and if the money is received, they will hand over the money to the original party. But if the bill is dishonoured they will note the fact of dishonour, with the reasons and give the bill back to their client. For this service they charge a small fee. This fee is known as ***noting charges***. The amount of noting charges is recoverable from the party which is responsible for dishonour.

Suppose X received from Y a bill for ₹1,000. On Maturity the bill is dishonoured and ₹10 is paid as noting charges. The entry in this case will be

		₹	₹
Y	Dr.	1,010	
To Bills Receivable Account			1,000
To Bank A/c			10

Suppose X had endorsed this bill in favour of Z. In that case entry for dishonoured bill would have been

Y	Dr.	1,010	
To Z			1,010

This is because Z will claim ₹1,010 from X and X has the right of recovering ₹1,010 from Y. Similarly, if the bill has been discounted with a bank, entry will be :

Y	Dr.	1,010	
To Bank A/c			1,010

13. RENEWAL OF BILL

Sometimes the acceptor is unable to pay the amount and he himself moves that he should be given extension of time and in consideration agrees to bear interest for the extended time period (calculated from the date of maturity of old bill till the date of expected settlement). In such a case a new bill will be drawn and the old bill will be cancelled. If this happens entries should be passed for cancellation of the old bill. This is done exactly as already explained for dishonour. When the new bill is received entries for the receipt of the bill will be repeated. The amount of the new bill may represent any of the following:

(i) *Where the drawee pays nothing:* Total of amount of original bill as well as the interest for the extended time period.

(ii) *Where the drawee pays the interest amount at the time of renewal:* Amount of the Original bill.

(iii) *Where the drawee makes part payment of the original bill or interest amount or both:* Unpaid part of total of amount of original bill as well as the interest for the extended time period on such amount.

14. RETIREMENT OF BILLS OF EXCHANGE & REBATE

We have seen that renewal of a bill of exchange is made when a person does not have sufficient fund to pay for the bill of exchange on the due date and he requires a further period of credit. Many a time instances do arise when the acceptor has spare funds much before the maturity date of the bill of exchange accepted by him. In such circumstances he approaches the payee of the bill of exchange and asks him whether the payee is prepared to accept cash before the maturity date. In such cases the acceptor gets a certain ***rebate*** or interest or discount for premature payment. The rebate becomes the income of the acceptor and expense of the payee. It is a consideration of premature payment.

ILLUSTRATION 1

Ms. Sujata receives two bills from Ms. Aruna dated 1st January 2022 for 2 months. The first bill is for 10,200 and the second bill is for ₹ 15,000. The First bill is discounted immediately with the bank for ₹ 10,000 and the second bill was endorsed in favour or Mr. Sree on 3rd January 2022. Pass the necessary journal entries in the books of Ms. Sujata.

SOLUTION

In the books of Sujata
Journal Entries

Date	Particulars		L.F.	DR. (₹)	CR. (₹)
01/01/2022	Bills receivables A/c	Dr.		25,200	
	To Aruna A/c				25,200
	(Being 2 bills receivable from Aruna)				
01/01/2022	Bank A/c	Dr.		10,000	
	Discount charges A/c	Dr.		200	
	To Bills receivable A/c				10,200
	(Being the bills receivable discounted with the bank at a charge of ₹ 200)				
03/01/2022	Sree A/c	Dr.		15,000	
	To Bills receivable A/c				15,000
	(Being bill endorsed in favour of Mr. Sree)				

ILLUSTRATION 2

Vijay sold goods to Pritam on 1st September, 2022 for ₹1,06,000. Pritam immediately accepted a three months bill. On due date Pritam requested that the bill be renewed for a fresh period of *two months. Vijay agrees provided interest at 9% p.a. was paid immediately in cash. To this Pritam was agreeable. The second bill was met on due date. Give Journal entries in the books of Vijay and Pritam.*

SOLUTION

Books of Vijay
Journal

2022		₹	₹
1 Sept.	Pritam Dr.	1,06,000	
	To Sales Account		1,06,000
	(Sales of goods to Pritam as per Invoice No…)		
	Bills Receivable Account Dr.	1,06,000	
	To Pritam		1,06,000
	(3 months acceptance received from Pritam for the amount due from him)		
Dec. 4	Pritam Dr.	1,06,000	
	To Bills Receivable Account		1,06,000
	(Pritam acceptance cancelled because of renewal)		
	Pritam Dr.	1,590	
	To interest		1,590
	(Interest @ 9% on ₹1,06,000 due from Pritam for 2 months because of renewal)		
	Bills Receivable Account Dr.	1,06,000	
	Cash Account Dr.	1,590	
	To Pritam		1,07,590
	[New acceptance for 2 months for ₹106,000 and Cash (for interest) received from Pritam]		
2023			
Feb. 7	Cash Account Dr.	1,06,000	
	To Bills Receivable Account		1,06,000
	(Cash received against Pritam's second acceptance)		

Books of Pritam
Journal

2022		₹	₹
1 Sept.	Purchase Account Dr.	1,06,000	
	To Vijay A/c		1,06,000
	(Purchase of goods from Vijay as per Invoice No...)		
	Vijay A/c Dr.	1,06,000	
	To Bills Payables Account		1,06,000
	(3 months acceptance given to Vijay for the amount)		
Dec. 4	Bills Payable Account Dr.	1,06,000	
	To Vijay A/c		1,06,000
	(Cancellation of bill because of renewal)		
	Interest Account Dr.	1,590	
	To Vijay		1,590
	(Interest @ 9% on ₹1,06,000 due to Vijay for 2 months because of renewal)		
	Vijay Account Dr.	1,07,590	
	To Cash Account		1,590
	To Bills Payable Account		1,06,000
	[New acceptance for 2 months for ₹106,000 and Cash (for interest) paid to Vijay]		
2023			
Feb. 7	Bills Payable Account Dr.	1,06,000	
	To Cash Account		1,06,000
	(Cash paid against second bill)		

ILLUSTRATION 3

On 1st January, 2022, Ankita sells goods for ₹5,00,000 to Bhavika and draws a bill at three months for the amount. Bhavika accepts it and returns it to Ankita. On 1st March, 2022, Bhavika retires her acceptance under rebate of 12% per annum. Record these transactions in the journals of Ankita and Bhavika.

SOLUTION

Journal Entries in the books of Ankita

Date 2022	Particulars		₹	₹
Jan. 1	Bhavika's account	Dr.	5,00,000	
	To Sales account			5,00,000
	(Being the goods sold to Bhavika on credit)			
	Bills receivable account	Dr.	5,00,000	
	To Bhavika's account			5,00,000
	(Being the acceptance of bill received)			
Mar.1	Bank account	Dr.	4,95,000	
	Rebate on bills account	Dr.	5,000	
	To Bills receivable account			5,00,000
	(Being retirement of bill by Bhavika one month before maturity, the rebate being given to her at 12% p.a.)			

Journal Entries in the books of Bhavika

Date 2022	Particulars		₹	₹
Jan. 1	Purchases account	Dr.	5,00,000	
	To Ankita Account			5,00,000
	(Being the goods purchased from Ankita on credit)			
	Ankita Account	Dr.	5,00,000	
	To Bills Payable Account			5,00,000
	(Being the acceptance of bill)			
Mar .1	Bills Payable Account	Dr.	5,00,000	
	To Rebate Income Account			5,000
	To Bank Account			4,95,000
	(Being retirement of bill one month before maturity, the rebate being received at 12% p.a.)			

ILLUSTRATION 4

Journalise the following transactions in K. Katrak's books.

(i) Katrak's acceptance to Basu for ₹ 2,500 discharged by a cash payment of ₹ 1,000 and a new bill for the balance plus ₹ 50 for interest.

(ii) G. Gupta's acceptance for ₹ 4,000 which was endorsed by Katrak to M. Mehta was dishonoured. Mehta paid ₹ 20 noting charges. Bill withdrawn against cheque.

(iii) D. Dalal retires a bill for ₹ 2,000 drawn on him by Katrak for ₹10 discount.

(iv) Katrak's acceptance to Patel for ₹ 5,000 and Mody's acceptance to Katrak for a similar amount were duly discharged.

SOLUTION

Books of K. Katrak
Journal Entries

			₹	₹
(i)	Bills Payable Account	Dr.	2,500	
	Interest Account	Dr.	50	
	To Cash A/c			1,000
	To Bills Payable Account			1,550
	(Bills Payable to Basu discharged by cash payment of ₹1,000 and a new bill for ₹1,550 including ₹50 as interest)			
(ii)	(a) G. Gupta	Dr.	4,020	
	To M. Mehta			4,020
	(G. Gupta's acceptance for ₹4,000 endorsed to M. Mehta dishonoured,₹20 paid by M. Mehta as noting charges)			
	(b) M. Mehta	Dr.	4,020	
	To Bank Account			4,020
	(Payment to M. Mehta on withdrawal of bill earlier received from Mr. G. Gupta)			
(iii)	Bank Account	Dr.	1,990	
	Discount Account	Dr.	10	
	To Bills Receivable Account			2,000
	(Payment received from D. Dalal against his acceptance for ₹2,000. Allowed him a discount of ₹10)			

(iv)	Bills Payable Account	Dr.	5,000	
	To Bills Receivable Account			5,000
	(Bills Receivable from Mody endorsed to Patel in settlement of bills payable issued to him earlier)			

ILLUSTRATION 5

On 1st January, 2022, Vilas draws a bill of exchange for ₹10,000 due for payment after 3 months on Eknath. Eknath accepts to this bill of exchange. On 4th March, 2022 Eknath retires the bill of exchange at a discount of 12% p.a. You are asked to show the journal entries in the books of Eknath.

SOLUTION

Journal entries in the books of Eknath

Date 2022	Particulars		Debit ₹	Credit ₹
Jan. 1	Vilas A/c	Dr.	10,000	
	To Bills Payable A/c			10,000
	(Being the bill draws by him accepted)			
Mar. 4	Bills Payable A/c	Dr.	10,000	
	To Bank A/c			9,900
	To Interest A/c (Discount A/c)			100
	(Being retirement of acceptance 1 month before maturity, interest allowed at 12% p.a.)			

ILLUSTRATION 6

On 1st January, 2022, Vilas draws a Bill of Exchange for ₹10,000 due for payment after 3 months on Eknath. Eknath accepts to this bill of exchange. On 4th March, 2022. Eknath retires the bill of exchange at a discount of 12% p.a. You are asked to show the journal entries in the books of Vilas.

SOLUTION

Journal entries in the books of Vilas

Date 2022	Particulars		Debit ₹	Credit ₹
Jan. 1	Bills Receivable A/c	Dr.	10,000	
	To Eknath A/c			10,000
	(Being bill of exchange drawn on Eknath due for payment on 4th April 2022)			

Mar. 4	Bank A/c	Dr.	9,900	
	Interest A/c (Discount) A/c	Dr.	100	
	To Bills Receivable A/c			10,000
	(Being retirement of bill of exchange due for maturity on 4th April, 2022 by Eknath 1 month before maturity, the rebate being given to him at12% p.a.)			

15. INSOLVENCY

Insolvency of a person means that he is unable to pay his liabilities. This means that bills accepted by him will be dishonoured. Therefore, when it is known that a person has become insolvent, entry for dishonour of his acceptance must be passed. Later on, something may be received from his estate. When and if an amount is received, cash account will be debited and the personal account of the debtor will be credited. The remaining amount will be irrecoverable and, therefore, should be written off as bad debt. The students should be careful to calculate the amount actually received from an insolvent's estate and amount to be written off only after preparing his account.

In the books of drawee of the bill, the amount not ultimately paid by him due to insolvency, should be credited to ***Deficiency Account.***

ILLUSTRATION 7

Mr. David draws two bills of exchange on 1.1.2022 for ₹6,000 and ₹10,000. The bills of exchange for ₹6,000 is for two months while the bill of exchange for ₹10,000 is for three months. These bills are accepted by Mr. Thomas. On 4.3.2022, Mr. Thomas requests Mr. David to renew the first bill with interest at 18% p.a. for a period of two months. Mr. David agrees to this proposal. On 20.3.2022, Mr. Thomas retires the acceptance for ₹10,000, the interest rebate i.e. discount being ₹100. Before the due date of the renewed bill, Mr. Thomas becomes insolvent and only 50 paise in a rupee could be recovered from his estate.

You are to give the journal entries in the books of Mr. David.

SOLUTION

Journal Entries in the books of Mr. David

2022			(₹)	(₹)
Jan. 1	Bills receivable (No. 1) A/c	Dr.	6,000	
	Bills receivable (No. 2) A/c	Dr.	10,000	

	To Mr. Thomas's A/c			16,000
	(Being drawing of bills receivable No. 1 due for maturity on 4.3.2022 and bills receivable No. 2 due for maturity on 4.4.2022)			
4-Mar	Mr. Thomas's A/c	Dr.	6,000	
	To Bills receivable (No.1) A/c			6,000
	(Being the reversal entry for bill No.1 on agreed renewal)			
4-Mar	Bills receivable (No. 3) A/c	Dr.	6,180	
	To Interest A/c			180
	To Mr. Thomas's A/c			6,000
	(Being the drawing of bill of exchange no. 3 due for maturity on 7.5.2022 together with interest at 18%p.a. in lieu of the original acceptance of Mr. Thomas)			
20-Mar	Bank A/c	Dr.	9,900	
	Discount A/c	Dr.	100	
	To Bills receivable (No. 2) A/c			10,000
	(Being the amount received on retirement of bills No.2 before the due date)			
7-May	Mr. Thomas's A/c	Dr.	6,180	
	To Bills receivable (No. 3) A/c			6,180
	(Being the amount due from Mr. Thomas on dishonour of his acceptance on presentation on the due date)			
7-May	Bank A/c	Dr.	3,090	
	To Mr. Thomas's A/c			3,090
	(Being the amount received from official assignee of Mr. Thomas at 50 paise per rupee against dishonoured bill)			
May 7	Bad debts A/c	Dr.	3,090	
	To Mr. Thomas's A/c			3,090
	(Being the balance 50% debt in Mr. Thomas's Account arising out of dishonoured bill written as bad)			

ILLUSTRATION 8

Rita owed ₹1,00,000 to Siriman. On 1st October, 2021, Rita accepted a bill drawn by Siriman for the amount at 3 months. Siriman got the bill discounted with his bank for ₹99,000 on 3rd October, 2021. Before the due date, Rita approached Siriman for renewal of the bill. Siriman agreed on the conditions that ₹50,000 be paid immediately together with interest on the remaining amount at 12% per annum for 3 months and for the balance, Rita should accept a new bill at three months. These arrangements were carried out. But afterwards, Rita became insolvent and 40% of the amount could be recovered from his estate.

Pass journal entries (with narration) in the books of Siriman.

SOLUTION

In the books of Siriman

Journal Entries

Particulars		₹	₹
Bills Receivable A/c	Dr.	1,00,000	
To Rita			1,00,000
(Being a 3 month's bill drawn on Rita for the amount due)			
Bank A/c	Dr.	99,000	
Discount A/c	Dr.	1,000	
To Bills Receivable A/c			1,00,000
(Being the bill discounted)			
Rita	Dr.	1,00,000	
To Bank A/c			1,00,000
(Being the bill cancelled up due to Rita's inability to pay it)			
Rita	Dr.	1,500	
To Interest A/c			1,500
(Being the interest due on ₹ 50,000 @ 12% for 3 months)			
Bank A/c	Dr.	51,500	
To Rita			51,500
(Being the receipt of a portion of the amount due on the bill together with interest)			
Bills Receivable A/c	Dr.	50,000	
To Rita			50,000
(Being the new bill drawn for the balance)			

Rita	Dr.	50,000	
To Bills Receivable A/c			50,000
(Being the dishonour of the bill due to Rita's insolvency)			
Bank A/c	Dr.	20,000	
Bad Debts A/c	Dr.	30,000	
To Rita			50,000
(Being the receipt of 40% of the amount due on the bill from Rita's estate)			

16. ACCOMMODATION BILLS

Bills of Exchange are usually drawn to facilitate trade transmission, that is, bills are meant to finance actual purchase and sale of goods. But the mechanism of bill can be utilised to raise finance also. Suppose Boss needs finance for three months. In that case he may persuade his friend Kapoor to accept his draft. The bill of exchange may then be taken by Boss to his bank and get it discounted there. Thus, Boss will be able to make use of funds. When the three months period expires, Boss will send the requisite amount to Kapoor and Kapoor will meet the bill. Thus, Boss is able to raise money for his use. If both Boss and Kapoor need money, the same devise can be used. Either Boss accepts a bill of exchange or Kapoor does. In either case, the bill will be discounted with the bank and the proceeds divided between the two parties according to mutual agreement. The discounting charges must also be borne by the two parties in the same ratio in which the proceeds are divided. On the due date the acceptor will receive from the other party his share. The bill will then be met. When bills are used for such a purpose, they are known as accommodation bills.

However, it may so happen that the drawer is not able to remit the proceeds to drawee on the due date. In such a case, the drawee may draw a bill on the drawer, and get it discounted with the bank to honour the first bill. If the new drawer (drawee of the first bill) also remits some proceeds of the new bill to new drawee (drawer of the first bill), then the proportion of discount to be borne by the new drawee will be based upon the proceeds remitted as well as the benefit obtained by him on the first bill (i.e., by not paying the amount due to the original drawee on due date).

Entries are passed in the books of two parties exactly in the way already pointed out for ordinary bills. The only additional entry to be passed is for sending the remittance for one party to the other party and also debiting the other party with the shared amount of discount.

ILLUSTRATION 9

On 1st July, 2022 Gorge drew a bill for ₹1,80,000 for 3 months on Harry for mutual accommodation. Harry accepted the bill of exchange. Gorge had purchased goods worth ₹1,81,000 from Jack on the same date. Gorge endorsed Harry's acceptance to Jack in full settlement. On 1st September, 2022, Jack purchased goods worth ₹1,90,000 from Harry. Jack endorsed the bill of exchange received from Gorge to Harry and paid ₹ 9,000 in full settlement of the amount due to Harry. On 1st October, 2022, Harry purchased goods worth ₹2,00,000 from Gorge. Harry paid the amount due to Gorge by cheque. Give the necessary Journal Entries in the books of Harry , Gorge and Jack.

SOLUTION

In the books of Harry
Journal Entries

Date	Particulars		₹	₹
1.7.2022	Gorge's account	Dr.	1,80,000	
	To Bills payable account			1,80,000
	(Acceptance of bill drawn by Gorge)			
1.9.2022	Jack's account	Dr.	1,90,000	
	To Sales account			1,90,000
	(Sales made to Jack)			
1.9.2022	Bills receivable account	Dr.	1,80,000	
	Bank account	Dr.	9,000	
	Discount account	Dr.	1,000	
	To Jack's account			1,90,000
	(Acceptance received from Jack's endorsement of bill received from Gorge for ₹ 1,80,000 and ₹ 9,000 received in full settlement of the amount due)			
1.9.2022	Bills payable account	Dr.	1,80,000	
	To Bills receivable account			1,80,000
	(Own acceptance received from Jack's endorsement, cancelled)			
1.10.2022	Purchase account	Dr.	2,00,000	
	To Gorge's account			2,00,000
	(Purchases made from Gorge)			

	Gorge's account Dr. To Bank account (Amount paid to Gorge after adjusting ₹180,000 for accommodation extended to him)	20,000	20,000

In the books of Gorge

Journal Entries

Date	Particulars	₹	₹
1.7.2022	Purchases Account Dr. To Jack Account (Purchase of goods from Jack)	1,81,000	1,81,000
1.7.2022	Bills Receivable Account Dr. To Harry Account (Acceptance by Harry of bill drawn on him)	1,80,000	1,80,000
1.7.2022	Jack's account Dr. To Rebate Account	1,81,000	1,000
	To Bills Receivable Account (Harry's bill endorsed to Jack)		1,80,000
1.10.2022	Harry Account Dr. To Sales account (Sales to Harry)	2,00,000	2,00,000
1.10.2022	Bank Account Dr. To Harry account (Amount received from Gorge after adjusting ₹180,000 for accommodation extended by him)	20,000	20,000

In the books of Jack

Journal Entries

Date	Particulars	₹	₹
1.7.2022	Gorge Account Dr. To Sales Account (Sold goods to Gorge)	1,81,000	1,81,000

1.7.2022	Bills Receivable Account	Dr.	1,80,000	
	Rebate Account	Dr.	1000	
	To Gorge Account			1 ,81,000
	(Being Harry's acceptance received from Gorge)			
1.9.2022	Purchase Account	Dr.	1,90,000	
	To Harry Account			1,90,000
	(Purchase of goods from Harry)			
1.9.2022	Harry Account	Dr.	1,90,000	
	To Bills Receivable Account			1,80,000
	To Bank Account			9,000
	To Discount Account			1000
	(Endorsement of bill received from Gorge for Rs. 1,80,000 to Harry and Rs. 9,000 paid in full settlement of the amount due)			

ILLUSTRATION 10

X draws on Y a bill of exchange for ₹ 30,000 on 1st April, 2022 for 3 months. Y accepts the bill and sends it to X who gets it discounted for ₹ 28,800. X immediately remits ₹ 9,600 to Y. On the due date, X, being unable to remit the amount due, accepts a bill for ₹ 42,000 for three months which is discounted by Y for ₹ 40,110. Y sends 6,740 to X. Before the maturity of the bill X becomes bankrupt, his estate paying fifty paise in the rupee. Give the journal entries in the books of X and Y.

SOLUTION

In the books of X

Journal Entries

Date	Particulars		DR. (in ₹)	CR. (in ₹)
1/4/2022	Bills receivables A/c	Dr.	30,000	
	To Y A/c			30,000
	(Being bill of exchange drawn on Mr. Y)			
1/4/2022	Bank A/c	Dr.	28,800	
	Discount charges A/c	Dr.	1,200	
	To Bills receivable A/c			30,000
	(Being the bills receivable discounted with the bank at a charge of ₹ 1,200)			

1/4/2022	Y A/c Dr. To Bank A/c To Discount charges (Being the amount remitted to Y along with his share of the bank charges)	10,000	 9,600 400
4/7/2022	Y A/c Dr. To Bills payable A/c (Being the bills drawn by Y, due to non-payment of earlier bill)	42,000	 42,000
4/7/2021	Bank A/ c Dr. Discount charges A/c $\left[\frac{20,000+6,740}{40,110}\times 1,890\right]$ Dr. To Y A/c (Being the amount discounted and sent it by Y to X)	6,740 1,260	 8,000
	Bills payable A/c Dr. To Y's A/c (Being the bill due dishonoured due to bankruptcy)		 42,000
	Y A/c Dr. To Bank A/c To Deficiency account (Being the amount due to Y discharged by payment of 50 paise in a rupee)	28,000	 14,000 14,000

In the books of Y

Journal Entries

Date	Particulars	DR. (in ₹)	CR. (in ₹)
1/4/2022	X A/c Dr. To Bills payable A/c (Being bill of exchange accepted and sent to Mr. X)	30,000	 30,000
1/4/2022	Bank A/c Dr. Discount charges A/c Dr.	9,600 400	

	To X A/c (Being the amount received from X on account of the bills receivable)			10,000
4/7/2022	Bills receivable A/c To X A/c (Being the bills accepted by X)	Dr.	42,000	42,000
4/7/2022	Bank A/c Discount charges A/c To Bills receivable A/c (Being X acceptance discounted with bank)	Dr. Dr.	40,110 1,890	42,000
	Bills payable A/c To Bank A/c (Being the amount met on the due date)	Dr.	30,000	30,000
	X A/c To Bank A/c To Discount account (Being the amount received and the discount debited to X)	Dr.	8,000	6,740 1,260
	X A/c To Bank A/c (Being X's acceptance which was discounted dishonoured due to X's bankruptcy)	Dr.	42,000	42,000
	Bank A/c Bad debts A/c To X A/c (The amount received from X and the balance being written off as debt)	Dr. Dr.	14,000 14,000	28,000

17. BILLS OF COLLECTION

When a person receives a bill of exchange, he may decide to retain the bill till the date of maturity. But in order to ensure safety, he may send it to bank with instructions that the bill should be retained till maturity and should be realised on that date. This does not mean discounting because the bank will not credit the client until the amount is actually realised. If the bill is sent to the bank with such instructions it is known as "Bill sent for collection".

It is better to make a record of this also in books by passing following entry:

Bills for Collection Account Dr.

To Bills Receivable Account

When the amount is realised the entry will be

Bank Account Dr.

To Bills for Collection Account

When the amount is not honoured, the entry will be

Drawee's A/c (from whom the bill was received) Dr.

To Bills for collections A/c

18. BILLS RECEIVABLE AND BILLS PAYABLE BOOKS

Bills receivable and bills payable books are journals (Day Books) to record in a chronological order the details of bills receivable and bills payable. When large number of bill transactions take place in an organization, it is convenient to maintain these books. Wherein any bill transaction takes place, the same is entered in the Day Books in the first instance. Postings to individual Debtors or Creditors accounts are made from the Day Books. Also totals of bills received or accepted are posted periodically to Bills Receivable Account and Bills Payable Account respectively.

Bills receivable book and bills payable book are very useful for following up the status of outstanding bills. When there are large number of bills and these bills fall due on different dates, some of these bills may not be honoured on maturity due to varied reasons. It is possible from these Day Books to trace the details of the outstanding bills and to identify the reasons for not honouring the bills. Given below are forms of Day Books for both bills receivable and bills payable:

Bills Receivable Book (Folio No . . .)

Date of receipt	Voucher No.	Party from whom Received	Acceptor	Date of Bill	Due Date	Place of Payment	Amt. ₹	L.F.	Mode of Disposal

Bills Payable Book (Folio No . . .)

Date of Acceptance	Drawer	Payee	Date of Bill	Due Date	Place of Payment	Amt.₹	L.F.	Mode of Disposal

SUMMARY

- A Bill of Exchange is defined as an "instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument".
- A promissory note is an instrument in writing, not being a bank note or currency note containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or to the order of a certain person. Under Section 31(2) of the Reserve Bank of India Act a promissory note cannot be made payable to bearer.
- A party which receives a Promissory Note or receives an accepted Bill of Exchange will treat it as a new asset under the name of Bills receivable. A party which issues a Promissory Note or accepts a Bill of Exchange will treat it as new liability under the heading of Bills Payable.

TEST YOUR KNOWLEDGE

True and False

1. *Bills payable account is a nominal account.*
2. *Promise to pay is included in a bill of exchange.*
3. *Days of rebate are added to the due date to arrive at the maturity date.*
4. *Discount at the time of retirement of a bill is a gain for the drawee.*
5. *Foreign bill is drawn in the country and payable outside the country.*
6. *Promissory note is different from bill of exchange because the amount is paid by the maker in case of former and by the acceptor in the later.*

7. *A has drawn a bill on B. B accepts the same and endorses the bill to C.*

8. *A bill given to a creditor is called bills payable.*

Multiple Choice Questions

1. *On 1.1.2022, A draws a bill on B for ₹1,20,000 for 3 months' maturity date of the bill will be:*

   (a) 1.4.2022

   (b) 3.4.2022

   (c) 4.4.2022

2. *On 16.6.2022 P draws a bill on Q for ₹1,25,000 for 30 days. 19th July is a public holiday, maturity date of the bill will be:*

   (a) 19th July

   (b) 18th July

   (c) 17th July

3. *PQ draws a bill on XY for ₹130,000 on 1.1.2022. XY accepts the same on 4.1.2022 for period of 3 months after date. What will be the maturity date of the bill:*

   (a) 4.4.2022

   (b) 3.4.2022

   (c) 7.4.2022

4. *A draws a bill on B. A endorsed the bill to C. The payee of the bill will be*

   (a) A

   (b) B

   (c) C

5. *A bill of ₹ 120,000 was discounted by Saras with the banker for ₹1,18,800. At maturity, the bill returned dishonoured, noting charges ₹ 200. How much amount will the bank deduct from Saras's bank balance at the time of such dishonour?*

   (a) ₹1,20,000

   (b) ₹1,18,800

   (c) ₹1,20,200

6. *X draws a bill on Y for ₹300,000 on 1.1.2022 for 3 months after sight, date of acceptance is 6.1.2022. Maturity date of the bill will be:*

   (a) 8.4.2022

   (b) 9.4.2022

   (c) 10.4.2022

7. *X sold goods to Y for ₹ 5,00,000. Y paid cash ₹4,30,000. X will grant 2% discount on balance, and Y request X to draw a bill for balance, the amount of bill will be:*

   (a) ₹ 98,000

   (b) ₹ 68,000

   (c) ₹ 68,600

8. *On 1.1.2022, X draws a bill on Y for ₹ 5,00,000 for 3 months. X got the bill discounted 4.1.2022 at 12% rate. The amount of discount on bill will be:*

   (a) ₹ 15,000

   (b) ₹ 16,000

   (c) ₹ 18,000

9. *Mr. Jay draws a bill on Mr. John for ₹ 3,00,000 on 1.1.2022 for 3 months. On 4.2.2022, John got the bill discounted at 12% rate. The amount of discount will be:*

   (a) ₹ 9,000

   (b) ₹ 6,000

   (c) ₹ 3,000

10. *XZ draws a bill on YZ for ₹ 2,00,000 for 3 months on 1.1.2022. The bill is discounted with banker at a charge of ₹1,000. At maturity the bill return dishonoured. In the books of XZ, for dishonour, the bank account will be credited by:*

    (a) ₹199,000

    (b) ₹ 200,000

    (c) ₹ 201,000

11. *On 1.1.2022, XA draws a bill on YB for ₹ 1,00,000. At maturity YB request XA to renew the bill for 2 months at 12% p.a. interest. Amount of interest will be:*

    (a) ₹ 2,000

    (b) ₹ 1,500

    (c) ₹ 1,800

12. *A bill of exchange is drawn by a*
    - (a) *Creditor*
    - (b) *Debtor*
    - (c) *Debenture holder*
13. *At the time of drawing a bill, the drawer credits*
    - (a) *Bills Receivables A/c*
    - (b) *Bills Payable A/c*
    - (c) *Debtor's A/c*
14. *A promissory note is made by a*
    - (a) *Seller*
    - (b) *Purchaser*
    - (c) *Endorsee*
15. *A bill of exchange contains*
    - (a) *An unconditional order*
    - (b) *A promise*
    - (c) *A request to deliver the goods*
16. *A promissory note contains*
    - (a) *An unconditional order*
    - (b) *A promise*
    - (c) *A request to deliver the goods*
17. *The rebate on the bill shows that*
    - (a) *It has been endorsed*
    - (b) *It has been paid after the date of maturity*
    - (c) *It has been paid before the date of maturity*
18. *Notary Public may charge his fee from the*
    - (a) *Holder of bill of exchange*
    - (b) *Drawer*
    - (c) *None*

Theoretical Questions

1. *Write short notes on:*

   (a) *Accommodation bill.*

   (b) *Renewal of bill.*

   (c) *Noting charges.*

2. *What is bill of exchange? How does it differ from Promissory Note?*

Practical Questions

1. *On 1st January, 2022, A sells goods for ₹10,000 to B and draws a bill at three months for the amount. B accepts it and returns it to A. On 1st March, 2022, B retires his acceptance under rebate of 12% per annum. Record these transactions in the journals of B.*

2. *A draws upon B three Bills of Exchange of ₹ 3,000, ₹ 2,000 and ₹ 1,000 respectively. A week later his first bill was mutually cancelled, B agreeing to pay 50% of the amount in cash immediately and for the balance plus interest ₹100, he accepted a fresh Bill drawn by A. This new bill was endorsed to C who discounted the same with his bankers for ₹1,500. The second bill was discounted by A at 5%. This bill on maturity was returned dishonoured (nothing charge being ₹30). The third bill was retained till maturity when it was duly met.*

   Give the necessary journal entries recording the above transactions in the books of A.

3. *Journalize the following in the books of Don:*

   (i) *Bob informs Don that Ray's acceptance for ₹ 3,000 has been dishonoured and noting charges are ₹ 40. Bob accepts ₹ 1,000 cash and the balance as bill at three months at interest of 10%. Don accepts from Ray his acceptance at two months plus interest @ 12% p.a.*

   (ii) *James owes Don ₹ 3,200; he sends Don's own acceptance in favour of Ralph for ₹ 3,160; in full settlement.*

   (iii) *Don meets his acceptance in favour of Singh for ₹ 4,500 by endorsing John's acceptance for ₹ 4,450 in full settlement.*

   (iv) *Ray's acceptance in favour of Don retired one month before due date, interest is taken at the rate of 6% p.a.*

ANSWERS/HINTS

True and False

1. False: The bills payable account is a personal account that represents a liability.
2. False: Bill of exchange contains an order to pay the required amount and not a mere promise to pay.
3. False:3 Days of grace are added to the due date to arrive at the maturity date.
4. True: Discount at the time of retirement of a bill is a gain for the drawee and loss for the drawer.
5. True: When a bill is drawn in the country and is payable outside the country it is termed as a foreign bill.
6. True: In case of the promissory note, it is generally the maker who makes the payment, but in case of the bill of exchange, the person accepting the bill shall be liable to make the payment to the holder of the bill.
7. False: B cannot endorse the bill to C as he is a drawee. Only A, the drawer can do so.
8. True: A bill given to a creditor is called Bills Payable as the debtor commits to pay by giving a bill to creditor.

Multiple Choice Questions

1.	**(c)**	2.	**(b)**	3.	**(a)**	4.	**(c)**	5.	**(c)**	6.	**(b)**
7.	**(c)**	8.	**(a)**	9.	**(b)**	10.	**(b)**	11.	**(a)**	12.	**(a)**
13.	**(c)**	14.	**(b)**	15.	**(a)**	16.	**(b)**	17.	**(c)**	18.	**(a)**

Theoretical Questions

1. (a) Bills of Exchange are usually drawn to facilitate trade transmission, that is, bills are meant to finance actual purchase and sale of goods. But the mechanism of bill can be utilised to raise finance also. When bills are used for such a purpose, they are known as accommodation bills.

(b) When the acceptor of a bill finds himself in financial straits to honour the bill on the due date, then he may request the drawer to cancel the original bill and draw on him a fresh bill for another period. And if the drawer agrees, a new bill in place of the original bill may be accepted by the drawee for another period. This is called the renewal of bill.

(c) The charges paid to Notary public for notify the dishonour are noting charges. Refer para 1.12 for details.

2. A bill of exchange has been defined as "an instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money only to or to the order of certain person or to the bearer of the instrument". When such an order is accepted by the drawee, it becomes a valid bill of exchange. A promissory note is an instrument in writing (not being a bank note or a government 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.

A promissory note needs no acceptance, as the debtor himself writes the document promising to pay the stated amount. Like bills of exchange, promissory notes are also negotiable instruments, and can be transferred by endorsement. In case of bill of exchange, the drawer and the payee may be the same person but in case of a promissory note, the maker and the payee cannot be the same person.

Practical Questions

1. **Journal Entries in the books of B**

Date	Particulars		Debit	Credit
2022			₹	₹
Jan. 1	Purchases account	Dr.	10,000	
	To A's account			10,000
	(Being the goods purchased from A on credit)			
	A's account	Dr.	10,000	
	To Bills payable account			10,000
	(Being the acceptance of bill given to A)			
1-Mar	Bills payable account	Dr.	10,000	
	To Bank account			9,900
	To Rebate on bills account			100
	(Being the bill discharged under rebate @ 12% p.a.)			

Working Note :

Calculation of rebate:

₹10,000 x 12/100 x 1/12 = ₹100

2. **Journal of A**

	₹	₹
Bills Receivable A/c Dr.	6,000	
To B		6,000
(Three bills for ₹3,000, ₹2,000 and ₹1,000 drawn on B and duly accepted by him received)		
B Dr.	3,000	
To Bills Receivable A/c		3,000
(Bill received from B cancelled for renewal)		
Cash Account Dr.	1,500	
Bill Receivable Account Dr.	1,600	
To B		3,000
To Interest Account		100
(Amount received on cancellation of the first bill,50% along with a new bill for 50% of the amount plus interest ₹100)		
C Dr.	1,600	
To Bills Receivable A/c		1,600
(A's acceptance endorsed in favour of C)		
Bank A/c Dr.	1,900	
Discount A/c Dr.	100	
To Bills Receivable A/c		2,000
(Second Bill for ₹ 2,000 discounted with the bank @ 5%)		
B Dr.	2,030	
To Bank A/c		2,030
(Second Bill for ₹2,000 discounted with the Bank dishonoured, noting charges ₹30 paid by the Bank)		
Bank A/c Dr.	1,000	
To Bills Receivable A/c		1,000
(Amount received on maturity of the third bill)		

Note: It is assumed that the bill for ₹1,600 has not yet fallen due for payment.

3. **Books of Don**

			₹	₹
(i)(a)	Ray	Dr.	3,040	
	To Bob			3,040
	(Ray's acceptance endorsed to Bob dishonoured on due date nothing charges paid by Bob ₹40)			
(b)	Bob	Dr.	3,040	
	Interest	Dr.	51	
	To Cash			1,000
	To Bills Payable A/c			2,091
	(Amount payable to Bob ₹3,040 settled by cash payment ₹1,000 and issue of new bill for ₹2,091 including interest ₹ 51 for three months on ₹2,040 @ 10% p.a.)			
(c)	Bills Receivable A/c	Dr.	3,100.80	
	To Ray			3,040.00
	To Interest			60.8
	(Bill received from Ray for ₹3,040due against earlier acceptance dishonoured plus ₹ 60.80 interest for two months @ 12% p.a.)			
(ii)	Bills Payable A/c	Dr.	3,160	
	Discount A/c	Dr.	40	
	To James			3,200
	(Cancellation of bills payable to Ralph for ₹3,160 in settlement of ₹3,200 due from James)			
(iii)	Bills payable A/c	Dr.	4,500	
	To Bills Receivable A/c			4,450
	To Discount A/c			50
	(Settlement of acceptance issued to Mr. Singh by endorsement of John's Acceptance for ₹4,450)			
(iv)	Bank A/c	Dr.	3,085.30	
	Discount A/c	Dr.	15.5	
	Total Bills Receivable A/c			3,100.80
	(Amount received from Ray in settlement of Bills Payable, retired one month before due date)			

NOTES

NOTES

CHAPTER 7

PREPARATION OF FINAL ACCOUNTS OF SOLE PROPRIETORS

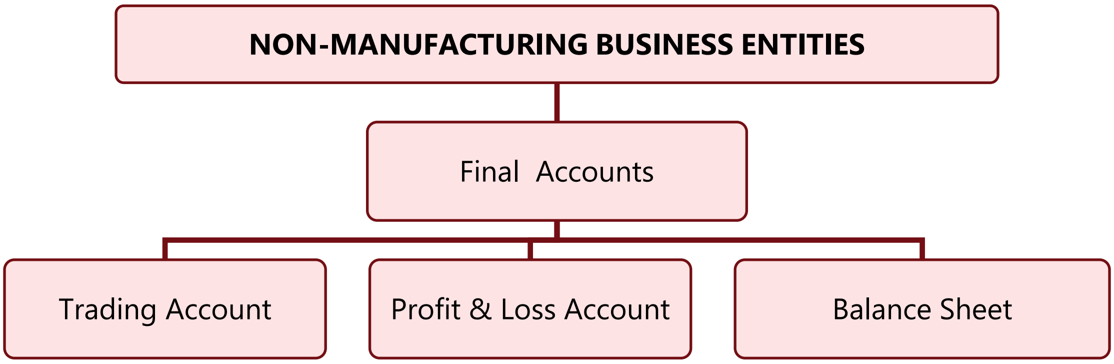
UNIT – 1 FINAL ACCOUNTS OF NON-MANUFACTURING ENTITIES

LEARNING OUTCOMES

After studying this unit, you would be able to:

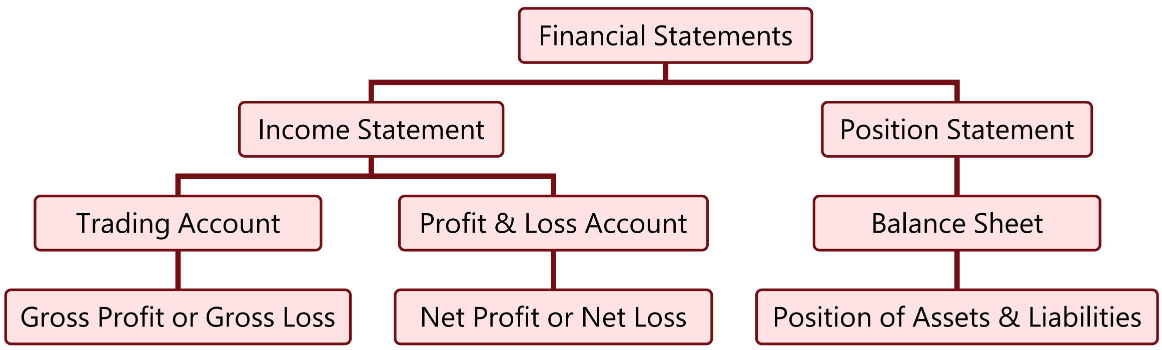
- Draw final Accounts of Non- manufacturing entities.
- Learn the relationship between Profit and Loss Account and Balance Sheet.
- Understand the Trading Account items. This will help you to learn which of the transactions and events should be shown in the Trading Account.
- Understand the items shown in the Profit and Loss Account. By that you will learn the technique of preparing Profit and Loss Account and deriving the Profit and Loss balance.
- Learn how to adjust outstanding and pre-paid expenses, accrued income and income received in advance.
- Understand the items to be shown in the balance sheet. Also learn the classification of assets and liabilities and the order by which they are presented in the Balance Sheet.

UNIT OVERVIEW



1.1 INTRODUCTION

Non-manufacturing entities are the trading entities, which are engaged in the purchase and sale of goods for profit without changing the form/ underlying use of such goods. In other words, non-manufacturing entities do not process the goods purchased rather sell them in their original form. Meanwhile the entity indulges in some liabilities, makes some assets and also incurs some expenses like salaries, stationery expenses, advertisement, rent etc. to run the business. At the end of the accounting year, the entity must be interested in knowing the results of the business. To ascertain the final outcome of the business i.e., the income and financial position, they prepare financial statements at the end of the accounting year.



Financial Statements are the systematically organized summary of all the ledger account heads and presented in such a manner that it gives detailed information about the financial position and the performance of the entity. As seen above, through categorization of Financial Statements into Income & Position Statement, the profit or loss is measured at two levels:

(a) Gross Profit or Gross Loss

(b) Net Profit or Net Loss

The profit or loss of the enterprise is obtained through the preparation of **Income Statement i.e. Trading and Profit & Loss A/c**

The financial position of the business enterprise is assessed by measuring the assets, liabilities and capital of the enterprise and the same is communicated to the users of financial statements. Financial position of the enterprise can be known through the preparation of the **Position Statement i.e Balance Sheet.**

Comparison between Income Statement and Position Statement

Income Statement	Position statement
Profit or loss is presented in the Income Statement prepared at the close of the financial year	It exhibits assets and liabilities of the business as at the close of the financial year.
Income Statement is sub-divided into following two parts for a non-manufacturing concern: (i) Trading account; and (ii) Profit and Loss account	Apart from balance sheet, to assess the financial position of the business, sometimes additional statements are also prepared like cash flow statement, statement of changes in equity etc. which is not mandatory for non-corporate entities. These additional statements are prepared for the better understanding of the financial position of the business.
Income Statement discloses net profit or net loss of the business after adjusting from the income earned during the year, all the expenditures of the business incurred in that year.	Position statement discloses the assets and liabilities position as on a particular date.

1.2 PREPARATION OF FINAL ACCOUNTS

The principal function of final accounts (Trading Account, Profit and Loss Account and the Balance Sheet) is to exhibit truly and fairly the performance and the financial position of the business to which they relate. In order that these may be properly drawn up, it is essential that a proper record of transactions entered into by the business during a particular accounting period should be maintained. The **BASIC PRINCIPLES** in regard to accumulation of accounting period data are:

(i) a distinction should be made between capital and revenue receipts and payments.

(ii) income and expenses relating to a period of account should be separated from those of another period.

(iii) different items of income and expenditure should be accumulated under significant heads so as to disclose the sources from which capital has been procured and the nature of liabilities, which are outstanding for payment.

Having regard to these basic principles, the various matters to which attention should be paid for determining the different aspects of transactions, a record of which should be kept, and the different heads of account under which various items of income and expenditure should be accumulated, are stated below:

(a) Distinction between personal and business income:- Since the final statements of account are intended to show the profitability of the business and not that of its proprietors, it is essential that all personal income and expenditure should be separated from business income and expenditure.

(b) Distinction between capital and revenue expenditure:- A distinction should be made between capital and revenue, both receipts and expenditure. Different types of income and expenditure should be classified under separate heads. Assets should be included in the Balance Sheet by following accounting principles and accounting standards. Likewise, a provision for expenses which have accrued but not paid, should be made by estimation or otherwise on the same basis as in the previous year.

(c) All material information to be disclosed:- Every information, considered material for evaluating the performance of the business or its financial position, should be disclosed. For example, when the labour charges have increased substantially on account of bonus having been paid to workmen, the amount of bonus paid should be disclosed. Similarly, If there are substantial write-offs in inventory due to any reason, it should be shown separately.

(d) Record only current period transactions:- Though the record of transactions should be maintained continuously, at the end of each accounting period, the transactions of the closing accounting period should be cut off from those of the succeeding period.

(e) Only transactions completed before close of accounts should be given effect:- It should be seen that only the effect of transactions, which were concluded before the close of period of account, has been adjusted in the accounts of the year. For example, when a sale of goods is to take place only after the goods have been inspected by the purchaser and the inspection had not been made before the close of the year, it would be incorrect to treat the goods as a sale in the accounts of the year.

Inter-relationship of the two statements

One of the points to be remembered is that of total expenditure incurred some type of expenditure appears in the Profit and Loss Account and some in the Balance Sheet. Consider few examples,

1. Salaries paid for current year is shown on the Dr. side of Profit and Loss Account but outstanding salaries is shown on liabilities side of Balance Sheet and is added to Salaries paid and shown under Profit and Loss Account.

Profit & Loss A/c

Particulars		Amount ₹	Particulars	Amount ₹
To Salaries paid	25,000			
Add: Outstanding Salaries	1,500	26,500		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Outstanding Salaries	1,500		

2. When a machine is purchased, that part of it which is attributable to the year considered as depreciation is debited to the Profit and Loss Account and the balance amount after reducing the amount of depreciation is shown in the Balance Sheet as an asset.

Profit & Loss A/c

Particulars	Amount ₹	Particulars	Amount ₹
To Depreciation	50,000		

Balance Sheet

Liabilities	Amount ₹	Assets		Amount ₹
		Fixed Assets	5,00,000	
		Less:- Depreciation	(50,000)	4,50,000

These illustrations show that the two statements, the Profit and Loss Account and the Balance Sheet, are thoroughly inter-related. The assets shown in the Balance Sheet are mostly only the remainder of the expenditure incurred after a suitable amount has been charged to the Profit and Loss Account or the Trading Account. For preparing the two statements properly, it is of the greatest importance that the amounts to be charged to the Profit and Loss Account should be properly determined otherwise both statements will show an incorrect position. The principle that governs this concept is called the **Matching Principle.**

Matching Principle

This principle demands that expenses incurred to earn the revenue should be properly matched. This means the following:

(a) If a certain revenue and income is entered in the Trading / Profit and Loss Account all the expenses relating to it, whether or not payment has been actually made, should be debited to the Trading / Profit and Loss Account. This is why at the end of the year an entry is recorded to bring into account the outstanding expenses. That is also the reason why the opening inventory of goods is debited to the Trading Account since the relevant sale is credited in the same account.

(b) If some expense has been incurred but against it sale will take place in the next year or income will be received next year, the expense should not be debited to the current year's Profit and Loss Account but should be carried forward as an asset and shown in the Balance Sheet. It will be debited to the Profit and Loss Account only when the relevant income will also be credited. The same reason applies to depreciation of assets also. The part of the cost which is used to earn current year revenue is debited in same year.

(c) If an income or revenue is received in the current year but the work against it has to be done and the cost in respect of it has to be incurred next year, i.e. income received in advance, such income or the revenue is considered to be of next year. It should be shown in the Balance Sheet on the liabilities side as "income received in advance" and should be credited to the Profit and Loss Account of the next year. E.g. Newspapers or magazines usually receive subscriptions in advance for a year. The part of subscription that covers copies to be supplied in the next year is treated as income received in advance.

An exception

There appears to be one exception to the rule that only such costs as have yielded or is expected to yield revenue should only be debited to Profit and Loss Account. For example, if a fire has occurred and has damaged the firm's property the loss must be debited to the Profit and Loss Account to the extent it is not covered by insurance. A loss, resulting from the fall of selling price below the cost or from some debts turning bad, must similarly be debited to the Profit and Loss Account. If this is not done the profit will be over-stated.

(NOTE: - The relevant entries and adjustments regarding the above three items are discussed in detail later in this unit.)

1.3 TRADING ACCOUNT

At the end of the year, as has been seen above, it is necessary to ascertain the net profit or the net loss. For this purpose, it is first necessary to know the gross profit or gross loss. Gross Profit is the difference between the selling price and the cost of the goods sold. For a trading firm, the cost of goods sold can be ascertained by adjusting the cost of goods still on hand at the end of the year against the purchases. It is done as follow:-

Opening Stock	***
Add:- Purchases (Net)	**
Add:- Direct Expenses	**
	***
Less:- Cost of Goods Sold	(**)
Closing Stock	***

Suppose, in the first year, the net purchases (that is after deducting returns) total ₹1,00,000 and that ₹15,000 worth of goods (at cost) were not sold at the end of the year. The cost of the goods sold will then be ₹ 85,000. If in the next year purchases are ₹1,50,000, direct expenses are ₹10,000 and the cost of goods sold is ₹ 1,45,000 the closing stock will be ₹ 30,000 calculated as follows:

	₹
Cost of unsold goods at the beginning of the year	15,000
Purchases during the year	1,50,000
Direct Expenses	10,000
	1,75,000
Less: Cost of sold goods during the year	1,45,000
Closing Stock	(30,000)

Gross profit is usually ascertained by preparing a Trading account. The format of Trading Account can be shown as below:-

Trading Account of.....for the year ended.....

		₹			₹
To Opening Stock		XXX	By Sales	XXX	XXX
To Purchases	XXX		*Less*: Returns Inwards	XXX	XXX
Less: Returns outwards	XXX	XXX	By Closing Stock		
To Direct expenses:		XXX	By Gross Loss c/d*		
Freight & Carriage		XXX			
Customs & Insurance	XXX				
Wages	XXX				
Gas, Water & Fuel	XXX				
Factory Expenses	XXX				
Royalty on production	XXX	XXX			
		XXX			XXX

To Gross Profit c/d*

*Only one will appear

If in the above example net sales, i.e., after adjustment for sales returns, is ₹ 2,00,000 then the gross profit will be ₹ 55,000, i.e., ₹2,00,000 – ₹ 1,45,000. This profit is called gross profit since from it indirect expenses have still to be deducted for knowing the net profit. Now, for the same example Trading account will appear as follows:-

Trading Account for the year ending

	₹		₹
To Opening Inventory	15,000	By Sales Account	2,00,000
To Purchase Account	1,50,000	By Closing Inventory	30,000
To Direct Expenses	10,000		
To Gross Profit carried to P & L A/c	55,000		
	2,30,000		2,30,000

Point to Remember:-

- The opening inventory and purchases are written on the debt side.
- Sales and the closing inventory are entered on the credit side.
- If there are any direct expenses then they should also be written on the debit side of the Trading account.
- If the balances of credit side is more, the difference is written on the debit side as gross profit. This amount will also be carried forward to the Profit and Loss Account on the credit side.
- In case of gross loss, i.e., when the debit side of the Trading Account exceeds the credit side, the amount will be written on the credit side of the Trading Account and transferred to the debit side of the Profit and Loss Account.

Trading Account Items

In a trading firm like a wholesaler, the main business consists of buying and selling the same goods. In addition to the amount of the opening inventory, the trading account will also be debited with all expenses incurred in bringing the goods to the godown of the firm (i.e. to the present condition and location) and in making them ready for sale.

For example, freight paid on purchases, cartage, octroi, etc. will all be debited to the Trading Account. The rule is that this account will be debited with all expenses incurred in bringing the goods to their present location and condition.

We shall now consider individual items:

(1) **Opening Inventory:** Since this was closing inventory of the last year, it must have been entered in the opening inventory account, through the opening entry. Therefore, it will be found in the trial balance. This item is usually put as the first item on the debit side of the Trading Account. Of course, in the first year of a business there will be no opening inventory.

Trading A/c Dr.

To Opening Stock A/c

(2) **Purchases and Purchase Returns:** The purchases account will have debit balance, showing the gross amount of purchases made of the materials. The purchase returns account will have credit balance showing the return of materials to the supplier. On the debit side of the trading account the net amount is shown as indicated (with assumed figures) :

	₹
To Purchases	3,00,000
Less : Purchase Returns	(10,000)
	2,90,000

Closing entry for this purpose is follows:

Purchases Return A/c Dr.

To Purchases A/c

(This Net Purchases is transferred to Trading account)

Trading a/c Dr.

To Purchase a/c

It happens sometimes that goods are received but the relevant invoice is not received from the supplier. On the date of the closing of the account, an entry must be passed to debit the purchases account and credit the supplier with the cost of goods.

(3) **Carriage or Freight Inwards/Freight:** This item should also be debited to the Trading Account, as it is incurred to bring the materials to the firm's godown and make them available for use. However, if any freight or cartage is paid on any asset, like machinery, it should be added to the cost of the asset and not debited to the Trading Account.

Trading a/c Dr.

To Carriage or Freight Inwards

(4) **Wages:** Wages paid to workers in the godown/stores, should be debited to the Trading Account. If any amount is outstanding, it must be brought into books so that full wages for the period concerned are charged to the Trading Account. However, if wages are paid for installation of a fixed asset, it should be added to the cost of the asset.

Trading a/c Dr.

To Wages

(5) **Sales and Sales Returns:** The sales account will have a credit balance indicating the total sales made during the year. The sales return account will have a debit balance, showing the total amount of goods returned by customer The net of the two amounts is entered on the credit side of the Trading Account.

Sales A/c Dr.

To Sales return

To Trading A/c

Sometimes, goods are sold on approval basis that is when the customer has the right to return the goods with in stipulated period in that case the sale entry should be reversed. It is discussed later in detail.

(6) **Closing Inventory and its valuation**: Usually there is no account to show the value of goods lying in the godown at the end of the year. However, to correctly ascertain the gross profit, the closing Inventories must be properly taken and valued.

The entry is

Closing Inventory Account Dr.

To Trading Account

Alternatively, Closing Inventory can be adjusted with purchases :

Closing Inventory Account Dr.

To Purchases Account

The effect of this entry is to reduce the debit in the Purchases Account. The closing inventory is also shown in balance sheet on Assets side.

If Closing Stock appears in the Trial balance:-

The closing inventory is then not entered in the trading account, it is shown only in the balance sheet. This is because it has already been adjusted to arrive at Cost of Goods Sold.

To ascertain value of the closing inventory, it is necessary to make a complete inventory or list of all the items in the godown together with quantities. Of course, damaged or obsolete items are separately listed. To the list of finished goods, one should also add the goods lying with agents sent to them on consignment basis and also the goods sent on approval to customer.

The valuation principle is cost or net realisable value whichever is lower.

Taking inventory is quite a lengthy process. Strictly, immediately at the end of the year the taking of inventory should be completed. Sometimes, however this is done either a few weeks before or a few weeks after the closing. In such a case the value of the inventory thus taken must be adjusted to relate it to the closing date. The adjustment will be necessary because, in the meantime, purchases and sales must have been made. The main point to remember is that in respect of sales their cost has been established. Cost will be sales less gross profit.

Below is the summary for all transfer / closing entries to Trading a/c:

(1) Trading Account Dr.

To Opening Inventory Account

To Purchases Account

To Wages Account

To Freight on Purchases Account, etc.

(2) Sales Account Dr.

Closing Inventory Account Dr.

To Trading Account

At this stage Trading Account will reveal the gross profit, if the credit side is more, or gross loss if the credit side is less. The gross profit will be transferred to the Profit and Loss Account by the entry:

Trading Account Dr.

To Profit and Loss Account

The entry for gross loss, if there be any is :

Profit and Loss Account Dr.

To Trading Account

ILLUSTRATION 1

Trial Balance for the financial year (FY) ended 31st March 2022 of M/s Deepakshi shows following details:

Particulars	***Debit (₹)***	***Credit (₹)***
Purchase & Sales	*10,00,000*	*12,00,000*
Debtors & Creditors	*5,00,000*	*4,00,000*
Opening Stock	*2,00,000*	
Closing Stock	*3,00,000*	
Other Expenses & Incomes	*7,00,000*	*9,00,000*
Fixed Assets & Long Term Liabilities	*25,00,000*	*6,00,000*
Capital		*21,00,000*
	52,00,000	*52,00,000*

Additional Information: Creditors balance as on 1st April, 2021 is ₹ 3,00,000.

You are required to calculate cost of goods sold and amount paid to creditors during the year.

SOLUTION

i) **Calculation of Cost of Goods sold:**

Particulars	₹
Opening Stock	2,00,000
Add: Purchases (Closing stock already adjusted)*	10,00,000
Cost of Goods Sold	12,00,000

*Since, closing stock appears in Trial Balance, it means following entry has already been passed in books:

Closing Stock A/c	Dr.	3,00,000	
To Purchases A/c			3,00,000

So, we can see purchases have already been reduced by the amount of unsold stock, therefore no more adjustment needs to be made on account of closing stock for computing Cost of goods sold (COGS).

ii) Calculation of amount paid to creditors:

Date	Particulars	₹	Date	Particulars	₹
31.3.22	To Bank A/c (Balancing Figure)	12,00,000	1.4.21	By Balance b/d	3,00,000
31.3.22	To Balance c/d	4,00,000		By Purchases A/c (Note:1)	13,00,000
		16,00,000			16,00,000

Note: 1) Purchases made during the year can be computed as:

Particulars	₹
Purchases as per Trial Balance	10,00,000
Add: Closing Stock already adjusted	3,00,000
Purchases made during the year	13,00,000

Students may note that in case Closing Stock is not mentioned in Trial Balance, then it means Opening Stock and Purchases appearing in Trial Balance include the value of unsold stock. Since, we prepare our financial statements using matching concept such unsold stock should not form part of cost and therefore is deducted. Therefore, in this case to compute Cost of goods sold (COGS) we will have to use:

COGS = Opening Stock +Purchases – Closing Stock – Purchase Returns

ILLUSTRATION 2

	₹
Opening Inventory	*1,00,000*
Purchases	*6,72,000*
Carriage Inwards	*30,000*
Wages	*50,000*
Sales	*11,00,000*
Returns inward	*1,00,000*
Returns outward	*72,000*
Closing Inventory	*2,00,000*

Required

From the above information, prepare a Trading Account of M/s. ABC Traders for the year ended 31st March, 2022 and Pass necessary closing entries in the journal proper of M/s. ABC Traders

SOLUTION

In the books of M/s. ABC Traders

Trading Account for the year ended 31st March, 2022

Particulars		**Amount**	**Particulars**		**Amount**
	₹	₹		₹	₹
To Opening Inventory		1,00,000	By Sales	11,00,000	
To Purchases	6,72,000		*Less* : Returns Inward	(1,00,000)	10,00,000
Less: Returns outward	(72,000)	6,00,000	By Closing Inventory		2,00,000
To Carriage Inwards		30,000			
To Wages		50,000			
To Gross profit (Balancing Figure)		4,20,000			
		12,00,000			12,00,000

Journal Proper in the Books of M/s. ABC Traders (Closing entries)

Date 2022	**Particulars**		**Amount ₹**	**Amount ₹**
Mar. 31	Returns outward A/c	Dr.	72,000	
	To Purchases A/c			72,000
	(Being the transfer of returns to purchases account)			
	Sales A/c	Dr.	1,00,000	
	To Returns Inward A/c			1,00,000
	(Being the transfer of returns to sales account)			
	Sales A/c	Dr.	10,00,000	
	To Trading A/c			10,00,000
	(Being the transfer of balance of sales account to trading account)			
	Trading A/c	Dr.	7,80,000	
	To Opening Inventory A/c			1,00,000
	To Purchases A/c			6,00,000
	To Wages A/c			50,000
	To Carriage Inwards A/c			30,000
	(Being the transfer of balances of opening Inventory, purchases and wages accounts)			
	Closing Inventory A/c	Dr.	2,00,000	
	To Trading A/c			2,00,000
	(Being the incorporation of value of closing Inventory)			
	Trading A/c	Dr.	4,20,000	
	To Gross Profit			4,20,000
	(Being the amount of gross profit)			
	Gross profit	Dr.	4,20,000	
	To Profit and Loss A/c			4,20,000
	(Being the transfer of gross profit to Profit and Loss Account)			

1.4 PROFIT AND LOSS ACCOUNT

The Profit and Loss Account starts with gross profit on the credit side. If there is gross loss, it will be written on the debit side. After that all those expenses and losses, which have not been entered in the Trading Account, will be written on the debit side of Profit and Loss Account. Incomes and gains, other than sales, will be written on the credit side.

If we understand word 'expenses' properly, there should be no difficulty in distinguishing between items that will be debited to the Profit and Loss Account and those that will be shown as Assets in the balance sheet. Further, it may be noted that the expenses which are personal in nature will not be charged to Profit and Loss A/c. Only those revenue expenses and losses which are related to the current year, are debited to Profit and Loss Account.

It is desirable, according to modern thinking that the Profit and Loss Account should be prepared in such a manner as will enable the reader to form a correct idea about the profit earned or loss incurred by the firm during the period together with the significant factor. Too many details will prevent a person from knowing properly the factors leading to the profit earned. Therefore, items should be according to the various functions, such as administrations, selling and financing. The profit/loss A/c appears as follows:-

Dr. **Profit and Loss Account for the year ended** **Cr.**

Particulars	₹	Particulars	₹
To Gross Loss b/d		**By Gross Profit b/d**	
Management expenses		**Other Income**	
To Salaries (administrative)		By Discount Received	
To Office rent, rates and taxes		By Commission Received	
To Printing and stationery		**Non-trading Income**	
To Telephone charges		By Bank Interest	
To Postage		By Rent of property let-out	
To Insurance		By Dividend from investment in shares	
To Audit Fees		**Abnormal Gains**	
To Legal Charges		By Profit on sale of machinery	
To Electricity Charges		By Profit on sale of investment	

Maintenance expenses			
To Repairs & renewals		**By Net Loss (transferred to capital A/c)**	
To Depreciation on:			
Office Equipment			
Office Furniture			
Office Buildings			
Selling and Distribution expenses			
To Salaries (selling staff)			
To Advertisement			
To Godown rent			
To Carriage Outward			
To Bad Debts			
To Provision for bad debts			
To Selling commission			
Financial expenses			
To Bank charges			
To Interest on loans			
To Discount on bills			
To Discount allowed to customers			
Abnormal Losses			
To Loss on sale of machinery			
To Loss on sale of investment			
To Loss by fire			
To Net Profit (transferred to Capital A/c)			

Note:

(i) Gross loss appears in the debit side of the Profit and Loss Account at the top; while Gross Profit on the credit side.

(ii) Net loss appears in the credit side of the Profit and Loss Account; while Net profit on debit side as balancing figures.

It will be good idea to either show these expenses in a separate schedule or to indicate the total of these prominently in the Profit and Loss Account. This rule should be followed wherever the number of items is rather large.

CLOSING ENTRIES

The entries that have to be made in the journal for preparing the Trading and the Profit and Loss Account that is for transferring the various accounts to these two accounts are known as closing entries. We have already seen the entries required for preparing the Trading Account and for transferring the gross profit to the profit and Loss Account. Now to complete the Profit and Loss Account, the under mentioned three entries will be necessary.

(a) For items to be debited to the Profit and Loss Account this account will be debited and the various accounts concerned will be credited. For example,

Profit and Loss Account Dr.

To Salaries Account

To Rent Account

To Interest Account

To Other Expenses Account

(b) Items of income or gain such as interest received or miscellaneous income will be credited to Profit and Loss Account.

Discount Received Account Dr.

Bad debts Recovered Account Dr.

To Profit and Loss Account

(c) At this stage, the Profit and Loss Account will show net profit or net loss. Both have to be transferred to the Capital Account.

In case of net profit, i.e., when the credit side is bigger than the debit side, the entry is:

Profit and Loss Account Dr.

To Capital Account

In the case of net loss, the entry will be

Capital Account Dr.

To Profit and Loss Account

Entries in detail

There may be other income such as interest received, discount received, rent from subletting of premises, miscellaneous incomes such as from sale of junk material etc., It would be desirable to show the totals only under each of the main categories of income. However, interest on fixed deposits, interests or income from investments and other interest should be shown separately. Similarly, items which have to be debited/credited to the proprietor should be segregated from other items. Examples would be interest charged on drawings, interest allowed on capital and charges for services rendered by the firm to the proprietor personally.

We shall now consider a few items individually:

(i) **Drawings:** Drawings are not expenses for the firm but reduction of capital and therefore should not be debited to the Profit and Loss Account but to Capital account of the proprietor.

Capital A/c Dr.

To Drawings

If the proprietor has enjoyed some benefit personally, like use of the firm's car, a suitable amount should be treated as drawing and to that extent the charge to the Profit and Loss Account will be reduced, Drawings are debited to the proprietor's capital account.

(ii) **Income Tax:** In case of companies, the income tax payable is treated like other expenses. But in the case of sole proprietorship, income tax is treated as a personal expense. It is debited to the Capital Account and not to the Profit and Loss Account.

Capital A/c Dr.

To Income Tax A/c

This is because the amount of the tax will depend on the total income of the partners or proprietor besides the profit of the firm. In case of partnership business, firm's tax liability is to be debited to profit and loss account of the firm but partners' tax liability are not to be borne by the firm. Therefore if the firm pays income tax on behalf of partners, such payment of personal income tax should be treated as drawings.

(iii) **Discount received and allowed:** We have already seen that discount is of two types. Trade discount and Cash discount. Trade discount is allowed when the order for goods is not below a certain figure. It is deducted from the invoice. Only the net amount of invoice is entered in books. There is no further treatment of the trade discount. Cash discount is allowed to a customer if he makes the payment before a certain date. It is allowance made to him for prompt payment and is recorded in the books. Therefore, Trade discount is not debited to P/L account because it is already adjusted in sales, but cash discount is debited to P/L account.

Discount received is a gain and is credited to the Profit and Loss Account while discount allowed is a loss and debited to Profit and Loss Account.

Profit/Loss A/c Dr.

To Discount Allowed A/c

Discount Received A/c Dr.

To Profit/Loss A/c

(iv) **Rebate:** It is the allowance given to a customer when his purchases during a period, say one year, total upto a certain figure. Suppose a firm allows a rebate of 4% to those customers whose purchases during the year are at least ₹ 5,000. One Customer's purchases are ₹ 4,500, he will not get any rebate. Another customer's purchases total ₹ 5,100, he will get a rebate of ₹ 204. The entry for rebate is made only at the end of the year. The Rebate Account is debited and is later written in the profit and Loss Account on the debit side. Various customers who have earned the rebate are credited.

Initially when Rebate is given

Rebate A/c Dr.

To Customer A/c

At the year end closing entry

Profit/Loss A/c Dr.

To Rebate A/c

(v) **Bad Debts:** When a customer does not pay the amount due from him and all hopes of recovering the amount are lost, it is said to be a bad debt. It is a loss to the firm. Therefore, the bad debts account is debited, which is later on transferred in the Profit and Loss Account on the debit side. Since it is no use showing the amount due still as an asset, the account of the customer concerned is closed by being credited. The entry

Bad Debts Account Dr.

To Debtor's / Customer (by name) Account

Profit/Loss Account Dr.

To Bad Debts A/c

In case the Provision for Bad debts has already been prepared then bad debts should be written off first from it. Entry for it will be:

*Provision for Bad Debts A/c Dr.

To Bad Debts A/c

If later on, the amount is recovered, it should be treated as a gain. It should not be credited to the party paying it. It should be credited to Bad Debts Recovered Account. It will be entered in the Profit and Loss Account on the credit side.

Bad Debts Recovered Account Dr.

To Profit/Loss Account

For detailed understanding of Provision of Bad Debts please refer Point (6) topic Adjustments of Provision of Bad and Doubtful Debts .

ILLUSTRATION 3

Revenue, Expenses and Gross Profit Balances of M/s ABC Traders for the year ended on 31st March 2022 were as follows:

Gross Profit ₹4,20,000, Salaries ₹1,10,000, Discount (Cr.), ₹18,000, Discount (Dr.) ₹19,000, Bad Debts ₹ 17,000, Depreciation ₹65,000, Legal Charges ₹25,000, Consultancy Fees ₹32,000, Audit Fees ₹ 1,000, Electricity Charges ₹17,000, Telephone, Postage and Telegrams ₹ 12,000, Stationery ₹27,000, Interest paid on Loans ₹70,000.

Required

Prepare Profit and Loss Account of M/s ABC Traders for the year ended on 31st March, 2022. Show necessary closing entries in the Journal Proper of M/s. ABC Traders also.

SOLUTION

In the Books of M/s. ABC Traders

Profit and Loss Account for the year ended 31st March, 2022

Particulars	Amount ₹	Particulars	Amount ₹
To Salaries	1,10,000	By Gross Profit	4,20,000
To Legal Charges	25,000	By Discount received	18,000
To Consultancy Fees	32,000		
To Audit Fees	1,000		
To Electricity Charges	17,000		
To Telephone, Postage &Telegrams	12,000		
To Stationery	27,000		

To Depreciation	65,000		
To Discount Allowed	19,000		
To Bad Debts	17,000		
To Interest	70,000		
To Net Profit (b/f)	43,000		
	4,38,000		4,38,000

Journal Proper in the Books of M/s. ABC Traders (Closing Entries)

Date 2022	Particulars		Amount ₹	Amount ₹
March 31	Profit & Loss Account	Dr.	3,95,000	
	To Salaries A/c			1,10,000
	To Legal Charges A/c			25,000
	To Consultancy Fees A/c			32,000
	To Audit Fees A/c			1,000
	To Electricity Charges A/c			17,000
	To Telephone, Postage & Telegrams A/c			12,000
	To Stationery A/c			27,000
	To Depreciation A/c			65,000
	To Discount Allowed A/c			19,000
	To Bad Debts A/c			17,000
	To Interest A/c			70,000
	(Being the transfer of balances of various expenses accounts)			
	Discount Received A/c	Dr.	18,000	
	To Profit & Loss A/c			18,000
	(Being the transfer of discount received account balance)			
	Gross Profit A/c	Dr.	4,20,000	

	To Profit & Loss A/c (Being the transfer of gross profit from Trading Account)			4,20,000
	Profit & Loss A/c To Net Profit A/c (Being the ascertainment of net profit)	Dr.	43,000	43,000
	Net Profit A/c To Capital A/c (Being the transfer of net profit to Capital A/c)	Dr.	43,000	43,000

Adjustments

The fundamental principle of accounting is that the period to which various items of income and expenditure pertain should be co-extensive with the period of account. As such before final accounts are drawn up, it must be ensured that the accounts which require adjustment on this consideration have been adjusted, both by providing for expense accrued and including income outstanding and excluding expenses the benefit of which extends beyond the year of account as well as the income received in advance. The entries that must be passed for adjusting various accounts of income and expenditure are shown below:

(1) Expenses accrued and accruing, e.g., Rent, Interest, Local Taxes, Wages etc.

Appropriate Expense Account Dr.

To Expenses Accrued/outstanding Account

For Example, if Rent Paid is ₹ 50,000 for a year and Outstanding Rent is ₹ 14,000. It will be treated as follows:-

Profit/Loss Account

Particulars		Amount ₹	Particulars	Amount ₹
To Rent paid	50,000			
Add: Outstanding Rent	14,000	64,000		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Outstanding Rent	14,000		

(2) Income accrued and accruing, e.g., Interest on Government Loans, Discounts on Bill, Professional fees, Rents and Premiums on leases, etc.

Interest/Fees etc. Accruing Account Dr.

To Appropriate Income Account

Suppose interest received is ₹ 1,50,000 and accrued interest for the same period is ₹ 45,000. It will be treated as follows:-

Profit/Loss Account

Particulars	Amount ₹	Particulars		Amount ₹
		By interest received	1,50,000	
		Add: Accrued Interest	45,000	1,95,000

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Accrued Interest	45,000

Notes:

(1) The term "accrued" signifies that an amount has been incurred as expense or earned as income, the due date of payment of which falls in the next accounting period. If the due date of payment occurs in the current accounting period the term used should be "outstanding" or "accrued and due".

(2) The expression accrued and accruing' signifies items which though not due for payment but pertain to the period of account, a provision for which has been made. Converse is the position so far as items of income are concerned.

(3) **Carrying forward income received in advance e.g.,** Subscription in the case of a club or fees in case of professional person.

Appropriate Income Account Dr.

To Income Received in Advance Account

For Example Subscription Received in advance is ₹ 70,000 and total subscription received is ₹ 1,75,000.

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
		By subscription received 1,75,000 *Less*: Advance (70,000)	1,05,000

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Advance Subscription	70,000		

(4) Carrying forward of payments made in advance e.g., Telephone, Rent, Insurance etc.,

Expenses Prepaid Account Dr.

To Appropriate Expenses Account

Suppose out of the total Rent of ₹ 50,000 paid, ₹ 14,000 pertains to the next year.

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Rent paid 50,000 *Less*: Prepaid Rent (14,000)	36,000		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Prepaid Rent	14,000

(5) **Adjustment of Inventory of materials in hand,** e.g., Stationery, Advertisement, Material, Manufacturing Stores, etc., the cost whereof already has been debited to expense account.

Inventory of Materials Dr.

To Appropriate Expenses Account

For Example, if opening stock of stationery is ₹ 15,000 and direct expenses on it is ₹ 1,700. It is also given outside the Trial Balance. Closing stock of stationery is ₹ 5,000. The treatment is as follow:-

Profit/Loss Account

Particulars		**Amount** ₹	**Particulars**	**Amount** ₹
To Stationery:				
Opening stock	15,000			
Add: Expenses	1,700			
Less: Closing Stock	(5,000)	11,700		

Balance Sheet

Liabilities	**Amount** ₹	**Assets**	**Amount** ₹
		Closing Stock	5,000

Note: Next year in the beginning entries No. (1) to (5) should be reversed.

(6) **Provision for Bad and doubtful Debts:** When it is feared that some of the amount due from customers will not be collected it is prudent to recognise the expected loss by reducing the current year's profit and placing the amount to the credit of a special account called "Provision for Bad and Doubtful Debts Account". The entry is;

Profit and Loss Account Dr.

To Provision for Bad and doubtful Debts Account

Note: The accounts of the customers concerned are not affected until the amount is actually written off for which the entry is,

Bad Debts Account Dr.

To Customer's A/c

Bad Debts when written off are debited to the provision in this respect where such a provision exists or directly to the Profit and Loss Account the corresponding credit being given (ultimately) to the trade receivable's account. If, on the other hand, a provision is required to be created, the amount of provision is also debited to the Profit and Loss Account. Where an examination problem requires that certain bad debts should be written off and a provision for doubtful debts made, the amount of bad debts to be written off should be first debited against the existing balance of the provision and the resulting balance in the account afterwards should be raised to the required figure. The method is illustrated below:

ILLUSTRATION 4

On 1st April 2021 provision for Doubtful Debts existed at ₹40,000. Trade receivables on 31.03.2021 were ₹15,00,000; bad debts totaled ₹1,00,000. It is required to write off the bad debts and create a provision equal to 5% of the Trade receivables' balances.

Show how you would compute the amount debited to the Profit and Loss Account.

SOLUTION

PARTICULARS	₹
Opening Provision (Cr.)	40,000
Bad Debts written off (Dr.)	1,00,000
Short Provision	60,000
Provision required (Dr.) (5% of ₹14,00,000)	70,000
Additional amount required for debit to the Profit and Loss Account (Dr.)	1,30,000

The account will appear as follows:

Provision for Doubtful Debts Account

		₹			₹
March 31, 2022	To Bad Debts	1,00,000	April 1, 2021	By Balance b/d	40,000
	To Balance c/d (required)	70,000	March 31, 2022	By Profit and Loss A/c (Balancing Figure)	1,30,000
		1,70,000			1,70,000
			April 1, 2022	By Balance b/d	70,000

(7) **Provision for Discount:** This provision is created in the same manner, discussed above but the amount of provision is required to be calculated after deducting the Provision for Bad Debts from the total trade receivables. This is because Provision for discount is created only on good debtors.

For Example, if Trade Receivables is ₹ 5,20,000 and provision for doubtful debt is ₹ 1,20,000. You are required to create a 10% provision for discount on debtors.

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Provision for Discount (10% of 4,00,000)	40,000		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Debtors 5,20,000 *Less*:- Provision for Doubtful debts (1,20,000) *Less*:- Provision for Discount (40,000)	3,60,000

(8) **Provision for Depreciation:** It is made either by debiting Depreciation Account and crediting the Provision for depreciation account concerned and afterwards closing of the Depreciation Account by transfer to the Profit and Loss Account or by directly debiting the profit and loss Account and crediting provision for depreciation account and explaining the nature of adjustment by recording a detailed narration in the Journal.

Profit/Loss account Dr.

To Depreciation/Provision for depreciation.

The amount of depreciation is deducted from the concerned asset and is then shown in the Balance sheet.

For Example if machinery Cost ₹ 15,00,000 and 10% depreciation is to be provided. The treatment is as follow:-

Depreciation a/c	Dr.	₹ 1,50,000	
To Provision for Depreciation a/c			₹ 1,50,000

Depreciation is now charged to P&L a/c as:

Profit/Loss account	Dr.	₹1,50,000	
To Depreciation			₹ 1,50,000

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Depreciation	1,50,000		

Balance Sheet

Liabilities	Amount ₹	Assets		Amount ₹
		Machinery	15,00,000	
		Less: Provision		
		for Depreciation	(1,50,000)	13,50,000

(9) **Other Provisions:** Whenever it is expected that a loss, the amount of which is not certain will occur, the proper course is to create a provision for meeting the loss if and when it occur. This would be the case, for example, if proprietor expects that compensation will be paid for the late delivery of goods. The entry is to debit the Profit and Loss Account and credit an account suitably named.

All accounts showing provisions may appear in the Balance Sheet on the liability side but it should be noted that:

(i) The provision for Bad and Doubtful Debts and the Provision for Discount on Trade receivables are deducted from the total book debts; and

(ii) The provision for Depreciation is deducted from the cost of the assets concerned.

(10) **Transfers, involving correction of errors,** are made by debit or credit to the accounts affected, the corresponding effect being recorded either in a Suspense Account of some other account.

Transfers in respect of special charges to the Profit and Loss Account e.g., partner's salaries, interest, etc., and in respect of appropriation of profits are recorded by debit to the Profit and Loss Account and credit to the parties concerned.

While making adjustments, it is important to remember that every entry has a two-fold aspect, debit and credit. For example, if an adjustment is required to be made on account of prepaid insurance charges, the Insurance Charges Account would be credited, and, to complete the double entry, Prepaid Expenses Account is debited with the same amount. The last mentioned balance would be included on the debit side of the Trial Balance.

Students should, as a matter of course, record on the rough working sheets, adjustments in respect of various items stated in a question and then give their effect in the Trial Balance, before proceeding to draw up the Final Accounts.

1.5 CERTAIN ADJUSTMENTS AND THEIR TREATMENTS

1. **Abnormal loss of Inventory by accident or fire:** Sometimes loss of goods occurs due to fire, theft, etc. If due to accident or fire, a portion of Inventory is damaged, the value of loss is first to be ascertained. Thereafter, Abnormal Loss Account is to be debited and Purchase Account or Trading Account is to be credited.

   Abnormal Loss Account is to be transferred to Profit & Loss Account. If amount of loss is recoverable from insurance company, then insurance company is to be debited instead of Profit & Loss Account. Till the money is not received from the insurance company, Insurance Company's Account will be shown in the Assets side of the Balance Sheet. If any part of the loss is recoverable from the insurance company, then the portion not compensated by the insurance company should be debited to Profit & Loss Account. For example, if goods worth ₹ 6,000 are destroyed by fire and the insurance company admits the claim for ₹ 4,500, the Journal entries will be:-

(i)	Loss by Fire Account	Dr.	6,000	
	To Purchases/Trading Account			6,000
(ii)	Insurance Company's A/c (Insurance Claim)	Dr.	4,500	
	Profit & Loss A/c	Dr.	1,500	
	To Loss by Fire A/c			6,000

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Loss by Fire (The amount not compensated by insurance company)	1,500		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Insurance Claim	4,500

In the Trading Account, Purchases will be reduced by 6,000.

2. **Goods sent on Approval basis:** Sometimes goods are sold to customers on sale or return basis or on approval basis. It should not be treated as actual sale till the time it is not approved by the customer. When goods were sold we have passed the entry for actual sales. Therefore, at the year end, if the goods are still lying with the customers for approval, following entries are to be passed:

For example -

Goods costing ₹10,000 sent to a customer on sale or return basis for ₹12,000. The entry for such unapproved sale shall be-

(i)	Sales A/c	Dr.	12,000	
	To Trade receivables A/c			12,000
(i)	Stock on approval A/c	Dr.	10,000	
	To Trading A/c			10,000

These goods should now be included in the amount of Closing Stock at their cost price.

3. **Goods used other than for sale:** Sometimes goods are used for some other purposes, such as distributed as free samples, used in construction of any assets or used by proprietor for personal use. In such cases the amount used for other purposes is subtracted from Purchases A/c and depending upon the specific use done, the suitable account head is debited.

For example:-

When goods are given away as donation-

Donation A/c	Dr.
To Purchases A/c	

When goods are used by the proprietor for his personal use-

Drawings A/c	Dr.
To Purchases A/c	

When goods are distributed as free samples :-

Free Samples / Advertisement A/c	Dr.
To Purchases A/c	

When goods are used in business for construction of Building or the Machinery :-

Building A/c / Plant & Machinery A/c	Dr.
To Purchases A/c	

When goods are used for maintenance of business premises/ Machinery: -

Repair & Maintenance A/c Dr.

To Purchases A/c

4. **Commission based on profit:** Sometimes commission is payable to manager based on net profit; in such a case calculation is done as follows:

(i) Commission on net profit **before** charging such commission =

$$\text{Profit before commission} \times \frac{\text{Rate of commission}}{100}$$

(ii) Commission on net profit **after** charging such commission =

$$\text{Profit before commission} \times \frac{\text{Rate of commission}}{100 + \text{Rate of commission}}$$

Commission is recorded by following journal entry

Commission A/c Dr.

To Commission Payable A/c

(Being commission payable to Mr ..... @ .....% on net profit after charging such commission, net profit before charging commission being ₹........)

Commission will be debited in the Profit & Loss Account and Commission Payable Account will be shown in the Balance Sheet on liability side.

Profit/Loss Account Dr.

To Commission A/c

For example if Net profit before Commission is ₹ 1,00,000 and Manager is entitled to a Commission of 10% of Net Profit before charging such commission. The amount of Commission is = ₹ 10,000 (10% of ₹ 1,00,000). It will be shown as follow:-

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Commission To Net Profit transferred to Capital A/c	10,000 90,000		

Balance Sheet

Liabilities	**Amount** ₹	**Assets**	**Amount** ₹
Commission Payable	10,000		

Now, let us assume that 10% commission is payable on Net Profit after charging such commission. The amount of commission now is = 9,090.90 or 9091 (approx) (₹ 1,00,000 x 10/110)

ILLUSTRATION 5

The following is the Trial Balance of C. Wanchoo on 31st March, 2022.

Trial Balance on 31st March , 2022

Particulars	₹	₹
Capital Account		*10,00,000*
Inventories as on 1st April,2021	*2,00,000*	
Cash in hand	*1,44,000*	
Machinery Account	*7,36,000*	
Purchases Account	*18,20,000*	
Wages Account	*10,00,000*	
Salaries Account	*10,00,000*	
Discount Allowed A/c	*50,000*	
Discount Received A/c		*30,000*
Sundry Office Expenses Account	*6,00,000*	
Sales Account		*50,00,000*
Sums owing by customer (Trade receivables)	*8,50,000*	
Trade payables (sums owing to suppliers)		*3,70,000*
Total	*64,00,000*	*64,00,000*

Value of Closing Inventory on 31st March, 2022 was ₹ 2,70,000

Prepare closing entries for the above items and Prepare Trading and Profit and Loss Account.

SOLUTION

Date	Particulars		₹	₹
2022				
March 31	Trading Account	Dr.	30,20,000	
	To Inventory Account			2,00,000
	To Purchase A/c			18,20,000
	To Wages A/c			10,00,000
	(Being the accounts in the Trial Balance which have to be transferred to the Trading Account debit side)			
March 31	Sales Account	Dr.	50,00,000	
	To Trading A/c			50,00,000
	(Being the amount of Sales transferred to the credit of Trading Account)			
March 31	Inventory (Closing) A/c	Dr.	2,70,000	
	To Trading A/c			2,70,000
	(Being the value of Inventory on hand on 31st March,2022)			
March 31	Trading A/c	Dr.	22,50,000	
	To Profit and Loss A/c			22,50,000
	(Being the transfer of gross profit.)			
March 31	Profit and Loss A/c	Dr.	16,50,000	
	To Discount Allowed Account			50,000
	To Salaries A/c			10,00,000
	To Sundry Office Expenses A/c			6,00,000
	(Being the various expense accounts transferred to the P & L Account)			
March 31	Discount Received A/c	Dr.	30,000	
	To P & L Account			30,000
	(Being the credit balance of discount received transferred to Profit and Loss A/c)			

March 31	Profit and Loss A/c Dr. To Capital A/c (Being the transfer to Net Profit to the Capital Account)	6,30,000	6,30,000
		1,28,50,000	1,28,50,000

C. WANCHOO

Trading Account of the year ended March 31, 2022

Particulars	₹	Particulars	₹
To Inventory A/c	2,00,000	By Sales A/c	50,00,000
To Purchases	18,20,000	By Inventory (Closing)	2,70,000
To Wages	10,00,000		
To Gross profit transfered to P & L A/c	22,50,000		
	52,70,000		52,70,000

Profit and Loss Account for the year ended March 31, 2022

Particulars	₹	Particulars	₹
To Salaries	10,00,000	By Gross profit transfered from	
To Discount Allowed	50,000	the Trading Account	22,50,000
To Sundry Office Expenses	6,00,000	By Discount Received	30,000
To Net Profit transferred to			
Capital A/c	6,30,000		
	22,80,000		22,80,000

1.6 BALANCE SHEET

The balance sheet may be defined as *"a statement which sets out the assets and liabilities of a firm or an institution as at a certain date."* Since even a single transaction will make a difference to some of the assets or liabilities, the balance sheet is true only at a particular point of time. That is the significance of the word "as at."

The assets are shown on the right hand side and liabilities and capital on the left hand side.

CHARACTERISTICS

The balance sheet has certain characteristics, which should be noted. These are the following:

(i) It is prepared at a particular date, rather the close of a day and not for a period. It is true only on that date and not later. Suppose, in the example given above, a part of the goods were sold on 1st April, 2021. This will mean that the value of the Inventory will be reduced, the cash in hand will increase and the capital account will be reduced or increased depending upon loss or profit on sale.

(ii) The balance sheet is prepared only after the preparation of the Profit and Loss Account. This is the reason why the Profit and Loss Account (including the Trading Account) and the Balance Sheet are together called Final Accounts (of course, the Balance Sheet is not an account, the two sides are not the debit and the credit sides.) Without being accompanied by the Profit and Loss Account, the Balance Sheet will not be able to throw adequate light on the financial position of the firm. For that purpose an appreciation of the profits of the firm is necessary.

(iii) Since capital always equals the difference between assets and liabilities and since the capital account will independently arrive at this figure, the two sides of the Balance Sheet must have the same totals. If it is not so, there is certainly an error somewhere.

In the illustration no. 5 worked out above it will be seen that the under mentioned accounts have not been closed even after preparation of the Profit and Loss Account and the transfer of the net profit to the capital account.

	₹	
Cash in Hand	1,44,000	Debit balance
Capital Accounts (₹ 10,00,000+ ₹ 6,30,000)	16,30,000	Credit balance
Machinery Account	7,36,000	Debit balance
Trade receivables	8,50,000	Debit balance
Trade payables	3,70,000	Credit balance
Inventories	2,70,000	Debit balance

Looking at these accounts, one would know that various assets: Cash balance in hand, cash at bank, machinery, furniture etc. that the firm possesses and the amounts that are owing as liability to trade payables and to the proprietor as capital. The capital, of course, will be the difference between the total of assets and of liabilities. The assets, liabilities and capital are usually presented in a statement called the Balance Sheet. This is given below for the accounts mentioned above.

C. WANCHOO

Balance Sheet as at March 31, 2022

Liabilities	Amount	Assets	Amount
	₹		₹
Trade payables	3,70,000	Cash in Hand	1,44,000
Capital	16,30,000	Trade receivables	8,50,000
		Inventories	2,70,000
		Machinery	7,36,000
	20,00,000		20,00,000

ARRANGEMENTS OF ASSETS AND LIABILITIES

(1) **Assets:** Assets may be grouped in one of the following two ways:

(i) **Liquidity:** Under this approach, the asset, which can be converted into cash first, is presented first. Those assets, which are most difficult in this respect, are presented at the bottom. As per Liquidity the balance sheet can be prepared as follow:-

Balance Sheet as at...

Liabilities	Amount	Assets	Amount
	₹		₹
Bills Payable		Cash in Hand	
Trade Creditors		Cash at Bank	
Loans		Government Securities	
Outstanding Expenses		Other Investments	
Reserves & Surplus		Bills Receivable	
Capital		Sundry Debtors	
		Stock	
		Furniture & Fixtures	
		Plant & Machinery	
		Land and Building	

(ii) **Permanence:** Assets, which are to be used, for long term in the business and are not meant to be sold are presented first. Assets, which are most liquid, such as cash in hand, are presented at the bottom.

Balance Sheet as at...

Liabilities	Amount	Assets	Amount
	₹		₹
Capital		Land and Building	
Reserves & Surplus		Plant & Machinery	
Outstanding Expenses		Furniture & Fixtures	
Loans		Stock	
Trade Creditors		Sundry Debtors	
Bills Payable		Bills Receivable	
		Other Investments	
		Government Securities	
		Cash at Bank	
		Cash in Hand	

Note:- Some of the assets may be capable of being sold easily like investment in government securities or shares of some companies. They should be treated as liquid or permanent according to the intention of the firm.

(2) **Liabilities:** Liabilities may also be shown according to the urgency with which payment has to be made. One way is to first show the capital, then long-term liabilities and last of all short term liabilities like amounts due to suppliers of goods or bills payable. The other way is to start with short-term liabilities and then show long term liabilities and last of all capital.

CLASSIFICATION OF ASSETS AND LIABILITIES

Assets are basically of following types:

Current Assets: - these assets are meant to be converted into cash as quickly as possible. Generally, within one year. For example:- Cash in hand, Cash at Bank, Trade receivables, Inventories.

Long Term Assets: - Those that are meant to be used by the firm over a long period and not sold the former type of assets is also called fixed assets. For example:- Machinery, Building, Long term Investment.

Intangible Assets: - the assets which have no physical existence and cannot be seen or touched are called as Intangible Assets. For example :- Patents, Copyrights etc.

It is desirable that in the balance sheet the two types of assets should be shown separately and prominently. This would give meaningful and logical information.

Liabilities to outsider will be of two types:

Current Liabilities: - this liability must be settled in one year or less. It is also called as short-term liability. For example: - Creditors, Bills Payable etc.

Long Term Liability: - those liabilities which exists for more than one year are Long term liabilities. For example long term loans from banks. Of course, it will include undistributed profits also.

Sole proprietors generally present Balance Sheet in a horizontal form with "Capital and Liabilities" on the left hand side and 'Assets' on the right-hand side. In the Balance Sheet the various items should be grouped suitably as indicated below:

Balance Sheet as on.............

Liabilities	**Amount**	**Assets**	**Amount**
	₹		₹
Capital A/c:		Tangible Fixed Assets :	
Balance		Land and Building	
Add : Net Profit/*Less*: Net Loss		Plant and Machinery	
Less : Drawings		Furniture and Fixture	
Long Term Loans :		Vehicles	
Term Loans		Intangibles :	
Other Loans		Goodwill	
Short Term Loans :		Patent Rights	
Cash Credit		Designs and Brand Names	
Overdrafts		Investments :	
Other Loans		Long term investments	
Current Liabilities :		Current Assets :	
Trade payables		Inventory in Trade	
Outstanding Expenses		Trade receivables	
Advances Taken		Short term investments	
Provision :		Prepayments	

Provision for Bad debts		Advances	
Provision for Retirement Benefits		Bank Balances	
Provision for Taxation		Cash In Hand	

In course, there is no hard and fast rule regarding presentation of assets, liabilities and equities in the Balance sheet. However, the model presentation shown above has been designed considering the nature of Balance Sheet elements and categorizing them appropriately.

Proper presentation of Balance Sheet items improves understandability of the information desired to be communicated to the users of account.

ILLUSTRATION 6

Given below Trial Balance of M/s Dayal Bros. as on 31st March, 2022 :

Particulars	***Debit Balances***	***Credit Balances***
	₹	₹
Capital A/c		*7,00,000*
Land and Building	*3,00,000*	
14% Term Loan		*4,00,000*
Loan from M/s. D & Co.		*4,60,000*
Trade receivables	*4,20,000*	
Cash in hand	*20,000*	
Inventories in Trade	*6,00,000*	
Furniture	*2,00,000*	
Trade payables		*40,000*
Advances to Suppliers	*1,00,000*	
Net Profit		*1,00,000*
Drawings	*60,000*	
	17,00,000	17,00,000

Required

Prepare Balance Sheet as on 31st March, 2022.

SOLUTION

In the Books of M/s Dayal Bros.

Balance Sheet as at 31st March, 2022

Liabilities		Amount	Assets	Amount
	₹	₹		₹
Capital: Balances	7,00,000		Land & Building	3,00,000
Add: Net Profit	1,00,000		Furniture	2,00,000
	8,00,000		Inventories in Trade	6,00,000
Less: Drawings	(60,000)	7,40,000	Trade receivables	4,20,000
14% Term Loan *(loan taken at year end)*		4,00,000	Advances to Suppliers	1,00,000
Loan from M/s D & Co.		4,60,000	Cash in Hand	20,000
Trade payables		40,000		
		16,40,000		16,40,000

ILLUSTRATION 7

The balance sheet of Thapar on 1st April, 2021 was as follows:

Liabilities	***Amount*** ₹	***Assets***	***Amount*** ₹
Trade payables	*15,00,000*	*Plant & Machinery*	*30,00,000*
Expenses Payable	*1,50,000*	*Furniture & Fixture*	*3,00,000*
Capital	*50,00,000*	*Trade receivables*	*14,00,000*
		Cash at Bank	*6,50,000*
		Inventories	*13,000,000*
	66,50,000		*66,50,000*

During 2021-22, his Profit and Loss Account revealed a net profit of ₹ 18,30,000. This was after allowing for the following :

(a) *Rent received from property let out ₹ 3,00,000.*

(b) *Depreciation on Plant and Machinery @ 10% and on Furniture and Fixtures @ 5%.*

(c) *A provision for Doubtful Debts @ 5% of the trade receivables as at 31st March, 2022.*

But while preparing the Profit and Loss Account he had forgotten to provide for (1) outstanding expenses totaling ₹ 1,80,000 and (2) prepaid insurance to the extent of ₹ 20,000.

His current assets and liabilities on 31st March, 2022 were: Inventories ₹ 14,50,000; Trade receivables ₹ 20,00,000; Cash at Bank ₹ 10,35,000 and Trade payables ₹ 11,40,000.

During the year he withdrew ₹ 6,00,000 for domestic use.

Required

Draw up his Balance Sheet at the end of the year.

SOLUTION

Profit and Loss Account (Revised)

Particulars	₹	Particulars	₹
To Outstanding expenses	1,80,000	By Balance b/d	18,30,000
To Net profit	16,70,000	By Prepaid insurance	20,000
	18,50,000		18,50,000

Balance Sheet of Thapar as at 31st March, 2022

Liabilities		₹	**Assets**	₹	₹
Capital	50,00,000		Cash at Bank		10,35,000
Add: Net Profit	16,70,000		Trade receivables	20,00,000	
	66,70,000		*Less:* Provision for		
			doubtful debts	(1,00,000)	19,00,000
Less : Drawings	(6,00,000)	60,70,000	Plant and Machinery	30,00,000	
Outstanding expenses		1,80,000	*Less:* Depreciation	(3,00,000)	27,00,000
Trade payables		11,40,000	Furniture & Fixtures	3,00,000	
			Less: Depreciation	(15,000)	2,85,000
			Inventories		14,50,000
			Prepaid insurance		20,000
		73,90 000			73,90,000

1.7 SEQUENCE OF ACCOUNTING PROCEDURE OR THE ACCOUNTING CYCLE

What has been done so far shows that the accounting process in the following order :

(i) recording the transactions in the journal or journalising;

(ii) preparing ledger accounts on the basis of the journal or posting into the ledger;

(iii) taking out the trial balance to check arithmetical accuracy;

(iv) preparing the trading and profit and loss account or the income statement for the period concerned; and

(v) preparing the balance sheet to show the financial position at the end of the period.

1.8 OPENING ENTRY

We have seen that on commencing a new business one debits the cash account and credits the capital account with the amount introduced. A firm closes the books of account at the end of each year and starts new books in the beginning of each year. The first entry in the journal is to record the closing balances of various assets and liabilities at the end of the previous year as the opening balances in the beginning of the new year. The balance sheet prepared at the end of the year records these balances and is the basis for this first entry. It is called the opening entry.

The assets shown in the balance sheet are debited and the liabilities and the capital account credited.

ILLUSTRATION 8

Balance Sheet as at 31st March, 2022

Liabilities	₹	***Assets***	₹
Mahendra & Sons	*5,60,000*	*Cash in hand*	*43,000*
Capital	*20,00,000*	*Cash at Bank*	*2,67,500*
		Trade receivables	*7,49,500*
		Closing Inventory	*9,00,000*
		Machinery and Equipment	*6,00,000*
	25,60,000		*25,60,000*

From the above given balance sheet prepare the relevant opening entry.

SOLUTION

The Opening Entry :01-04-2022

		Dr. ₹	Cr. ₹
Cash A/c	Dr.	43,000	
Bank A/c	Dr.	2,67,500	
Trade receivables	Dr.	7,49,500	
Inventory A/c	Dr.	9,00,000	
Machinery and Equipment A/c	Dr.	6,00,000	
To Mahendra & Sons A/c			5,60,000
To Capital A/c			20,00,000
(Being the balances brought forward)		25,60,000	25,60,000

Posting the Opening Entry

All the assets show debit balance. Such accounts are opened and the relevant amounts written on the debit side as "To Balance b/d". Following is the cash account arising from the entry given above.

Cash Account

Date 2022	Particulars	Amount ₹	Date	Particulars	Amount ₹
April 1	To Balance b/d	43,000			

Similarly account should be opened for all other assets and relevant amount should be posted on the Dr. side.

The accounts of liabilities show credit balances. An account for each liability is opened and the relevant account is written on the credit side as "By Balance b/d". This is shown below by opening the accounts of Mahendra & Sons mentioned in the entry given above.

Mahendra & Sons

Date	Particulars	Amount ₹	Date 2022	Particulars	Amount ₹
			April 1	To Balance b/d	5,60,000

By posting the opening entry completely all the accounts of assets and liabilities in the beginning are opened. We illustrate below a complete cycle of journalising, posting and trial balance.

Students should work through the following illustration given by way of practice on the method of making adjustments in some of the accounts contained in a Trial Balance and afterwards preparing the final Account.

ILLUSTRATION 9

Shri Mittal gives you the following Trial Balance and some other information:

Trial Balances as on 31st March, 2022

Particulars	**Dr. ₹**	**Cr. ₹**
Capital		*8,70,000*
Purchases and Sales	*6,05,000*	*12,10,000*
Opening Inventory	*72,000*	
Trade receivables and Trade payables	*90,000*	*1,70,000*
14% Bank Loan (loan taken at year end)		*2,00,000*
Overdrafts (overdraft taken at year end)		*1,12,000*
Salaries	*2,70,000*	
Advertisements	*1,10,000*	
Other expenses	*60,000*	
Returns	*40,000*	*30,000*
Furniture	*4,50,000*	
Building	*8,90,000*	
Cash in Hand	*2,000*	
Input CGST	*9,000*	
Input SGST	9,000	
Output IGST		*15,000*
	26,07, 000	*26,07,000*

Closing Inventory on 31st March, 2022 was valued at ₹ 1,00,000.

Required

Prepare final accounts of Shri Mittal for the year ended 31st March, 2022.

SOLUTION

In the books of Shri Mittal

Trading Account for the year ended 31st March, 2022

Particulars		Amount	Particulars		Amount
		₹			₹
To Opening inventory		72,000	By Sales	12,10,000	
To Purchases	6,05,000		*Less:* Returns	(40,000)	11,70,000
Less: Returns	(30,000)	5,75,000	By Closing inventory		1,00,000
To Gross Profit		6,23,000			
		12,70,000			12,70,000

Profit and Loss Account for the year ended 31st March, 2022

Particulars	Amount (₹)	Particulars	Amount (₹)
To Salaries	2,70,000	By Gross profit	6,23,000
To Advertisement	1,10,000		
To Other expenses	60,000		
To Net profit	1,83,000		
	6,23,000		6,23,000

Balance Sheet as at 31st March, 2022

Liabilities		Amount (₹)	Assets	Amount (₹)
Capital	8,70,000		Building	8,90,000
Add: Net profit	1,83,000	10,53,000	Furniture	4,50,000
14% Bank Loan		2,00,000	Trade receivables	90,000
Trade payables		1,70,000	Closing inventory	1,00,000
Overdrafts		1,12,000	Cash in hand	2,000
			Input SGST (W.N.)	3,000
		15,35,000		15,35,000

Note: As loan and overdraft taken at year end so no interest shown.

Working Note:

Output IGST liability is paid by utilizing Input CGST of ₹ 9,000 and Input SGST of ₹ 6,000. Thereafter, closing balance of Input SGST of ₹ 3,000 is reported in Balance Sheet.

ILLUSTRATION 10

Mr. Mohan gives you the following trial balance and some other information:

Trial Balance as on 31st March, 2022

Particulars	₹	₹
Capital		6,50,000
Sales		9,70,000
Purchases	4,30,000	
Opening Inventory	1,10,000	
Freights Inward	40,000	
Salaries	2,10,000	
Other Administration Expenses	1,50,000	
Furniture	3,50,000	
Trade receivables and Trade payables	2,10,000	1,90,000
Returns	20,000	12,000
Discounts	19,000	9,000
Bad Debts	5,000	
Investments in Government Securities	1,00,000	
Cash in Hand and Cash at Bank	1,89,000	
Input CGST	10,000	
Input SGST	10,000	
Output CGST		8,000
Output SGST		8,000
Output IGST		6,000
	18,53,000	18,53,000

Other Information:

(i) *Closing Inventory was ₹ 1,80,000;*

(ii) *Depreciate Furniture @ 10% p.a.*

Required

Prepare Trading and Profit and Loss Account for the year ended on 31.3.2022 and Balance Sheet of Mr. Mohan as on that date.

SOLUTION

In the books of Mr. Mohan
Trading Account for the year ended 31st March, 2022

Particulars		Amount	Particulars		Amount
		₹			₹
To Opening Inventory		1,10,000	By Sales	9,70,000	
To Purchases	4,30,000		*Less:* Returns	(20,000)	9,50,000
Less: Returns	(12,000)	4,18,000	By Closing Inventory		1,80,000
To Freight Inwards		40,000			
To Gross profit		5,62,000			
		11,30,000			11,30,000

Profit and Loss Account for the year ended 31st March, 2022

Particulars	₹	Particulars	₹
To Depreciation	35,000	By Gross profit	5,62,000
To Salaries	2,10,000	By Discount received	9,000
To Administration expenses	1,50,000		
To Discount allowed	19,000		
To Bad debts	5,000		
To Net profit	1,52,000		
	5,71,000		5,71,000

Balance Sheet as at 31st March, 2022

Liabilities		Amount ₹	Assets		Amount ₹
Capital	6,50,000		Furniture	3,50,000	
Add: Net profit	1,52,000	8,02,000	*Less:* Depreciation	(35,000)	3,15,000
Trade payables		1,90,000	Closing Inventory		1,80,000
Output IGST		2,000	Trade receivables		2,10,000

			Investment in Govt Securities		1,00,000
			Cash in Hand and Cash at Bank		1,89,000
		9,94,000			9,94,000

Working Note:

Summary of Output and Input GST liability (as per Trial Balance)

	OUTPUT GST (₹)	INPUT GST (₹)
IGST	6,000	
CGST	8,000	10,000
SGST	8,000	10,000

Output liability (Tax head)	Tax Payable	Paid through ITC			Tax paid in cash
		IGST	CGST	SGST	
IGST	6,000		2,000	2,000	2,000
CGST	8,000		8,000		
SGST	8,000			8,000	

In the above solution, it is assumed that balance IGST liability of ₹ 2,000 (after utilising CGST and SGST) is not paid off in cash.

Alternatively, students may assume that the balance liability of ₹ 2,000 is paid off in cash. Accordingly, Output IGST liability of ₹ 2,000 shall not appear under liability side of the balance sheet and amount of cash at bank is reported as ₹ 1,87,000

ILLUSTRATION 11

The Balance Sheet of Mr. Popatlal, a merchant on 31st March, 2022 stood as below:

Liabilities	***Amount***	***Assets***		***Amount***
	₹			₹
Capital	*2,40,000*	*Fixed Assets*		*1,25,600*
Trade payables	*1,64,000*	*Inventories*		*2,06,400*

Bank Overdraft	*1,46,000*	*Trade receivables*	*1,88,000*	
		Less: Provision	*(6,200)*	*1,81,800*
		Cash		*36,200*
	5,50,000			*5,50,000*

Required

Show opening journal entry on 1st April, 2022 in the books of Mr. Popatlal.

SOLUTION

Opening entry

			(Dr.) ₹	(Cr.) ₹
1.4.2022	Fixed Assets A/c	Dr.	1,25,600	
	Inventories A/c	Dr.	2,06,400	
	Trade receivables A/c	Dr.	1,88,000	
	Cash A/c	Dr.	36,200	
	To Trade payables A/c			1,64,000
	To Bank Overdraft A/c			1,46,000
	To Provision for Doubtful Debts A/c			6,200
	To Capital A/c			2,40,000

ILLUSTRATION 12

The following is the schedule of balances as on 31.3.22 extracted from the books of Shri Gavaskar, who carries on business under the same name and style of Messrs Gavaskar Viswanath & Co., at Mumbai:

Particulars	**Dr.**	**Cr.**
	₹	₹
Cash in hand	*14,000*	
Cash at bank	*26,000*	
Sundry Debtors	*8,60,000*	
Stock on 1.4.2021	*6,20,000*	
Furniture & fixtures	*2,14,000*	

Office equipment	*1,60,000*	
Buildings	*6,00,000*	
Motor Car	*2,00,000*	
Sundry Creditors		*4,30,000*
Loan from Viswanath		*3,00,000*
Provision for bad debts		*30,000*
Purchases	*14,00,000*	
Purchase Returns		*26,000*
Sales		*23,00,000*
Sales Returns	*42,000*	
Salaries	*1,10,000*	
Rent for Godown	*55,000*	
Interest on loan from Viswanath	*27,000*	
Rates & Taxes	*21,000*	
Discount allowed to Debtors	*24,000*	
Discount received from Creditors		*16,000*
Freight on purchases	*12,000*	
Carriage Outwards	*20,000*	
Drawings	*1,20,000*	
Printing and Stationery	*18,000*	
Electricity Charges	*22,000*	
Insurance Premium	*55,000*	
General office expenses	*30,000*	
Bad Debts	*20,000*	
Bank charges	*16,000*	
Motor car expenses	*36,000*	
Capital A/c		*16,20,000*
TOTAL	*47,22,000*	*47,22,000*

Prepare Trading and Profit and Loss Account for the year ended 31st March, 2022 and the Balance Sheet as at that date after making provision for the following:

1. *Depreciate: (a) Building used for business by 5 percent; (b) Furniture and fixtures by 10 percent; One steel table purchased during the year for ₹ 14,000 was sold for same price but the sale proceeds were wrongly credited to Sales Account; (c) Office equipment by 15 percent; Purchase of a typewriter during the year for ₹ 40,000 has been wrongly debited to purchase; and (d) Motor car by 20%.*
2. *Value of stock at the close of the year was ₹ 4,40,000.*
3. *Two month's rent for godown is outstanding.*
4. *Interest on loan from Viswanath is payable at 12 percent per annum, this loan was taken on 1.5.2021.*
5. *Provision for bad debts is to be maintained at 5 percent of Sundry Debtors.*
6. *Insurance premium includes ₹ 40,000 paid towards proprietor's life insurance policy and the balance of the insurance charges cover the period from 1.4.2021 to 30.6.2022.*

SOLUTION

M/s Gavaskar Viswanath & Co.

Trading for the year ended 31st March, 2022

Particulars	Details	Amount ₹	Particulars	Details	Amount ₹
To opening Stock		6,20,000	By Sales	23,00,000	
To Purchases	14,00,000		*Less*: Sale of furniture included in sale	14,000	
Less: Typewriter included in purchases	40,000		*Less*: Sales Returns	42,000	22,44,000
Less: Purchase Returns	26,000	13,34,000	By Closing Stock		4,40,000
To Freight on purchase		12,000			
To Gross Profit c/d		7,18,000			
		26,84,000			26,84,000

M/s Gavaskar Viswanath & Co.

Profit/Loss Account for the year ended 31st March, 2022

Particular	Details	Amount ₹	Particular	Details	Amount ₹
To Salaries		1,10,000	By Gross profit b/d		7,18,000
To Rent for Godown	55,000				

Add: Outstanding	11,000	66,000	By Discount received		16,000
To provision for doubtful debts(4)		33,000			
To Rent and Taxes		21,000			
To Discount Allowed		24,000			
To Carriage outwards		20,000			
To printing and stationery		18,000			
To Electricity charges		22,000			
To Insurance premium (1)		12,000			
To Depreciation (2)		1,20,000			
To general office expenses		30,000			
To Bank Charges		16,000			
To interest on loan	27,000				
Add: Outstanding (3)	6,000	33,000			
To Motor car expenses		36,000			
To Net Profit transferred to Capital a/c		1,73,000			
		7,34,000			7,34,000

Balance Sheet of M/s Gavaskar Vishwanath & Co.

as at 31st March, 2022

Liabilities	Details	Amount ₹	Assets	Details	Amount ₹
Capital	16,20,000		Building	6,00,000	
Add: Net Profit	1,73,000		*Less*: Dep.	(30,000)	5,70,000
Less: Drawings	(1,20,000)				
Less: Insurance Premium	(40,000)	16,33,000	Motor Car	2,00,000	
			Less: Dep.	(40,000)	1,60,000
Loan from Vishwanath	3,00,000				
Add: Outstanding	6,000	3,06,000	Office equipment	2,00,000	
			Less: Dep.	(30,000)	1,70,000
Sundry Creditors		4,30,000			
Outstanding rent		11,000	Furniture & Fixture	2,00,000	

			Less: Dep.	(20,000)	1,80,000
			Stock in Trade		4,40,000
			Sundry Debtors	8,60,000	
			Less: Provision for doubtful debts	(43,000)	8,17,000
			Cash at hand		26,000
			Cash in bank		14,000
			Prepaid insurance (1)		3,000
		23,80,000			23,80,000

Working Notes :

(1) Insurance premium

	₹
Insurance premium as given in trial balance	55,000
Less: Personal premium	(40,000)
Less: Prepaid for 3 months $\left(\frac{15,000}{15} \times 3\right)$	(3,000)
Transfer to Profit & Loss a/c	12,000

(2) Depreciation

Building @ 5% on 6,00,000	30,000
Motor Car @ 20% on 2,00,000	40,000
Furniture & Fittings @ 10% on 2,00,000(2,14,000-14,000)	20,000
Office Equipment @ 15% on 2,00,000 (1,60,000 + 40,000)	30,000
Total	1,20,000

(3) Interest on Loan

Interest on Loan (3,00,000 x 12% x 11/12)	33,000
Less : Interest as per Trial Balance	(27,000)
Profit &Loss account (Outstanding)	6,000

(4) **Provision for bad debts a/c**

Particulars	Amount ₹	Particulars	Amount ₹
To bad debts a/c	20,000	By balance b/d	30,000
To balance c/d	43,000	By P&L a/c	33,000
	63,000		63,000

(5) Purchase of a typewriter during the year for ₹ 40,000 which was wrongly debited to purchase added to office equipment.

1.9 PROVISIONS AND RESERVES

Provision means "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy". *A provision is a liability which can be measured only by using a substantial degree of estimation.*

Thus, a provision may be either in respect of loss in the value of an asset provided or written off on the basis of an estimate or the one in respect of a liability for expenses incurred in respect of a claim which is disputed i.e. when it is a contingent liability. On the occurrence of a diminution in asset values due to some of them having become irrecoverable or Inventory items are lost as a result of some natural calamity, amounts contributed or transferred from profit to make good the diminution also are described as provision.

The following are instances of amount retained in the business out of earning for different purposes that are described as provisions.

(1) Amount provided for meeting claims which are admissible in principle, but the amount whereof has not been ascertained.

(2) An appropriation made for payment of taxes still to be assessed.

(3) Amount set aside for writing off bad debts or payment of discounts.

The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability is known as reserves. The reserves are primarily of two types: capital reserves and revenue reserves. Also provisions in excess of the amount considered necessary for the purposes these were originally made, are to be considered as reserves. ***It is thus evident that provisions are a charge against profits, while reserve is an appropriation of profits.*** Also provisions that ultimately prove to be in excess of amounts required or have been made too liberally are reserves. Such a distinction is essential for disclosing truly in the Balance Sheet the amount by which the equity of shareholders has increased with the accumulation of undistributed profits.

Reserve Fund: It signifies the amount standing to the credit of the reserve that is invested outside the business in securities which are readily realisable e.g., when the amounts set apart for replacement of an asset are invested periodically, in government securities or shares. The account to which these amounts are annually credited is described as the Reserve Fund.

ILLUSTRATION 13

Crimpson traders profit and loss account for the year ended 31st March, 2022 includes the following information:

		₹
(i)	*Depreciation*	*57,500*
(ii)	*Bad debts written off*	*21,000*
(iii)	*Increase in provision for doubtful debts*	*18,000*
(iv)	*Retained profit for the year*	*20,000*
(v)	*Liability for tax*	*4,000*

Required

State which one of the items (i) to (vi) above are – (a) transfer to provisions; (b) transfer to reserves; and (c) neither related to provisions nor reserves.

SOLUTION

(a) Transfer to provisions - (i), (iii) (v)

(b) Transfer to reserves - (iv)

(c) Neither related to provisions nor reserves - (ii),.

A summary of all adjustments are as follows:

Adjustment	If Given in Trial Balance	If Not Given in Trial Balance
1. Closing stock	Balance Sheet – Asset Side	(a) Trading A/c – Credit Side (b) Balance Sheet – Asset Side
2. Outstanding Expenses	Balance Sheet – Liability Side	(a) Trading/Profit & Loss A/c Debit Side. Add to the concerned expenses.

		(b) Balance Sheet – Liability Side
3. Prepaid Expenses	Balance Sheet – Asset Side	(a) Trading/Profit & Loss A/c Debit Side. Deduct from the concerned expense.
		(b) Balance Sheet - Asset
4. Income Outstanding	Balance Sheet – Asset Side	(a) Profit & Loss A/c – Credit Side. Add to the concerned income.
		(b) Balance Sheet – Asset Side.
5. Incomes Received in Advance	Balance Sheet – Liability Side	(a) Profit & Loss A/c – Credit Side. Deduct from concerned income.
		(b) Balance Sheet – Liability Side
6. Bad Debts	Profit & Loss A/c – Debit Side	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Asset Side. Deduct from debtors .
7. Provision for Bad or Doubtful debts	Profit & Loss A/c – Debit Side	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Asset Side. Deduct from Debtors after additional bad debts, if any.
8. Provision for Discount on Debtors	Balance Sheet – Asset Side Deduct from Debtors.	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Asset Side. Deduct from debtors after providing for provision for bad debts
9. Depreciation	Profit & Loss A/c – Debit Side	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Asset Side. Deduct from Respective Asset.
10. Interest on Capital	Profit & Loss A/c – Debit Side	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Liability Side. Add to Capital.
11. Interest on Drawings	Profit & Loss A/c – Credit Side	(a) Profit & Loss A/c – Credit Side.
		(b) Balance Sheet – Liability Side. Deduct from Capital.

12. Loss by Fire	Profit & Loss A/c – Debit Side	(a) Trading A/c – Credit Side (with full amount of loss)
		(b) Profit & Loss A/c – Debit Side (Actual loss, if any) [adjusted with insurance claim if any]
		(c) Balance Sheet – Asset Side (with insurance claim admitted by Insurance Co.)
13. Goods withdrawn for personal use	Trading A/c - Credit Side	(a) Trading A/c – Credit Side or Deduct from Purchases.
		(b) Balance Sheet – Liability Side (Deduct from Capital as Drawings)
14. Goods Distributed as free Samples	Profit & Loss A/c – Debit Side	(a) Trading A/c – Credit Side or Deduct from Purchases
		(b) Profit & Loss A/c – Debit Side
15. Sale of Goods on Approval Basis, approval not yet received	Usually it is not given in Trial Balance	(a) Trading A/c – Credit Side. Deduct from Sales the selling price of goods sold and add to stock at cost price.
		(b) Balance Sheet – Asset Side. Deduct from Debtors the selling price of such sales and show the cost price of such sales along with closing stock.

1.10 LIMITATIONS OF FINANCIAL STATEMENTS

Financial statements suffer from a number of limitations. These must, therefore, be studied with care, in order that correct inferences may be drawn. The limitations are less serious if the objective is only to appraise the performance of a single company over a period of year Where, however, a comparison of the working of different companies for the same period is to be made. It can be misleading unless the companies concerned have followed the same system and basis of accounting. On the account, a comparison of the performancey of different industries on the basis of financial statements, should be undertaken only if it is not practicable to make such a comparison on any other basis.

The principal limitations affecting financial statements are the following:

(a) **Historical Cost:** Accounting records and, on that account, the financial statements are prepared only on the basis of the money value prevailing at the time the transaction were entered into. Thus, the effect of subsequent changes in the value of money is not taken into account. At times this has the effect of making the statements of account quite misleading. Take the obvious example of a house built in 1980, say at the cost of ₹15,000, in 2022 the benefit receivable from its occupation will be as much as that of a house created in 2022, say at a cost of ₹30,00,000. If the house were included in the financial statements at its original cost, as normally it would not convey a true picture except to a knowledgeable person.

The limitations can be serious in the case of other fixed assets that have been working over a long period over which prices have changed radically. It is, however, not easy to get over this difficulty, since revaluation of fixed assets, apart from being costly is not practicable when the value of money is continuously falling. On this account, historical cost continues to be the accepted basis for the preparation of financial statements. Though it may not be possible to do much to remove the limitation mentioned above, one must always remember to read the balance sheet and the profit and loss account in the light of what they cannot reveal as well as what they do.

(b) **Intangible strengths and weaknesses:** A company may have a number of strengths and weaknesses which cannot be shown in the balance sheet e.g., the loyalty and calibre of its staff. These must be kept in mind while judging the financial position of the company.

(c) **Perpetual continuity and periodical account:** Financial statements ordinarily are drawn up at the end of each year but the accounting record is maintained on the assumption that the business undertaking shall continue to exist forever on the basis of going concern assumption. In consequence, much of the expenditure other than revenue expenditure has to be distributed arbitrarily over a number of years during which benefit of the expenditure is expected to arise. As a result, financial statements of account are not absolutely correct.

(d) **Different accounting policies:** It is permissible for a company within certain limits to adopt different policies for the preparation of accounts, valuation of various assets and distribution of expenditure over different periods of account. For example, a company may decide to provide annually for payment of pensions and gratuities to staff and thus build up a 'fund' out of which payments will be made ultimately whereas another company may deal with these only when actual payments are made. Similarly, a company may decide whether or not to include intangible assets amongst its assets or manner in which the amounts thereof should be written off.

(e) **Management policies:** Management can have different accounting policies for welfare of the staff and public at large.

SUMMARY

- Non-manufacturing entities are the trading entities, which are engaged in the purchase and sale of goods at profit without changing the form of the goods.
- For accounting, profit is measured at two levels:

  (a) Gross Profit

  (b) Net Profit
- The principal function of final statements of account (Trading Account, Profit and Loss Account and the Balance Sheet) is to exhibit truly and fairly the profitability and the financial position of the business to which they relate. In order that these may be properly drawn up, it is essential that a proper record of transactions entered into by the business during a particular accounting period should be maintained.
- At the end of the year, it is necessary to ascertain the net profit or the net loss. For this purpose, it is first necessary to know the gross profit or gross loss. Gross Profit is the difference between the selling price and the cost of the goods sold. For a trading firm, the cost of goods sold can be ascertained by adjusting the cost of goods still on hand at the end of the year against the purchases.

TEST YOUR KNOWLEDGE

True and False

1. *The income statement shows either net profit or net loss for a particular period.*
2. *Gains from the sale or exchange of assets are not considered as the revenue of the business.*
3. *The salary paid in advance is not an expense because it neither reduces assets or nor increase liabilities.*
4. *A loss is an expenditure which does not bring any benefit to the concern.*
5. *All liabilities which become due for payment within the year are classified as long-term liabilities.*
6. *The term current asset is used to designate cash and other assets or resources which are reasonably expected to be realized or sold or consumed within one year.*
7. *An asset gives rise to expenditure when it is acquired and to an expense when it is consumed.*

8. *If the balance of an account on the debit side of the trial balance where the benefit has already expired then it is treated as an expense.*

9. *Sales less cost of goods sold = gross profit.*

10. *If the debit side of the trading account exceeds its credit side then the balance is termed as gross profit.*

11. *The provision for bad debts is debited to Sundry Debtors Account.*

12. *The provision for discount on creditors is often not provided in keeping with the principle of conservatism.*

13. *The debts written off as bad, if recovered subsequently are credited to Debtors Account.*

14. *The adjustment entry in respect of income received in advance is debit Income received in advance account and credit income account.*

15. *Premium paid on the life policy of a proprietor is debited to profit and loss account.*

16. *Depreciation account appear in the trial balance is taken only to profit and loss account.*

17. *Personal purchases included in the purchases day book are added to the sales account in the Trading account.*

18. *Medicines given to the office staff by a manufacturer of medicines will be debited to salaries account.*

19. *Goods worth ₹ 600 taken by the proprietor for personal use should be credited to Capital Account.*

20. *If Closing Stock appears in the Trial Balance, the Closing inventory is then not entered in Trading Account. It is only shown in the Balance Sheet.*

Multiple Choice Questions

(1) *A debit to an account may*

(a) *increase expense*

(b) *decrease an asset.*

(c) *increase a liability.*

(2) *Prepayment of insurance premium will appear in the Balance Sheet and in the Insurance Account respectively as:*

(a) *a liability and a debit balance.*

(b) *an asset and a debit balance.*

(c) *an asset and a credit balance.*

(3) *Gross profit is the difference between:*

(a) *sales and purchases*

(b) *sales and cost of sales.*

(c) *sales and total expenses.*

(4) *Payment made to a creditor subject to cash discount will :*

(a) *reduce a liability, reduce an asset and add to expenses.*

(b) *reduce a liability, add to an asset, and add to revenue.*

(c) *reduce an asset, reduce a liability, and add to revenue.*

(5) *A customer returns goods already charged to him. We should:*

(a) *debit his account.*

(b) *credit his account.*

(c) *make no entry on his account.*

(6) *Capital is the difference between*

(a) *Income and expenses*

(b) *Sales and Cost of goods sold*

(c) *Assets and liabilities*

(7) *The capital of a sole trader would change as a result of:*

(a) *A creditor being paid his account by cheque.*

(b) *Raw materials being purchased on credit.*

(c) *Wages being paid in cash.*

(8) *A decrease in the provision for doubtful debts would result in:*

(a) *An increase in liabilities.*

(b) *A decrease in working capital.*

(c) *An increase in net profit.*

(9) *A Company wishes to earn a 20% profit margin on selling price. Which of the following is the profit mark up on cost, which will achieve the required profit margin?*

(a) *33%*

(b) 25%

(c) 20%

(10) *If sales is ₹ 2,000 and the rate of gross profit on cost of goods sold is 25%, then the cost of goods sold will be*

(a) ₹ 2,000.

(b) ₹ 1,500.

(c) ₹ 1,600.

(11) *Sales for the year ended 31st March, 2022 amounted to ₹ 10,00,000. Sales included goods sold to Mr. A for ₹ 50,000 at a profit of 20% on cost. Such goods are still lying in the godown at the buyer's risk. Therefore, such goods should be treated as part of*

(a) Sales.

(b) Closing Inventory.

(c) Goods in transit.

(12) *If sales revenues are ₹ 4,00,000; cost of goods sold is ₹ 3,10,000 and expenses are ₹ 60,000, the gross profit is*

(a) ₹ 30,000.

(b) ₹ 90,000.

(c) ₹ 3,40,000.

Theoretical questions

1. *Write shorts notes on:*

   (a) Balance sheet.

   (b) Trading account

   (c) Closing entries

2. *Distinguish between Provision and reserve fund.*

Practical questions

1. *From the following particulars extracted from the books of Ganguli, prepare trading and profit and loss account and balance sheet as at 31st March, 2022 after making the necessary adjustments:*

	₹		₹
Ganguli's capital account (Cr.) as on 1.4.2021	*5,40,500*	*Interest received*	*7,250*
Stock on 1.4.2021	*2,34,000*	*Cash with Traders Bank Ltd.*	*40,000*
Sales	*14,48,000*	*Discounts received*	*14,950*
Sales return	*43,000*	*Investments (at 5%) as on 1.4.2021*	*25,000*
Purchases	*12,15,500*	*Furniture as on 1-4-2021*	*9,000*
Purchases return	*29,000*	*Discounts allowed*	*37,700*
Carriage inwards	*93,000*	*General expenses*	*19,600*
Rent	*28,500*	*Audit fees*	*3,500*
Salaries	*46,500*	*Fire insurance premium*	*3,000*
Sundry debtors	*1,20,000*	*Travelling expenses*	*11,650*
Sundry creditors	*74,000*	*Postage and telegrams*	*4,350*
Loan from Dena Bank Ltd. (at 12%)	*1,00,000*	*Cash in hand*	*1,900*
Interest paid	*4,500*	*Deposits at 10% as on 1-4-2021 (Dr.)*	*1,50,000*
Printing and stationery	*17,000*	*Drawings*	*50,000*
Advertisement	*56,000*		

Adjustments:

(1) *Value of stock as on 31st March, 2022 is ₹ 3,93,000. This includes goods returned by customers on 31st March, 2022 to the value of ₹ 15,000 for which no entry has been passed in the books.*

(2) *Purchases include furniture purchased on 1st January, 2022 for ₹10,000.*

(3) *Depreciation should be provided on furniture at 10% per annum.*

(4) *The loan account from Dena bank in the books of Ganguli appears as follows:*

		₹			₹
31.3.2022	*To Balance c/d*	*1,00,000*	*1.4.2021*	*By Balance b/d*	*50,000*
			31.3.2022	*By Bank*	*50,000*
		1,00,000			*1,00,000*

(5) *Sundry debtors include ₹ 20,000 due from Robert and sundry creditors include ₹ 10,000 due to him.*

(6) *Interest paid include ₹ 3,000 paid to Dena bank.*

(7) *Interest received represents ₹ 1,000 from the sundry debtors (due to delay on their part) and the balance on investments and deposits.*

(8) *Provide for interest payable to Dena bank and for interest receivable on investments and deposits.*

(9) *Make provision for doubtful debts at 5% on the balance under sundry debtors. No such provision need to be made for the deposits.*

2. *Sengupta & Co. employs a team of eight workers who were paid ₹30,000 per month each in the year ending 31st March, 2021. At the start of financial year 2021-2022, the company raised salaries by 10% to ₹33,000 per month each.*

On October 1, 2021 the company hired two trainees at salary of ₹21,000 per month each. The work force are paid salary on the first working day of every month, one month in arrears, so that the employees receive their salary for January on the first working day of February etc.

You are required to calculate:

(i) *Amount of salaries which would be charged to the profit and loss for the year ended 31st March, 2022.*

(ii) *Amount actually paid as salaries during 2021-22*

(iii) *Outstanding Salaries as on 31st March, 2022.*

3. *You are required, prepare a Trading and Profit and Loss Account for the year ending 31st March, 2022 and a Balance Sheet as on that date from the Trial Balance given below:*

Particulars	**₹**	***Particulars***	**₹**
Debit Balance:			
Trade receivables	*3,50,000*	*Salaries*	*2,20,000*
Inventory 1st April, 2021	*5,00,000*	*Purchases*	*12,50,00*
Cash in Hand	*5,60,000*	*Plant and Machinery*	*15,70,000*
Wages	*3,00,000*	*Credit Balance:*	
Bad Debts	*50,000*	*Capital*	*25,00,000*
Furniture and Fixtures	*1,50,000*	*Trade payables*	*9,00,000*
Depreciation	*1,50,000*	*Sales*	*17,00,000*

On 31st March, 2022 the Inventory was valued at ₹10,00,000.

4. *Mr. Kotriwal is engaged in business of selling magazines. Several of his customers pay money in advance for subscribing his magazines. Information related to year ended 31st March 2022 has been given below:*

On 1.4.2021 he had a balance of ₹ 2,00,000 advance from customers of which ₹ 1,50,000 is related to year 2021-22 while remaining pertains to year 2022-23. During the year 2021-22 he made cash sales of ₹ 5,00,000. You are required to compute:

(i) *Total income for the year 2021-22.*

(ii) *Total money received during the year if the closing balance in advance from customers account is ₹ 1,70,000.*

5. *Mr. Birla is a proprietor engaged in business of trading electronics. An excerpt from his Trading & P&L account is as follows:*

Trading and P&L A/c for the year ended 31st March, 2022

Particulars	₹	**Particulars**	₹
To Cost of Goods Sold	45,00,000	By Sales	C
To Gross Profit c/d	D		
	E		E
To Rent A/c	26,00,000	By Gross Profit b/d	D
To Office Expenses	13,00,000	By Miscellaneous Income	E
To Selling Expenses	B		
To Commission to Manager (on Net Profit before charging such commission)	2,00,000		
To Net Profit	A		
	G		60,00,000

Commission is charged at the rate of 10%.

Selling Expenses amount to 1% of total sales.

You are required to compute the missing figures.

ANSWERS/HINTS

True and False

1. True: Profit and loss account shows either net profit or net loss for a particular period.
2. False: Gains from the sale or exchange of assets are considered as the revenue of the business. But this revenue not in the ordinary course of business so it is capital receipts.
3. True: The salary paid in advance is an asset it is not an expense because it neither reduces assets or nor increase liabilities.
4. True: A loss is an expenditure of the business which does not bring any gain to the business.
5. False: All liabilities which become due for payment within one year are classified as current liabilities.
6. True: Current assets are all the assets which are expected to be realized or sold or consumed within one year.
7. True: When an asset is purchase capital expenditure is incurred and when the asset is put to use expenses are incurred in consumption.
8. True: Debit balance of accounts are treated as expenses whose benefit is already received or expired.
9. True: Gross profit is obtained by deducting cost of goods sold from sales.
10. False: If the debit side of the trading account exceeds its credit side then the balance is termed as gross loss.
11. False: The provision for bad debts is debited to debited to Profit and loss Account, in Balance Sheet it is shown either on liability side or deducted from the head Debtors.
12. True: According to the provision of conservatism provision is maintained for the losses to be incurred in future. Discount on creditors is an income so provision in not maintained.
13. False: The debts written off as bad, if recovered subsequently are credited to Bad Debts Recovered Account and becomes an income.
14. False: Income received in advance is reduces it from the concerned income in profit and loss account. And, it is shows it as a liability in the current balance sheet under the head Current Liabilities.
15. False: Premium paid on the life policy of a proprietor is to be debited to capital account, as it is personal expense.

16. True: Depreciation is charge on each of the asset on a certain percentage. Depreciation is a charge to profit and loss account and should be debited to profit & loss account by crediting the respective assets. If it appears in trial balance then it is taken only to profit and loss account.

17. False: Personal purchases included in the purchases day book are deducted from the purchases account in the Trading account.

18. True: Any benefit given to the staff is debited to the salary account.

19. False: Goods taken by the proprietor for personal use should be credited to Purchase Account as less goods are left in the business for sale.

20. True: The closing Stock appears in the trial balance only when it is adjusted against purchases by passing the entry. In this case, closing stock is not entered in Trading Account and is shown only in Balance Sheet.

Multiple Choice Questions

1.	**(a)**	**2.**	**(c)**	3.	**(b)**	4.	**(c)**	5.	**(b)**	6.	**(c)**
7.	**(c)**	**8.**	**(c)**	9.	**(b)**	10.	**(c)**	11.	**(a)**	12.	**(b)**

Theoretical Questions

1. (a) The balance sheet may be defined as "a statement which sets out the assets and liabilities of a firm or an institution as at a certain date." Since even a single transaction will make a difference to some of the assets or liabilities, the balance sheet is true only at a particular point of time. That is the significance of the word "as at."

(b) At the end of the year, it is necessary to ascertain the net profit or the net loss. For this purpose, it is first necessary to know the gross profit or gross loss with the helps to Trading A/c. Gross Profit is the difference between the selling price and the cost of the goods sold.

(c) Closing entries: The entries that have to be made in the journal for preparing the Trading and the Profit and Loss Account that is for transferring the various accounts to these two accounts are known as closing entries.

2. Provision means "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy".

Reserve Fund: It signifies the amount standing to the credit of the reserve that is invested outside the business in securities which are readily realisable e.g., when the amounts set apart for replacement of an asset are invested periodically, in government securities or shares. The account to which these amounts are annually credited is described as the Reserve Fund.

Practical Questions

1. **In the books of Ganguli**

Trading and Profit & Loss Account for the year ended 31st March,2022

	₹	₹		₹	₹
To Opening stock		2,34,000	By Sales	14,48,000	
To Purchases	12,15,500		*Less:* Returns	(58,000)	13,90,000
Less: Transfer to furniture A/c	(10,000)		By Closing stock		3,93,000
	12,05,500				
Less: Returns	(29,000)	11,76,500			
To Carriage inwards		93,000			
To Gross profit c/d		2,79,500			
		17,83,000			17,83,000
To Salaries		46,500	By Gross profit b/d		2,79,500
To Rent		28,500	By Interest		17,250
To Advertisement		56,000	By Discount received		14,950
To Printing & stationery		17,000			
To Interest		7,500			
To Discount allowed		37,700			
To General expenses		19,600			
To Travelling expenses		11,650			
To Fire insurance premium		3,000			
To Postage & telegrams		4,350			
To Provision for doubtful debts (W.N.I)		4,750			

To Depreciation on furniture		1,150			
To Audit fees		3,500			
To Capital A/c (Net profit transferred)		70,500			
		3,11,700			3,11,700

Balance Sheet as at 31st March,2022

Liabilities	₹	₹	Assets	₹	₹
Capital account:			Furniture	9,000	
Balance on 1st April,2021	5,40,500		Additions during the year	10,000	
Add: Net profit	70,500			19,000	
	6,11,000		*Less:* Depreciation	(1,150)	17,850
Less: Drawings	(50,000)	5,61,000	Investments		25,000
Loan from Dena Bank Ltd.		1,00,000	Deposits		1,50,000
Insurance accrued on bank loan (W.N.2)		3,000	Interest accrued on investment & deposits (W.N.3)		10,000
Sundry creditors		64,000	Stock in trade		3,93,000
			Sundry debtors	95,000	
			Less: Provision	(4,750)	90,250
			Cash with Traders Bank Ltd.		40,000
			Cash in hand		1,900
		7,28,000			7,28,000

Working Notes:

1. **Calculation of provision for doubtful debts:**

	₹
Sundry debtors as per trial balance	1,20,000
Less: Sales returns not recorded	(15,000)
	1,05,000

	Less: Cancellation against sundry creditors	(10,000)
	Adjusted balance of sundry debtors	95,000
	Provision for doubtful debts @ 5%	4,750
2.	**Accrued interest on bank loan:**	
	Annual interest @12%	6,000
	Less: Interest paid to Dena bank	(3,000)
	Accrued interest	3,000
3.	**Interest accrued on investments and deposits:**	
	Annual interest on investments @ 5%	1,250
	Annual interest on deposits @ 10%	15,000
		16,250
	Less: Interest received on investments and deposits	(6,250)
	Accrued interest	10,000

2.

		₹
(i)	**Salaries to be charged to profit and loss account for the year** ended 31st March, 2022:	
	Salaries of 8 employees for full year @ ₹ 33,000 per month each	31,68,000
	Salaries of 2 trainees for 6 months @ ₹ 21,000 p.m.	2,52,000
		34,20,000
(ii)	**Salaries actually paid in 2021-22**	
	March, 2021 salaries paid in April, 2021 (8 x 30,000)	2,40,000
	Salaries of 8 employees for April 2021 to March, 2022 paid in May 2021 to March 2022 @ ₹ 33,000 for 11 months	29,04,000
	Salaries of 2 trainees for October 2021 to February 2022 paid in November 2021 to March 2022 @ ₹ 21,000 for 5 months	2,10,000
		33,54,000
(iii)	**Outstanding salaries as at 31st March, 2022**	
	8 employees @ ₹ 33,000 each for 1 month	2,64,000
	2 trainees @ ₹ 21,000 each for 1 month	42,000
		3,06,000

3. Trading and Profit and Loss Account for the year ending 31st March, 2022

Particulars	₹	Particulars	₹
To Opening Inventory	5,00,000	By Sales	17,00,000
To Purchases	12,50,000	By Closing Inventory	10,00,000
To Wages	3,00,000		
To Gross Profit	6,50,000		
	27,00,000		27,00,000
To Bad Debts	50,000	By Gross Profit	6,50,000
To Depreciation	1,50,000		
To Salaries	2,20,000		
To Net Profit transferred. to Capital A/c	2,30,000		
	6,50,000		6,50,000

Balance Sheet as at 31st March, 2022

Liabilities	₹	₹	Assets	₹	₹
Trade payables		9,00,000	Cash in Hand	5,60,000	
Capital:			Trade receivables	3,50,000	
Previous Balance	25,00,000		Closing Inventory	10,00,000	19,10,000
Add : Net Profit	2,30,000	27,30,000			
			Furniture & Fixtures	1,50,000	
			Plant & Machinery	15,70,000	17,20,000
		36,30,000			36,30,000

4. (i) Computation of Income for the year 2021-22:

	₹
Money received during the year related to 2021-22	5,00,000
Add: Money received in advance during previous years	1,50,000
Total income of the year 2021-22	6,50,000

(ii) **Advance from Customers A/c**

Date	Particulars	₹	Date	Particulars	₹
	To Sales A/c (Advance related to current year transferred to sales)	1,50,000	1.4.2021	By Balance b/d	2,00,000
				By Bank A/c (Balancing Figure)	1,20,000
31.3.22	To Balance c/d	1,70,000			
		3,20,000			3,20,000

So, total money received during the year is:

	₹
Cash Sales during the year	5,00,000
Add: Advance received during the year	1,20,000
Total money received during the year	6,20,000

5. A) **Computation of Net Profit:**

Commission Manager = Rate of Commission X Net Profit before charging such commission

So, Commission to manager = 10/100 X Net Profit before charging such commission

= ₹ 2,00,000 = 10/100 X Net Profit before charging such commission

= Net Profit before charging such commission = ₹ 20,00,000

=> Net Profit (A) = ₹ (20,00,000 - 2,00,000) = ₹18,00,000

B) **Computation of Selling Expenses:**

Total income appearing in P&L A/c = ₹ 60,00,000

Total expenses other than selling expenses = ₹(26,00,000 + 13,00,000 + 2,00,000)= ₹ 41,00,000

So, Selling Expenses + Remaining Expenses + Net Profit = Total Income

= Selling Expenses = ₹ 60,00,000 -₹ 41,00,000 - ₹ 18,00,000

= Selling Expenses = ₹ 1,00,000

C) Computation of Sales:

We have been given selling expenses amount to 1% of Sales

So, Sales = $\frac{\text{Selling Expenses}}{1} \times 100 = \frac{1,00,000}{1} \times 100$ = ₹ 100,00,000

D) Computation of Gross Profit:

In Trading A/c

Particulars	₹	Particulars	₹
To COGS	45,00,000	By Sales (from C above)	100,00,000
To Gross Profit (Balancing Figure)	55,00,000		
Total (F)	100,00,000	Total (F)	100,00,000

So, Gross Profit (D) = ₹ 55,00,000

E) Miscellaneous Income = Total Income in P&L - Gross Profit

= ₹ (60,00,000 - 55,00,000) = ₹ 5,00,000

F) = ₹ 100,00,000 (As computed in D above)

G) = ₹ 60,00,000 (Total of both sides of P&L is equal after balancing has been done)

UNIT – 2 FINAL ACCOUNTS OF MANUFACTURING ENTITIES

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ♦ Understand the purpose of preparing Manufacturing Account.
- ♦ Learn the items to be included in the Manufacturing Account
- ♦ Draw Manufacturing accounts of Manufacturing entities

UNIT OVERVIEW

MANUFACTURING BUSINESS ENTITIES

- Final Accounts
  - Manufacturing Account
  - Trading Account
  - Profit & Loss Account
  - Balance Sheet

2.1 INTRODUCTION

The manufacturing entities generally prepare a separate Manufacturing Account as a part of Final accounts in addition to Trading Account, Profit and Loss Account and Balance Sheet. The objective of preparing Manufacturing Account is to determine manufacturing costs of finished goods for assessing the cost effectiveness of manufacturing activities. Manufacturing costs of finished goods are then transferred from the Manufacturing Account to Trading Account.

(a)	Trading account shows Gross Profit while Manufacturing Account shows cost of goods sold which includes direct expenses.
(b)	Manufacturing account also deals with the raw materials, and work in progress while the trading account would deal with finished goods only.

2.2 PURPOSE

A manufacturing account serves the following functions:

(1) It shows the total cost of manufacturing the finished products and sets out in detail, with appropriate classifications, the constituent elements of such cost. It is, therefore, debited with the cost of materials, manufacturing wages and expenses incurred directly or indirectly to manufacture.

(2) It provides details of factory cost and facilitates reconciliation of financial books with cost records. It also serves as a basis of comparison of manufacturing operations from period to period.

(3) The Manufacturing Account may also be used for various other purposes. For example, if the output is carried to the Trading Account at market prices, it shows the profit or loss on manufacture. Similarly, it may also be used to fix the amount of production linked bonus when such schemes are in force.

2.3 MANUFACTURING COSTS

Manufacturing costs are classified into:

+ Raw Material Consumed	....
+ Direct Manufacturing Wages	....
+ Direct Manufacturing Expenses	....
+ Direct Manufacturing Cost	....
+ Indirect Manufacturing expenses or	
+ Manufacturing Overhead	....
Total Manufacturing Cost	_____

Raw Material consumed is arrived at after adjustment of opening and closing Inventory of raw materials:

Raw Material Consumed	=	Opening inventory of Raw Materials	+ Purchases –	Closing inventory of Raw Materials

If there remain unfinished goods at the beginning and at the end of the accounting period, cost of such unfinished goods (also termed as Work-In-Process) is shown in the Manufacturing Account.

Opening inventory of Work-in-Process is posted to the debit of the Manufacturing Account and closing inventory of Work-in-Process is posted to the credit of the Manufacturing Account.

DIRECT MANUFACTURING EXPENSES

Direct manufacturing expenses are costs, other than material or wages, which are incurred for a specific product or saleable service.

Examples of direct manufacturing expenses are (i) Royalties for using license or technology if based on units produced, (ii) Hire charge of the plant and machinery used on hire, if based on units produced, etc.

When royalty or hire charges are based on units produced, these expenses directly vary with production.

ILLUSTRATION 1

1,00,000 units were produced in a factory. Per unit material cost was ₹ 10 and per unit labour cost was ₹ 5. That apart it was agreed to pay royalty @ ₹ 3 per unit to the Japanese collaborator who supplied technology.

Required

Calculate Manufacturing Cost.

SOLUTION

In this case Manufacturing Cost comprises of –

Raw Material consumed	(1,00,000 × ₹ 10)	₹ 10,00,000
Direct Wages	(1,00,000 × ₹ 5)	₹ 5,00,000
Direct Expenses	(1,00,000 × ₹ 3)	₹ 3,00,000
		₹ 18,00,000

INDIRECT MANUFACTURING EXPENSES OR OVERHEAD EXPENSES

These are also called Manufacturing overhead, Production overhead, Works overhead, etc. Overhead is defined as total cost of indirect material, indirect wages and indirect expenses.

Overhead = Indirect Material + Indirect Wages + Indirect Expenses

Indirect material means materials which cannot be linked directly with the units produced, for example, stores consumed for repair and maintenance work, small tools, fuel and lubricating oil, etc.

Indirect wages are those which cannot be directly linked to the units produced, for example, wages for maintenance works, holding pay, etc.

Indirect expenses are those which cannot be directly linked to the units produced, for example, training expenses, depreciation of plant and machinery, depreciation of factory shed, insurance premium for plant and machinery, factory shed, etc.

Accordingly, indirect manufacturing expenses comprise indirect material, indirect wages and indirect expenses of the manufacturing division.

BY-PRODUCTS

In most manufacturing operations, the production of the main product is accompanied by the production of a subsidiary product which has a value on sale. For example, the production of hydrogenated vegetable oil is accompanied by the production of oxygen gas and the production of steel yields scrap. The subsidiary product is termed as a by-product because its production is not consciously undertaken but results out of the production of the main product. It is usually very difficult to ascertain the cost of the product. Moreover, its value usually forms a very small percentage of the main product.

By-product is a secondary product. This is produced from the same raw materials, which are used for producing the main product and without incurring any additional expenses from the same production process in which the main product is produced. Some examples of by-product are given below:

(i) Molasses is the by-product in sugar manufacturing;

(ii) Butter milk is the by-product of a dairy which produces butter and cheese, etc.

By-products generally have insignificant value as compared to the value of main product. They are **generally valued at net realizable value,** if their costs cannot be separately identified. It is often treated, as Other Operating income” but the correct treatment would be to credit the sale value of the by-product to Manufacturing Account so as to reduce to that extent, the cost of manufacture of main product.

2.4 DESIGN OF A MANUFACTURING ACCOUNT

There is no standardized design for the presentation of a Manufacturing Account. Given below is a format covering various elements:

Manufacturing Account

Particulars	**Units**	**Amount**	**Particulars**	**Units**	**Amount**
		₹			₹
To Raw Material Consumed:			By By-products at net realizable value		
Opening inventory					
Add: Purchases	… .		By Closing Work-in- Process		
Less: Closing inventory	.....		By Trading A/c		
To Direct Wages	.....	......	Cost of production		
To Direct expenses:	......				
Prime cost		......			
To Factory overheads:					
Royalty	.....				
Hire charges	.....				
To Indirect expenses:	.....				
Repairs & Maintenance	.....				
Depreciation	.....	....			
Factory cost		....			
To Opening Work-in-process		....			

Tutorial Note: Frequently, problems are set, in which all the ledger balances are not given. Instead, details are given regarding the number of items in Inventories, quantity manufactured etc. the figures for Inventories, sales etc., would therefore have to be worked out independently from the data given.

The following general rules may be observed.

(a) The Manufacturing Account should have columns showing the quantities and values. Frequently, all the quantities are not given and the quantities applicable to one or more of the items would have to be worked out. For example, if the question does not state the total number of items sold, the quantity can be worked out by adding opening inventory and units manufactured and deducting closing inventory. It is, therefore, useful to have quantity columns in the account so that it can be seen that both sides balance.

(b) The Manufacturing Account will show the quantity of raw materials in inventory at the beginning and at the end of the year and the purchases during the year. As regards finished goods, it will only show the quantity manufactured and, as regards work-in-progress, the opening and closing amounts.

(c) The Trading Account will show the quantities of finished goods manufactured and sold and the opening and closing inventory. It will not show the quantity of raw materials or work-in-progress.

(d) For determining the value of closing inventory, in the absence of specific instruction to the contrary, it must be assumed that sales have been on "first in-first out" basis, that is, the closing inventory consists as far as possible of goods produced during the year, the opening inventory being sold out.

It may be mentioned here that nowadays no manufacturing business entity prepares manufacturing account as part of its final set of accounts. Even the items of manufacturing account are shown either in trading account (in case of non-corporate entities) or in Statement of profit and loss (in case of corporate entities).

The procedure of preparation of Trading Account, Profit and Loss Account and Balance Sheet have already been explained in Unit 1 of this chapter. Students should refer the earlier unit for attempting the problems based on the preparation of complete set of final accounts of a sole proprietor.

ILLUSTRATION 2

Mr. Vimal runs a factory which produces soaps. Following details were available in respect of his manufacturing activities for the year ended on 31.3.2022:

	₹
Opening Work-in-Process (10,000 units)	*16,000*
Closing Work-in-Process (12,000 units)	*20,000*
Opening inventory of Raw Materials	*1,70,000*
Closing inventory of Raw Materials	*1,90,000*
Purchases	*8,20,000*
Hire charges of machine @ ₹ 0.60 per unit manufactured	
Hire charges of factory	*2,20,000*

Direct wages-Contracted @ ₹ 0.80 per unit manufactured and @ ₹ 0.40 per unit of	
Closing W.I.P.	
Repairs and Maintenance	*1,80,000*
Units produced – 5,00,000 units	

Required

Prepare a Manufacturing Account of Mr. Vimal for the year ended 31.3.2022.

SOLUTION

In the Books of Mr. Vimal

Manufacturing Account for the Year ended 31.3.2022

Particulars		Units	Amount	Particulars	Units	Amount
			₹			₹
To Opening Work-in-Process		10,000	16,000	By Closing Work-in-Process	12,000	20,000
To Raw Materials Consumed:				By Trading A/c – Cost of finished goods transferred	5,00,000	19,00,800
Opening inventory	1,70,000					
Add: Purchases	8,20,000					
	9,90,000					
Closing Inventory	(1,90,000)		8,00,000			
To Direct Wages – W.N. (1)			4,04,800			
To Direct expenses:						
Hire charges on Machinery – W.N. (2)			3,00,000			
To Indirect expenses:						
Hire charges of Factory Shed			2,20,000			
Repairs Maintenance			1,80,000			
			19,20,800			19,20,800

Working Notes:

(1)	Direct Wages – 5,00,000 units @ ₹ 0.80 =	₹ 4,00,000
	12,000 units @ ₹ 0.40 =	₹ 4,800
		₹ 4,04,800
(2)	Hire charges on Machinery (5,00,000 units @ ₹ 0.60)	₹ 3,00,000

ILLUSTRATION 3

On 31st March, 2022 the Trial Balance of Mr. White were as follows:

Trial Balance as on 31st March, 2022

Particulars	Dr. ₹	Particulars	Cr. ₹
Stock on 1st April 2021			
Raw Materials	21,000	Sundry Creditors	15,000
Work in Progress	9,500	Bills Payable	7,500
Finished goods	15,500	Sale of Scrap	2,500
Sundry Debtors	24,000	Commission Received	450
Carriage on Purchases	1,500	Provision for doubtful debts	1,650
Bills Receivable	15,000	Capital Account	1,00,000
Wages	13,000	Sales	1,67,200
Salaries	10,000	Bank Overdraft	8,500
Telephone, Postage etc.	1,000		
Repairs to Office Furniture	350		
Cash at Bank	17,000		
Office Furniture	10,000		
Repairs to Plant	1,100		
Purchases	85,000		
Plant and Machinery	70,000		
Rent	6,000		
Lighting	1,350		
General Expenses	1,500		
	3,02,800		3,02,800

The following additional information is available:

Stocks on 31st March, 2022 were:

Raw Materials ₹ 16,200

Finished goods ₹ 18,100

Semi-finished goods ₹ 7,800

Salaries and wages unpaid for March 2022 were respectively, ₹ 900 and ₹ 2,000

Machinery is to be depreciated by 10% and office furniture by 71/2 %

Provision for doubtful debts is to be maintained @ 1% of sales

Office premises occupy 1/4 of total area.

Lighting is to be charged as to 2/3 to factory and 1/3 to office.

Prepare the Manufacturing Account Trading Account, Profit and Loss Account and the Balance Sheet relating to 31st March 2022.

SOLUTION

In the books of Mr. White

Manufacturing Account for the year ended 31st March, 2022

Particulars		₹	**Particulars**	₹
Raw material consumed:			By Closing Stock of Work in Progress	7,800
To Opening Stock of Raw Materials	21,000		By Sale of Scrap	2,500
			By Cost of goods Manufactured	
Add: Purchases	85,000		(Transferred to Trading Account)	1,19,000
Less: Closing Stock	16,200	89,800		
To Opening Stock of WIP		9,500		
To Wages	13,000			
Add: Outstanding Wages	2,000	15,000		
To Carriage on Purchases		1,500		
To Repairs to Plant		1,100		
To Rent *(3/4)*		4,500		

To Lighting *(2/3)*		900		
To Depreciation of Plant		7,000		
		1,29,300		1,29,300

Trading Account for the year ended 31st March, 2022

Particulars	₹	Particulars	₹
To Opening Stock of finished goods	15,500	By Sales	1,67,200
To Cost of goods transferred from Manufacturing A/c	1,19,000	By Closing Stock of finished goods	18,100
To Gross Profit c/d	50,800		
	1,85,300		1,85,300

Profit and Loss Account for the year ended 31st March, 2022

Particulars		₹	Particulars	₹
To Salaries	10,000		By Gross Profit b/d	50,800
Add: Outstanding	900	10,900	By Commission	450
To Telephone & Postage		1,000		
To Repairs to Furniture		350		
To Depreciation of furniture		750		
To Rent (1/4)		1,500		
To Lighting (1/3)		450		
To General Expenses		1,500		
To Provision for doubtful Debts: Required (1 % of ₹1,67,200)	1,672			
Less: Existing Provision	1,650	22		
To Net Profit		34,778		
		51,250		51,250

Balance Sheet as at 31st March, 2022

Capital and Liabilities		₹	**Assets**		₹
Capital Account	1,00,000		Plant & Machinery	70,000	
Add: Net Profit	34,778	1,34,778	*Less*: Depreciation	7,000	63,000
Bank Loan		8,500	Office Furniture	10,000	
Sundry Creditors		15,000	*Less*: Depreciation	750	9,250
Bills Payable		7,500	Closing Stock		
Salary Payable		900	Raw Materials		16,200
Wages Payable		2,000	Work in Progress		7,800
			Finished Goods		18,100
			Sundry Debtors	24,000	
			Less: Provision for Bad & Doubtful Debts	1,672	22,328
			Bills Receivable		15,000
			Cash at Bank		17,000
		1,68,678			1,68,678

NOTE: The ICAI has, through technical guide (issued in June, 2022) provided guidance on the formats of financial statements for non-corporate entities. This would enable these entities to communicate their financial performance and financial position in standardised formats thereby enhancing their consistency and comparability. The said format of financial statements has been given as **Annexure – I** at the end of the chapter for awareness of students. It may be noted that this format does not form part of syllabus and has been given here for the knowledge of students only.

SUMMARY

- Direct manufacturing expenses are costs, other than material or wages, which are incurred for a specific product or saleable service.
- Indirect Manufacturing expenses these are also called Manufacturing overhead, Production overhead, Works overhead, etc.
- Overhead is defined as total cost of indirect material, indirect wages and indirect expenses.
- Indirect material means materials which cannot be linked directly with the units produced, for example, stores consumed for repair and maintenance work, small tools, fuel and lubricating oil, etc. In most manufacturing operations, the production of the main product is accompanied by the production of a subsidiary product which has a value on sale.
- By-product is a secondary product. This is produced from the same raw materials, which are used for producing the main product and without incurring any additional expenses from the same production process in which the main product is produced.

TEST YOUR KNOWLEDGE

True and False

1. *By-products valued at cost or net realisable value whichever is lower.*
2. *The manufacturing account is prepared to ascertain the profit or loss on the goods produced.*
3. *If there remain unfinished goods at the beginning and at the end of the accounting period, cost of such unfinished goods is shown in the Manufacturing Account.*
4. *Raw Material Consumed = Opening inventory of Raw Materials + Purchases – Closing inventory of Raw Materials.*
5. *The Trading Account will show the quantities of finished goods, raw materials and work-in-progress.*
6. *Overhead is defined as total cost of direct material, direct wages and direct expenses.*
7. *Manufacturing A/c is prepared by an enterprise engaged in trading activities.*

Multiple Choice Questions

1. *Under-statement of closing work in progress in the period will*
   - (a) *Understate cost of goods manufactured in that period.*
   - (b) *Overstate current assets.*
   - (c) *Understate net income in that period.*
   - (d) *None of the three.*
2. *Sales is equal to*
   - (a) *Cost of goods sold – Gross profit.*
   - (b) *Cost of goods sold + Gross profit.*
   - (c) *Gross profit – Cost of goods sold.*
   - (d) *Net profit + cost of goods sold.*
3. *Indirect Manufacturing expenses are also called*
   - (a) *Manufacturing overhead.*
   - (b) *Production overhead.*
   - (c) *Works overhead.*
   - (d) *All the three.*
4. *Sale value of the by-product is credited to*
   - (a) *Manufacturing account.*
   - (b) *Capital account.*
   - (c) *Overheads account.*
   - (d) *Trading account.*
5. *Manufacturing account shows*
   - (a) *Total cost of manufacturing the finished products.*
   - (b) *It provides details of factory cost.*
   - (c) *It facilitates reconciliation of financial books with cost records.*
   - (d) *All the three.*

Theoretical Questions

1. *Write short note on by-products.*

2. *Differentiate between Direct Manufacturing Expenses and Indirect Manufacturing expenses.*

Practical Questions

1. *Mr. Pankaj runs a factory which produces motor spares of export quality. The following details were obtained about his manufacturing expenses for the year ended on 31.3.2022.*

			₹
W.I.P.	- Opening		3,90,000
	- Closing		5,07,000
Raw Materials	- Purchases		12,10,000
	- Opening		3,02,000
	- Closing		3,10,000
	- Returned		18,000
	- Indirect material		16,000
Wages	- direct		2,10,000
	- indirect		48,000
Direct expenses	- Royalty on production		1,30,000
		- Repairs and maintenance	2,30,000
		- Depreciation on factory shed	40,000
		- Depreciation on plant & machinery	60,000
By-product at selling price			20,000

You are required to prepare Manufacturing Account of Mr. Pankaj for the year ended on 31.3.2022.

2. *Following are the Manufacturing A/c, Creditors A/c and Trading A/c provided by Ms. Shivi related to 2021-22. There are certain figures missing from these accounts.*

Raw Material A/c

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Opening Stock A/c	1,00,000		By Raw Material Consumed	....
	To Creditors A/c	....		By Closing Stock A/c	....

Creditors A/c

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Bank A/c	22,00,000		By Balance b/d	15,00,000
	To Balance c/d	6,00,000			

Manufacturing A/c

Particulars	Amount ₹	Particulars	Amount ₹
To Raw Material Consumed	....	By Trading A/c	17,94,000
To Wages	3,50,000		
To Depreciation	2,00,000		
To Direct Expenses	2,44,000		

Additional Information:

1) *Purchase of machinery worth ₹ 10,00,000 has been omitted. Machinery are chargeable at a depreciation rate of 10%.*

2) *Wages include the following*

   Paid to Factory Workers - ₹ 3,00,000

   Paid to labour at office - ₹ 50,000

3) *Direct Expenses include following:*

   - *Electricity charges of ₹ 80,000 of which 30% pertained to office.*
   - *Fuel Charges of ₹ 20,000*
   - *Freight Inwards of ₹ 35,000*
   - *Delivery charges to customers - ₹ 20,000.*

You are required to prepare revised Manufacturing A/c, and Raw Material A/c.

3. *The following is the trial balance of Mr. Pandit for the year ended 31st March, 2022:*

Trial Balance as on 31st March 2022

Particulars	**Dr. ₹**	**Particulars**	**Cr. ₹**
Opening Stock:			
Raw Materials	*1,50,000*	*Sundry Creditors*	*50,000*
Finished goods	*75,000*	*Purchase Returns*	*5,000*
Purchase of Raw Materials	*5,00,000*	*Capital*	*1,00,000*
Land & Building	*1,00,000*	*Bills Payable*	*24,000*
Loose tools	*30,000*	*Long-Term Loan*	*2,00,000*
Plant & Machinery	*30,000*	*Provision for Bad and Doubtful Debts*	*2,000*
Investments	*25,000*	*Sales*	*8,50,000*
Cash in Hand	*20,000*	*Bank Overdraft*	*23,000*
Cash at Bank	*5,000*		
Furniture & Fixtures	*15,000*		
Bills Receivable	*15,000*		
Sundry Debtors	*40,000*		
Drawings	*20,000*		
Salaries	*20,000*		
Coal and Fuel	*15,000*		
Factory rent & rates	*20,000*		
General Expenses	*4,000*		
Advertisement	*5,000*		
Sales Return	*10,000*		
Bad Debts	*4,000*		
Direct Wages (Factory)	*80,000*		
Power	*30,000*		
Interest Paid	*7,000*		
Discount Allowed	*3,000*		

Carriage Inwards	*15,000*		
Carriage Outwards	*7,000*		
Commission Paid	*9,000*		
	12,54,000		*12,54,000*

Additional Information

Stock of finished goods at the end of the year ₹1,00,000.

A provision for doubtful debts is to be created. at 5% on Sundry Debtors. Depreciation on building ₹ 1,000 and ₹ 3,000 on Plant & Machinery to be provided.

Accrued commission of ₹ 12,500 is to be received for the year. Interest has accrued on investment ₹ 15,000.

Salary Outstanding ₹ 2,000 and Prepaid Interest ₹ 1,500.

You are required to prepare Manufacturing, Trading and Profit and Loss Account for the year ended 31st March, 2022.

ANSWERS/HINTS

True and False

1. False: By-products generally have insignificant value as compared to the value of main product. Therefore, they are generally valued at net realizable value.

2. False: The objective of preparing Manufacturing Account is to determine manufacturing costs of finished goods for assessing the cost effectiveness of manufacturing activities.

3. True: Manufacturing account deals with the raw material and work in progress.

4. True: Raw Material consumed is arrived at after adjustment of opening and closing inventory of raw materials and purchases.

5. False: The Trading Account will show the quantities of finished goods manufactured and sold and the opening and closing inventory. It will not show the quantity of raw materials or work-in-progress.

6. False: Overhead is defined as total cost of indirect material, indirect wages and indirect expenses.

7. False: Manufacturing A/c is prepared by the entities engaged in manufacturing activities.

Multiple Choice Questions

1.	(c)	**2.**	(b)	**3.**	(d)	**4.**	(a)	**5.**	(d)		

Theoretical Questions

1. By-products generally have insignificant value as compared to the value of main product. They are **generally valued at net realisable value,** if their costs cannot be separately identified. It is often treated, as "Miscellaneous income" but the correct treatment would be to credit the sale value of the by-product to Manufacturing Account so as to reduce to that extent, the cost of manufacture of main product.

2. **Direct manufacturing expenses** are costs, other than material or wages, which are incurred for a specific product or saleable service.

   Indirect Manufacturing expenses are also called Manufacturing overhead, Production overhead, Works overhead, etc. Overhead is defined as total cost of indirect material, indirect wages and indirect expenses.

   For detail, refer para 2.3

Practical Problems

1. **In the Books of Mr. Pankaj**

Manufacturing Account for the year ended on March 31,2022

Particulars		**Amount**	**Particulars**	**Amount**
	₹	₹		₹
To Opening W.I.P.		3,90,000	By Closing W-I-P	5,07,000
To Raw Material Consumed:			By by products	20,000
Opening inventory	3,02,000		By Trading A/c-	17,81,000
Purchases	12,10,000		Cost of finished	
	15,12,000		goods transferred	
Less: Return	(18,000)			
	14,94,000			

Less: Closing inventory	(3,10,000)	11,84,000		
To Direct Wages		2,10,000		
To Direct expenses:				
Royalty		1,30,000		
To Manufacturing Overhead:				
Indirect Material	16,000			
Indirect Wages	48,000			
Repairs & Maintenance	2,30,000			
Depreciation on				
Factory Shed	40,000			
Depreciation on Plant &				
Machinery	60,000	3,94,000		
		23,08,000		23,08,000

2. **Manufacturing A/c**

Particulars	Amount ₹	Particulars	Amount ₹
To Raw Material Consumed			
(Balancing Figure)	10,00,000	By Trading A/c (W.N. 4)	18,00,000
To Wages (W.N. 2)	3,00,000		
To Depreciation (W.N. 1)	3,00,000		
To Direct Expenses (W.N. 3)	2,00,000		
	18,00,000		18,00,000

Raw Material A/c

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Opening Stock A/c	1,00,000		By Raw Material Consumed (from Trading A/c above)	10,00,000

	To Creditors A/c (W.N. 5)	13,00,000		By Closing Stock A/c (Balancing Figure)	4,00,000
		14,00,000			14,00,000

Working Notes:

1) Since purchase of Machinery worth ₹ 10,00,000 has been omitted.

So, depreciation omitted from being charged = ₹ 10,00,000 X 10%

= ₹1,00,000

Correct total depreciation expense = ₹ (2,00,000 + 1,00,000)

= ₹ 3,00,000

2) Wages worth ₹ 50,000 will be excluded from manufacturing account as they pertain to office and hence will be charged P&L A/c.

3) Expenses to be excluded from direct expenses:

Office Electricity Charges (80,000 X 30%)	24,000
Delivery Charges to Customers	<u>20,000</u>
Total expenses not part of Direct Expenses	<u>44,000</u>

=> Revised Direct Expenses = ₹ (2,44,000 - 44,000) = ₹ 2,00,000

Fuel charges are related to factory expenses and also freight inwards are incurred for bringing goods to factory/ godown so they are part of direct expenses.

4) **Revised Balance to be transferred to Trading A/c:**

Particulars	**Amount ₹**
Current Balance transferred	17,94,000
Add: Depreciation charges not recorded earlier	1,00,000
Less: Wages related to Office	(50,000)
Less: Office Expenses	(44,000)
Revised balance to be transferred	18,00,000

5) **Creditors A/c**

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Bank A/c	22,00,000		By Balance b/d	15,00,000
	To Balance c/d	6,00,000		By Raw Materials A/c (Bal. figure)	13,00,000
		28,00,000			28,00,000

3. **In the books of Mr. Pandit**

Manufacturing Account for the year ended 31st March, 2022

Particulars		₹	Particulars	₹
To Opening Stock of Raw Materials		1,50,000	By Cost of Manufactured goods transferred to Trading A/c	8,08,000
To Purchase	5,00,000			
Less: Purchase Return	5,000	4,95,000		
To Carriage Inwards		15,000		
To Direct Wages		80,000		
To Power		30,000		
To Coal and fuel		15,000		
To Factory Rent and Rates		20,000		
To Depreciation on Machinery		3,000		
		8,08,000		8,08,000

Trading Account for the year ended 31st March, 2022

Particulars	₹	Particulars		₹
To Opening Stock of finished goods	75,000	By Sales	8,50,000	
To Cost of goods transferred from Manufacturing A/c	8,08,000	*Less*: Sales Return	10,000	8,40,000
		By Closing Stock		1,00,000
To Gross Profit c/d	57,000			
	9,40,000			9,40,000

Profit and Loss Account for the year ended 31st March 2022

Particulars		₹	Particulars	₹
To Carriage Outward		7,000	By Gross Profit b/d	57,000
To Discount Allowed		3,000	By Accrued Commission	12,500
To Commission Paid		9,000	By Accrued Interest	15,000
To General Expenses		4,000		
To Advertisement		5,000		
To Salaries	20,000			
Add: Outstanding	2,000	22,000		
To Interest Paid	7,000			
Less: Prepaid	1,500	5,500		
To Provision for Bad & Doubtful Debts	2,000			
Add: Bad Debts	4,000			
Less: Old Provision for Doubtful Debts	2,000	4,000		
To Depreciation on Building		1,000		
To Net Profit c/d		24,000		
		84,500		84,500

Balance Sheet as at 31st March, 2022

Capital and Liabilities		₹	Assets		₹
Capital	1,00,000		Plant & Machinery	30,000	
Add: Net Profit	24,000		*Less*: Depreciation	3,000	27,000
	1,24,000		Land & Building	1,00,000	
Less: Drawings	20,000	1,04,000	*Less*: Depreciation	1,000	99,000
Bills Payable		24,000	Furniture & Fixtures		15,000
Sundry Creditors		50,000	Investments		25,000
Salary Outstanding		2,000	Closing Stock		1,00,000
Long-Term Loans		2,00,000	Loose Tools		30,000

Bank Overdraft		23,000	Sundry Debtors	40,000	
			Less: Provision for Bad & Doubtful Debts	2,000	38,000
			Bills Receivable		15,000
			Accrued Commission		12,500
			Accrued Interest		15,000
			Prepaid Interest		1,500
			Cash in Hand		20,000
			Cash at Bank		5,000
		4,03,000			4,03,000

NOTES

ANNEXURE-I

FORMATS OF FINANCIAL STATEMENTS FOR NON-CORPORATE ENTITIES

PART I – Form of BALANCE SHEET

Name of the Non-Corporate Entity................

Balance Sheet as at ....

(Rupees in............)

	Particulars	**Note No**	**Figures as at the end of (Current reporting period) (in Rs.) ________ (DD/MM/YYYY)**	**Figures as at the end of (Previous reporting period) (in Rs.) ________ (DD/MM/YYYY)**
	1	**2**	**3**	**4**
I.	**EQUITY AND LIABILITIES**			
	(1) Owners' Fund			
	(a) Owners Capital Account			
	(b) Reserves and surplus			
(2)	**Non-current liabilities**			
	(a) Long-term borrowings			
	(b) Deferred tax liabilities (Net)			
	(c) Other Long term liabilities			
	(d) Long-term provisions			
(3)	**Current liabilities**			
	(a) Short-term borrowings			
	(b) Trade payables:- (A) total outstanding dues of micro, small and medium enterprises and (B) total outstanding dues of creditors other than micro, small and medium enterprises.			

	(c) Other current liabilities			
	(d) Short-term provisions			
	TOTAL			
II.	**ASSETS**			
(1)	**Non-Current Assets**			
	(a) Property, Plant and Equipment and Intangible assets			
	(i) Property, Plant and Equipment			
	(ii) Intangible assets			
	(iii) Capital work-in-progress			
	(iv) Intangible assets under development			
	(b) Non-current investment			
	(c) Deferred tax assets (net)			
	(d) Long-term loans and advances			
	(e) Other non-current assets			
(2)	**Current assets**			
	(a) Current investments			
	(b) Inventories			
	(c) Trade receivables			
	(d) Cash and bank balances			
	(e) Short-term loans and advances			
	(f) Other current assets			
	TOTAL			

See accompanying notes which form part of the financial statements

Notes

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as current when it satisfies any of the following criteria:

   (a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;

   (b) it is held primarily for the purpose of being traded;

   (c) it is expected to be realized within twelve months after the reporting date; or

   (d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

   All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.

3. A liability shall be classified as current when it satisfies any of the following criteria:

   (a) it is expected to be settled in the company's normal operating cycle;

   (b) it is held primarily for the purpose of being traded;

   (c) it is due to be settled within twelve months after the reporting date; or

   (d) the Non-Corporate entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

   All other liabilities shall be classified as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

6. A Non-Corporate entity may disclose the following in the Notes to Accounts:

   A. Owners Funds

   For each owner following items for the year to be disclosed separately:

   (a) opening balance;

   (b) capital Introduced/Contributed during the year;

(c) remuneration for the year;

(d) interest for the year;

(e) withdrawals during the year;

(f) share of profit or loss for the year (share in % and amount);

(g) closing balance.

B. Reserves and Surplus

(i) Reserves and Surplus may be classified as:

(a) Capital Reserves;

(b) Revaluation Reserve;

(c) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);

(d) Undistributed Surplus i.e. balance in Statement of Profit and Loss.

(ii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Undistributed Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

C. Long-Term Borrowings

(i) Long-term borrowings may be classified as:

(a) Term loans

- From banks
- From other parties

(c) Deferred payment liabilities.

(d) Loans and advances from related parties.

(e) Long term maturities of finance lease obligations

(f) Other loans and advances (specify nature).

(ii) Borrowings may further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by partners/proprietor/owners or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Terms of repayment of term loans and other loans may be stated.

D. Long-term provisions

The amounts may be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

E. Short-term borrowings

(i) Short-term borrowings may be classified as:

(a) Loans repayable on demand

- From banks
- From other parties

(b) Loans and advances from related parties.

(b) Other loans and advances (specify nature).

(ii) Borrowings may further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by partners/proprietor/ owners or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) current maturities of Long term borrowings may be disclosed separately.

F. Trade Payables

The following details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes:-

(a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;

(b) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

(c) the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;

(d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and

(e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

Explanation.-The terms 'appointed day', 'buyer',' enterprise', 'micro enterprise', 'small enterprise' and 'supplier', shall have the same meaning assigned to those under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.

G. Other current liabilities

The amounts may be classified as:

(a) Current maturities of finance lease obligations;

(b) Interest accrued but not due on borrowings;

(c) Interest accrued and due on borrowings;

(d) Income received in advance;

(e) Other payables (specify nature);

H. Short-term provisions

The amounts may be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

I. Property, Plant and Equipment

(i) Classification may be given as:

(a) Land.

(b) Buildings.

(c) Plant and Equipment.

(d) Furniture and Fixtures.

(e) Vehicles.

(f) Office equipment.

(g) Others (specify nature).

(ii) Assets under lease may be separately specified under each class of asset.

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment) and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

J. Intangible assets

(i) Classification may be given as:

(a) Goodwill.

(b) Brands /trademarks.

(c) Computer software.

(d) Mastheads and publishing titles.

(e) Mining rights.

(f) Copyrights, and patents and other intellectual property rights, services and operating rights.

(g) Recipes, formulae, models, designs and prototypes.

(h) Licenses and franchise.

(i) Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of intangible assets) and other adjustments and the related amortisation and impairment losses or reversals shall be disclosed separately.

K. Non-current investments

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:

(a) Investment property;

(b) Investments in Equity Instruments;

(c) Investments in preference shares;

(d) Investments in Government or trust securities;

(e) Investments in debentures or bonds;

(f) Investments in Mutual Funds;

(g) Investments in partnership firms;

(h) Other non-current investments (specify nature)

Under each classification, details may be given of names of the entities (indicating separately whether such entities are joint ventures or controlled special purpose entities) in whom investments have been made (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) may be given.

(ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.

(iii) The following shall also be disclosed:

(a) Aggregate amount of quoted investments and market value thereof;

(b) Aggregate amount of unquoted investments;

(c) Aggregate provision for diminution in value of investments.

L. Long-term loans and advances

(i) Long-term loans and advances may be classified as:

(a) Capital Advances;

(b) Loans and advances to related parties (giving details thereof);

(c) Other loans and advances (specify nature).

(ii) The above may also be separately sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed separately.

M. Other non-current assets

Other non-current assets may be classified as:

(i) Security Deposits;

(ii) Bank deposits with more than 12 months maturity;

(ii) Others (specify nature).

N. Current Investments

(i) Current investments shall be classified as:

(a) Investments in Equity Instruments;

(b) Investment in Preference Shares;

(c) Investments in government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms;

(g) Other investments (specify nature).

Under each classification, details may be given of names of the entities (indicating separately whether such entities are joint ventures or controlled special purpose entities) in whom investments have been made (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) may be given.

(ii) The following shall also be disclosed:

(a) The basis of valuation of individual investments;

(b) Aggregate amount of quoted investments and market value thereof;

(c) Aggregate amount of unquoted investments;

(d) Aggregate provision made for diminution in value of investments.

O. Inventories

(i) Inventories shall be classified as:

(a) Raw materials;

(b) Work-in-progress;

(c) Finished goods;

(d) Stock-in-trade (in respect of goods acquired for trading);

(e) Stores and spares;

(f) Loose tools;

(g) Others (specify nature).

(ii) Goods-in-transit may be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation may be stated.

P. Trade Receivables

(i) Aggregate amount of trade receivables outstanding for a period exceeding six months from the date they are due for receipt may be stated separately.

(ii) Trade receivables may be sub-classified as:

(a) Secured, considered good;

(b) Unsecured considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed separately.

Q. Cash and bank balances

(i) Cash and cash equivalents shall be classified as:

(a) Balances with banks;

(b) Cheques, drafts on hand;

(c) Cash on hand;

(d) Others (specify nature).

(ii) Other bank balances shall be classified as

(a) Bank Deposits - Earmarked balances with banks.

(b) Margin money or deposits under lien shall be disclosed separately.

(c) Bank deposits with original maturity for more than 3 months but less than 12 months from reporting date.

(d) others (specify nature)

R. Short-term loans and advances

(i) Short-term loans and advances may be classified as:

(a) Loans and advances to related parties (giving details thereof);

(b) Others (specify nature).

(ii) The above may also be sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances may be disclosed under the relevant heads separately.

S. Other current assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent liabilities (to the extent not provided for)

(i) Contingent liabilities may be classified as:

(a) Claims against the non-corporate entity not acknowledged as debt;

(b) Guarantees;

(c) Other money for which the non-corporate entity is contingently liable.

PART II – Form of STATEMENT OF PROFIT AND LOSS

Name of the Non-Corporate Entity........................

Statement of Profit and Loss for the year ended ....

(Rupees in............)

	Particulars	**Note**	**Figures for the current reporting period (in)** **From _______ (DD/MM/YYYY)** **To _________ (DD/MM/YYYY)**	**Figures for the previous reporting period (in)** **From_________ (DD/MM/YYYY)** **To___________ (DD/MM/YYYY)**
	1	**2**	**3**	**4**
I.	Revenue from operations		xxx	xxx
II.	Other income		xxx	xxx
III.	**Total Income (I + II)**		xxx	xxx
IV.	Expenses			
(a)	Cost of Goods Sold			
(b)	Employee benefits expense		xxx	xxx
(c)	Depreciation and amortization expense		xxx	xxx
(d)	Finance Cost		xxx	xxx
(e)	Other expenses		xxx	xxx
	Total expenses		xxx	xxx
V	Profit before exceptional and extraordinary items		xxx	xxx
	and tax (III-IV)			
VI	Exceptional items		xxx	xxx
VII	Profit before extraordinary items and tax (V - VI)		xxx	xxx
VIII	Extraordinary Items		xxx	xxx

IX	Profit before tax (VII- VIII)		xxx	xxx
X	Tax expense:			
(i)	Current tax		xxx	xxx
(ii)	Deferred tax		xxx	xxx
XI	Profit (Loss) for the period from continuing operations (IX-X)		xxx	xxx
XII	Profit/(loss) from discontinuing operations		xxx	xxx
XIII	Tax expense of discontinuing operations		xxx	xxx
XIV	Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)		xxx	xxx
XV	Profit/ (Loss) (XI + XIV)		xxx	xxx

See accompanying notes which form part of the financial statements

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part may be applied to the income and expenditure account in like manner as they apply to a statement of profit and loss.

2. **(A)** Revenue from operations may disclose separately in the notes revenue from—

(a) Sale of products;

(b) Sale of services;

(c) Grants or donations received;

(d) Other operating revenues;

(e) Less: Excise duty

(B) In respect of a finance Non-Corporate entity, revenue from operations may include revenue from—

(a) Interest; and

(b) Other financial services.

3. **Cost of Goods Sold**

Costs of Goods Sold shall be classified as:

(a) Cost of materials consumed;

(b) Purchases of Stock-in-Trade;

(c) Changes in inventories of finished goods;

(d) Work-in-progress and Stock-in-Trade.

4. **Finance Costs**

Finance costs may be classified as:

(a) Interest expense;

(b) Other borrowing costs;

(c) Applicable net gain/loss on foreign currency transactions and translation.

5. **Other income**

Other income shall be classified as:

(a) Interest Income;

(b) Dividend Income;

(c) Net gain/loss on sale of investments;

(d) Other non-operating income (net of expenses directly attributable to such income).

6. Following may be disclosed by way of notes regarding aggregate expenditure and income on the following items:—

(i) (a) Employee Benefits Expense showing separately (i) salaries and wages, (ii) Contribution to provident and other funds, (iii) staff welfare expenses;

(b) Any item of income or expenditure which exceeds one per cent of the revenue from operations or Rs.1,00,000 whichever is higher;

(c) Adjustments to the carrying amount of investments;

(d) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);

(e) Details of items of exceptional and extraordinary nature;

(f) Prior period items.

(ii) Expenditure incurred on each of the following items, separately for each item:—

(a) Consumption of stores and spare parts;

(b) Power and fuel;

(c) Rent;

(d) Repairs to buildings;

(e) Repairs to machinery;

(f) Insurance;

(g) Rates and taxes, excluding, taxes on income;

(h) Miscellaneous expenses.

NOTES

CHAPTER 8

FINANCIAL STATEMENTS OF NOT-FOR-PROFIT ORGANISATIONS

LEARNING OUTCOMES

After studying this unit, you would be able to:

- Understand the meaning of Not-for-profit-organisations and distinction between a profit-making organisation and a Not-for-profit-organisation.
- Accounting for Not-for-profit-organisations.
- Understand the meaning and technique of preparation of Receipts and Payments Account and Income and Expenditure Account and understand the distinction between the two Accounts.
- Learn the technique of preparing Balance Sheet of Not-for-profit-organisations.
- Understand the different adjustments and their accounting treatment in the books of Not for profit organisations.

CHAPTER OVERVIEW

Financial statements of Not-for-profit-Organisations

- Receipts and Payments Account equivalent to Cash Book
- Income and Expenditure Account equivalent to Profit and Loss Account
- Balance Sheet

Donations, Entrance and Admission Fees, Subscription, Life Membership Fee are some of the Sources of incomes for the non-profit organizations which have different treatments based on the nature of the receipts.

1. INTRODUCTION

A non-profit organization is a legal accounting entity that is operated for the benefit of the society as a whole, rather than for the benefit of a sole proprietor or a group of partners or shareholders. The main motive behind the non-profitable organization is to render service to the society or the members of the organisation.

There is difference in the final accounts prepared between the profit making and the non-profitable organisations. The sources of receipts and payments also vary with the nature of the activity that is being carried on by the organisation. Non-profit making organisations such as public hospitals, public educational institutions, clubs, Temples, churches etc., as a part of their final accounts prepare Receipts and Payments Account and Income and Expenditure Account to show periodic performance (either surplus or deficit) and Balance Sheet to show financial position at the end of the period. In this Chapter, we shall discuss the technique of preparing Receipts and Payments Account, Income and Expenditure Accounts and Balance Sheet of not-for-profit organisations.

The Income and Expenditure Account (non- profitable organisation) is just similar to Profit and Loss Account prepared for the profit making organisations but there has been different terminology employed for the word Profit as SURPLUS – excess of income over expenditure or loss as DEFICIT – excess of expenditure over income. In non-profit making organisations, total cash receipts and total cash payments are highlighted through Receipts and Payments Account.

2. NATURE OF RECEIPTS AND PAYMENTS ACCOUNT

A Receipts and Payments Account is a summary of the cash book without date column. It is an elementary form of account commonly adopted by not for profit making concerns such as hospitals, clubs, societies, temples, churches etc., for presenting the receipts and payments periodically together with the cash balances at the beginning and close of the period. The receipts are entered on the left hand side, and payments on the right hand side i.e., the same way as they appear in Cash Book. "The main point to be noted here is that- receipts and payments account is not based on the accrual system of book keeping as it records all the receipts and payments whether capital or revenue, pertaining to the current, previous or future periods."

Features:

- It is the summary of the cash and bank transactions like cash book, all the receipts (**capital or revenue**) are debited, similarly, all the expenditures (**capital or revenue**) are credited.
- It starts with opening cash and bank balances and also ends with their closing balances. This account is usually not a part of the double entry system as it includes all cash and bank receipts and payments, whether they are related to present, past or future periods.
- Surplus or deficit for an accounting period cannot be ascertained from this account, since, it shows only the Cash/Bank position and excludes all non cash items.

ILLUSTRATION 1

The receipts and payments for the Swaraj Club for the year ended March 31, 2022 were: Entrance fees ₹ 300; Membership Fees ₹ 3,000; Donation for Club Pavilion ₹ 10,000, Foodstuff sales ₹ 1,200; Salaries and Wages ₹ 1,200 Purchase of Foodstuff ₹ 800; Construction of Club Pavilion ₹11,000; General Expenses ₹ 600; Rent and Taxes ₹ 400; Bank Charges ₹ 160.

Cash in hand–April. 1st ₹ 200, March. 31st ₹ 350

Cash in Bank–April. 1st ₹ 400; March. 31st ₹ 590

You are required to prepare Receipts and Payment Account.

SOLUTION

Swaraj Club
Receipts and Payments Accounts
for the year ended 31st March, 2022

	Receipts	₹		Payments	₹
To	Balance b/d(opening bal.)Cash in hand	200	By	Salaries and Wages	1,200
To	Cash with bank	400	By	Purchase of Foodstuff	800
To	Entrance Fees	300	By	Club Pavilion (Expenditure	
To	Membership Fees	3,000		on its construction)	11,000
To	Donation of Account		By	General Expenses	600
	of Club Pavilion	10,000	By	Rent and Taxes	400
To	Sales of foodstuff	1,200	By	Bank Charges	160
			By	Balance c/d (closing bal) Cash in hand	350
				Cash in bank	590
		15,100			15,100

2.1 Limitations of Receipts and Payments Account

From the study of the above account, it is apparent that the increase in the cash and bank balances at the end of the year, as compared to those in beginning, does not truly represent the surplus for the year since it does not take into account the other important transactions, such as cost of construction of the pavilion, which is in excess of the donation received, the outstanding subscription or those which were collected in advance, etc.

Another important drawback is that the Receipts and Payments Account includes items relating to all periods and of all types whether capital or revenue. In order to ascertain whether the organisation has made surplus or deficit, there is a need to construct an account which considers all the relevant revenue transactions for the current period. Since the Receipts and payments account does not consider the above, its preparation is not favoured except where the activities of the organization, the results of which are to be exhibited, are simple and modest, involve no carry over from one period to the next and it has no assets, apart from cash balance and no liabilities.

3. INCOME AND EXPENDITURE ACCOUNT

The income and expenditure account is **equivalent** to the Profit and Loss Account of a Profit making business enterprise. It is an account which is widely adopted by most of the Non-profit making concerns and is prepared by following **accrual principle**. Only items of revenue nature pertaining to the current period of account are included. The preparation of the account, therefore, requires adjustments in relevant accounts in respect of both outstanding and advance items of income and expenditure. The only difference is in the terms used to represent the profit and loss. Profit is termed as Surplus- Excess of income over expenditure and loss is termed as Deficit- Excess of expenditure over income.

Non-profit organizations registered under section 8 of the Companies Act, 2013 are required to prepare their Income and Expenditure account and Balance Sheet as per the Schedule III to the Companies Act, 2013.

Features:

- It is a revenue account prepared at the end of the accounting period for finding out the surplus or deficit of that period.
- It is prepared by matching expenses against the revenue of that period concerned.
- Both cash and non-cash items, such as depreciation, are taken into consideration.
- All capital expenditures and incomes are excluded.
- Only current years' income and expenses are considered. This Surplus/deficit is taken to the balance sheet and is added / deducted respectively with the capital fund (opening balance).

3.1 Main Sources of Income

For a not for profit organisation, the sources of income, largely depend on the nature of the activity carried on by them. The income for a charitable hospital is different from that of a income received by a sports club. Broadly for the purposes of solving the illustrations, we can classify the sources of income as subscriptions, ordinary donations, membership fees or entrances fees (if the amount is normal or provided according to bye-laws of the society), recurring grants from local authorities and income from investments, etc.

Any amount raised for a special activity, e.g. on sale of match tickets, is deducted from the expenditure of that activity and net amount is shown in the income and expenditure account. Any receipt of capital nature shall not be shown as income but will be credited to the Capital Fund or special purpose fund e.g. "Building Fund' or if the receipts is on account of sale of a fixed asset, it shall be credited to the asset account. This system of showing the donation towards specific purposes separately is termed as fund accounting.

Examples:

Hospital - medicines and cost of tests and investigations.

Sports Club - sports materials, tournament expenses, etc.

Drama Club - expenses of staging plays, rent of the hall, payment to artists, etc.

Educational Societies - award of scholarships, organisation of seminars, etc.

Library Societies - newspapers and magazines.

Any expenditure for acquisition of a fixed asset will be capitalised, though the amount of annual depreciation shall be debited to revenue expenditure.

It may be noted that after various accounts have been adjusted as is considered necessary by transferring all the revenue accounts to the income and Expenditure account and all the capital items to the balance sheet. If a regular Trial Balance is available, the preparation of the Income and Expenditure Account and the Balance Sheet is on the lines of final accounts.

3.2 Distinction between Receipts and Payments Account and Income and Expenditure Account

Not for profit organizations such as public hospitals, public educational institutions, clubs, Temples, churches etc., conventionally prepare Receipt and Payment Account and Income and Expenditure Account to show periodic performance for a particular accounting period. The distinguishing features of both the accounts can be summarized as:

Receipt and Payment Account is an elementary form of account consisting of a classified summary of cash receipts and payments over a certain period together with cash balances at the beginning and close of the period. The receipts are entered on the left hand side and payments on the right hand side i.e. same sides as those on which they appear in cash book. All the receipts and payments whether of revenue or capital nature are included in this account. The receipts and payments pertaining to the current, previous or future periods are also considered here. The balance of the account at the end of a period represents the difference between the amount of cash received and paid up. It is always in debit since it is made up of cash in hand and at bank.

Income and expenditure account resembles and is drawn in the same form of a Profit and loss account in case of profit-making organisations. Expenditure of revenue nature is shown on the debit side, income and gains of revenue nature are shown on the credit side. Income and Expenditure Account contains all the items of income and expenditure relevant to the current accounting period only, whether received or paid as well as that which have fallen due for recovery or payment. Capital Receipts, prepayments of income and capital expenditures, prepaid expenses are excluded. It does not start with any opening balance. The balancing figure represents the amount by which the income exceeds the expenditure or vice versa.

3.3 Preparation of Income and Expenditure Account from Receipts and Payments Account

Situations may require compilation of Income and Expenditure Account and the Balance Sheet from the Receipts and Payments Account after making adjustments in respect of Income accrued but not collected and expenses outstanding. The preparation of Balance Sheet in such a case is also necessary since an Income and Expenditure Account must always be accompanied by a Balance Sheet. The procedure which should be followed in this regard is briefly outlined below.

(i) Compute the opening balance of the Accumulated Fund, or Capital Fund of the Institution with the help of making opening balance sheet. It will be excess of the total value of the assets over that of the liabilities at the commencement of the period.

(ii) Open ledger accounts in respect of various items of income and expenditure (e.g. subscription, rents, printing, purchase of sports materials etc.) in which accruals or outstanding at the beginning or at the end of period have to be adjusted. Enter therein any accrual or outstanding at the end of the period as well as amounts which relate to an earlier period or the following period. The balance of the ledger accounts therefore will represent the amounts or income or expenditure pertaining to the period. These should be transferred to the Income and Expenditure Account.

(iii) Post from the debit of the Receipts & Payments Account to the credit of the Income and Expenditure Account other items of income wherein accruals and outstanding amount have to be adjusted. Likewise, post item of expenses in which no adjustment is to be made directly to debit of income and Expenditure Account.

(iv) Transfer the balance of Income and Expenditure Account to the Accumulated Fund/Capital Fund Account.

(v) Post the receipts and payments of capital nature from the Receipts and Payments Account to the appropriate asset or liability account for incorporating in the Balance Sheet. If a part or whole of an asset has been sold, the capital profit/loss, if any, is credited / debited in the Income and Expenditure Account. The balance of Income and Expenditure Account should be transferred to the Accumulated Fund/Capital Fund Account.

(vi) Prepare a Balance Sheet by including therein all the balances left over after transfers to the Income and Expenditure Account have been made.

ILLUSTRATION 2

During 2022, subscription received in cash is ₹42,000. It includes ₹1,600 for 2021 and ₹600 for 2023. Also ₹3,000 has still to be received for 2022.

Required

Calculate the amount to be credited to Income and Expenditure Account in respect of subscription.

SOLUTION

		₹
Amount received		42,000
Add : Outstanding on 31st Dec., 2022		3,000
		45,000
Less : Received on account of 2021	1,600	
2023	600	(2,200)
		42,800

The various accounts will appear as under:

Subscription Outstanding Account

2022		₹	2022		₹
Jan. 1	To Balance b/d (transfer)	1,600	Dec. 31	By Subscription A/c	1,600
Dec. 31	To Subscription A/c	3,000	Dec. 31	By Balance c/d	3,000
		4,600			4,600
2023					
Jan. 1	To Balance b/d	3,000			

Subscription Account

2022		₹	**2022**		₹
Dec. 31	To Subscription Outstanding A/c (transfer)	1,600	Dec. 31	By Cash A/c	42,000
Dec. 31	To Subscription received in advance A/c	600	Dec. 31	By Subscription Outstanding A/c	3,000
Dec. 31	To Income and Expenditure A/c	42,800			
		45,000			45,000

Subscription received in Advance Account

2022		₹	**2022**		₹
Dec. 31	To Balance c/d	600	Dec. 31	By Subscription A/c	600
			2023 Jan. 1	By Balance b/d	600

Subscription outstanding ₹ 3,000 and Subscription received in advance ₹ 600 will be shown in the balance sheet on the assets and liabilities side respectively.

ILLUSTRATION 3

Suppose salaries paid during 2022 were ₹23,000. The following further information is available:

		₹
Salaries unpaid on 31st March,	*2021*	*1,400*
" pre-paid on " "	*2021*	*400*
" un-paid on " "	*2022*	*1,800*
" pre-paid " "	*2022*	*600*

Required

Calculate the amount to be debited to Income and expenditure account in respect of salaries and also show necessary ledger accounts.

SOLUTION

Salaries Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
April, 1, 2021	To Prepaid Salaries A/c	400	April, 1, 2021	By Salaries Outstanding A/c	1,400
March, 31, 2022	To Cash	23,000	March, 31, 2022	By Salaries Prepaid A/c	600
	To Salaries Outstanding A/c	1,800		By Transfer to Income & Expenditure A/c	23,200
		25,200			25,200

Salaries Outstanding Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
April, 1, 2021	To Salaries A/c	1,400	April,1, 2021	By Balance b/d	1,400
March, 31, 2022	To Balance c/d	1,800	March, 31, 2022	By Salaries A/c	1,800
		3,200			3,200
			April, 1,2022	By Balance b/d	1,800

Salaries Prepaid Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
April, 2021	To Balance b/d	400	April, 1, 2021	By Salaries A/c (transfer)	400
March, 31, 2022	To Salaries A/c	600	March, 31, 2022	By Balance c/d	600
		1,000			1,000
April, 1, 2022	To Balance b/d	600			

4. BALANCE SHEET

A Balance Sheet is the statement of assets and liabilities of an accounting unit at a given date. It is generally prepared at the end of an accounting period after the Income and Expenditure Account has been prepared. It is classified summary of the ledger balances left over, after accounts of all the revenue items have been closed by transfer to the Income and Expenditure Account. In not for profit organizations, the excess of total assets over total outside liabilities is known as **Capital Fund**. The Capital fund represents the amount contributed by members, through legacies, special donations, entrance fees and accumulated surplus over the years. If however, members have not contributed any amount, it shall be termed as "Accumulated fund" instead of "Capital fund". The surplus or deficit, if any, on the year's working as disclosed by the Income and Expenditure Account is shown either as an addition to or deduction from the Capital / Accumulated Fund brought forward from the previous period respectively.

4.1 Accounting Treatment of Some Special Items

4.1.1 Donations: These may have been raised either for meeting some revenue or capital expenditure; those intended for the first mentioned purpose are credited directly to the Income and Expenditure Account but others, if the donors have declared their specific intention, then they are credited to special fund account and in the absence thereof, to the Capital Fund Account. If any investments are purchased out of a special fund or an asset is acquired therefrom, these are disclosed separately. Any income received from such investments or any donations collected for a special purpose are credited to an account indicating the purpose and correspondingly the expenditure incurred in carrying out the purpose of the fund is debited to this account. On no account any such expense is charged to the Income and Expenditure Account. **The term "Fund" is strictly applicable to the amounts collected for a special purpose when these are invested, e.g. Scholarship Fund, Prize Fund etc.** In other cases, <u>when the amounts collected are not invested</u> in securities or assets distinguishable from those belonging to the institution, <u>the word "Account" is more appropriate e.g. Building Account</u>, Tournament Account etc.

Instead of paying cash, a donor may sometimes give away or transfer a security or some other readily realisable asset. In such a case, the value of asset on valuation, must be credited to the fund for which the amount has been donated.

4.1.2 Entrance and Admission Fees: Such fees which are payable by a member on admission to club or society are normally considered capital receipts and credited to Capital Fund. This is because these do not give rise to any special obligation towards the member who is entitled to the same privileges as others who have paid only their annual subscription. Nevertheless, where the amount is small, meant to cover expenses concerning admission, or the rules of the society provided that such fees could be treated as income of the society, these amounts may be included in the Income and Expenditure Account. The treatment depends upon the requirement of question. If the question is silent then always take it to be capital receipt.

4.1.3 Subscription: Subscriptions being an income should be allocated over the period of their accrual. For testing the knowledge of candidates of this important accounting principle, questions are often set in examinations wherein figures of subscription collected by a society during the year as well as those outstanding at the beginning of the year and at its close are given. If some subscriptions have been received in advance, their amount is also indicated. In such cases, it is always desirable to set up a Subscription Account for determining the amount of subscription pertaining for the period for which accounts are being prepared. For example, if it is stated that subscriptions collected by a society during the year 2022 amounted to ₹ 1,850 out of which ₹ 200 represented subscription for the year 2021; ₹100 were subscriptions collected in advance for the year 2023, and subscriptions amounting to ₹ 500 were outstanding for recovery at the end of 2022, the adjusting journal entries and the Subscription Account should be set up as follows:

	₹	₹
Subscription Outstanding Account Dr.	500	
To Subscriptions Account		500
(The amount outstanding for this year credited to Subscription Account)		
Subscription A/c Dr.	300	
To Outstanding Subscription A/c		200
To Subscriptions Received in Advance A/c		100
(Subscription received ₹200 for the previous year and ₹100 for the next year, adjusted)		

Subscription Account

Dr. 2022		₹	2022		**Cr.** ₹
Jan 1	To Balance b/d (Outstanding Subscriptions)	200	Dec.	By Cash A/c	1,850
Dec. 31	To Subscriptions received in advance	100		By Balance c/d (Subscriptions Outstanding)	500
	To Income and Expenditure Account	2,050			
		2,350			2,350

The amount of outstanding subscription is adjusted in the Subscription Account by debit to Outstanding Subscription Account and that balance is shown as an asset in Balance Sheet. The Subscription Account is closed off by transferring its balance at the end of the year to the Income and Expenditure Account.

4.1.4 Life Membership Fee: Fees received for life membership is a **capital receipt** as it is of non-recurring nature. It is **directly added to capital fund** or general fund.

For adjusting lump sum subscription collected from the life members, one of the following methods can be adopted:

(1) The entire amount may be carried forward in a special account until the member dies, after which the same may be transferred to the credit of the Accumulated Fund.

(2) An amount equal to the normal annual subscription may be transferred every year to the Income and Expenditure Account and balance carried forward till it is exhausted. If, however, the life member dies before the whole of the amount paid by him has been transferred in this way, the balance should be transferred to the Accumulated Fund on the date of his death.

(3) An amount, calculated according to the age and average life of the member, may annually be transferred to the credit of Income and Expenditure Account.

Other concepts

Treatment of Important Items in Not For Profit Organization

1. **Donation:** it is **gift** in **cash** or **kind** from some person. It may be of two types:

    (a) **Specific Donation:** It is received for certain specific purpose like Building Donation, Library Books donation etc. It should be capitalized and shown on the liabilities side of the balance sheet.

    (b) **General Donation:** It is not received for any specific purpose and shown on the credit side of Income and Expenditure Account.

2. **Entrance Fees:** It may also be known as admission fees. **Entrance Fees should be capitalized** and added to the capital fund for all organization. If the question gives any specific treatment of Entrance fees, then it should be followed accordingly.

3. **Legacy:** It is an amount received by an organization as per the **will** of the person after the death of the person. It should be capitalised and shown on the liabilities side of the balance sheet by adding to the Capital Fund.

4. **Life Membership Fees:** It should **be capitalized** and shown on the liabilities side of the balance sheet. If the question gives any specific treatment of Life membership Fees, then it should be followed accordingly.

5. **Endowment Fund Donation:** It is a donation received and **only income from that donation is to be used for certain specific purpose**. In such cases income relating to special funds should be added to these funds on the liabilities side of the Balance

Sheet. All the expenses should be deducted from that fund on the liabilities side of the Balance Sheet.

6. **Treatment of Sale of Old Newspaper and Periodicals:** The amount received on such sale is shown as Income on the credit side of income and expenditure account.

7. **Sale of old Fixed Assets:** The Sale proceeds of old Fixed Assets are treated as **capital receipts**. The profit or loss on sale of fixed asset is shown in the Income and Expenditure A/c

8. **Honorarium:** It is paid to someone for receiving any services from person who are **not the employees** of the Not for Profit Organisation.

4.2 Preparation of Balance Sheet

♦ **Preparation of opening balance sheet and calculation of surplus:** If capital fund or accumulated surplus in the beginning of the year is not given, it is calculated by deducting liabilities from assets in the beginning of year. While calculating opening capital fund, care should be taken to include prepaid expenses and accrued incomes as assets and outstanding expenses and advance incomes as liabilities. Any surplus earned during the year is added to the opening capital fund and deficit suffered during the year is deducted from the opening capital fund.

♦ **Cash and bank balance:** Closing cash and bank balance as disclosed in Receipt and Payment Account is shown in the assets side of Balance Sheet. If there is a bank overdraft, it is to be shown on the liabilities side of the balance sheet.

♦ **Fixed assets:** Opening balances of Fixed Assets (Furniture, building, equipment, etc.) are increased by the amount of purchases and reduced by sales of the same and depreciation on the same.

♦ **Liabilities:** Opening balances of liabilities should be adjusted for any increase or decrease in the same.

Note: The illustrations explained in this chapter comprise of clubs not registered under the Companies Act, 2013. Therefore, Income & Expenditure Account and Balance Sheet are not prepared as per Schedule III of the Companies Act, 2013.

ILLUSTRATION 4

Following is the Receipts and Payments Account of New bird Forty Club for the year ended 31st March, 2022:

Dr **Receipts and payments A/c for the year ended on 31st March 2022** Cr

Receipts	Amount (₹)	Payments	Amount (₹)
To balance b/d	2,50,000	By Salaries and wages	1,65,000
To Subscription-		By Office expenses	35,000
2020-2021	65,000	By Sports equipment	3,42,000
2021-2022	3,55,000	By Telephone Charges	28,000
To Donations	55,000	By Electricity charges	32,000
To Entrance fees	85,000	By Travelling and conveyance	65,000
		By balance c/d	1,43,000
	8,10,000		8,10,000

Additional information :

(a) Outstanding subscriptions for the year ended 31st March, 2022 – ₹ 55,000.

(b) Outstanding salaries and wages – ₹ 40,000 for the year ended on 31st March 2022.

(c) Depreciate sports equipment by 25% for the year ended on 31st March 2022.

(d) Capitalize 50% of the entrance fees.

Prepare Income and Expenditure Account of the club from the above particulars for the year ended on 31st March 2022.

SOLUTION

In the books of New bird forty Club

Dr Income and expenditure Account for the year ended on 31st March 2022 Cr

Expenditure		Amount (₹)	Income		Amount (₹)
Salaries and wages	1,65,000		By Subscriptions	4,20,000	
Add: Outstanding Salaries for 2022	40,000	2,05,000	*Add*: Outstanding Subscriptions for 2022	55,000	

To Office expenses	35,000	*Less*: Outstanding Subscriptions for 2021	65,000	4,10,000
To Depreciation (25% × 3,42,000)	85,500			
To Telephone Charges	28,000			
To Electricity charges	32,000	By Donations		55,000
To Travelling and conveyance	65,000	By Entrance fees (50% × 85,000)		42,500
Excess of income over expenditure	57,000			
	5,07,500			5,07,500

ILLUSTRATION 5

From the following information of a club show the amounts of match expenses and match fund in the appropriate Financial Statements of the club for the year ended on 31st March, 2022:

Details	***Amount (₹)***
Match expenses paid during the year ended 31st March 2022	*1,10,000*
Match fund as on 01.04.2021	*30,000*
Donations for Match fund (received during the year)	*55,000*
Proceeds from the sale of the match tickets (during the year)	*20,000*

SOLUTION

Balance sheet as at March 31st 2022 (extract)

Liabilities	**Amt. (₹)**	**Assets**	**Amt (₹)**
Match fund	30,000		
Add: Donation for match fund	55,000		
Add: Proceeds from sale of tickets	20,000		
Less: Match expenses *(Note)*	(1,05,000)		
	NIL		

Note: Since the expenses incurred are more than the Match fund available ₹ 1,05,000 we are limiting the expenses to ₹ 1,05,000. The remaining expenses of ₹ 5000 (1,10,000-1,05,000) will be debited to the Income and expenditure account.

ILLUSTRATION 6

During the year ended 31st March, 2022, the subscriptions received by the Jaipur Literary Society were ₹ 4,50,000. These subscriptions include ₹ 20,000 received for the year ended 31st March, 2021. On 31st March, 2022, subscriptions due but not received were ₹ 15,000. Advance subscription received for the year ending 31st March 2022 but pertaining to year 2023 amounted to ₹ 26,000. The Subscriptions received in advance for the year ending 31st March, 2021 includes ₹ 18,000 pertaining to year 2021-22. Show the subscription account in book of the society?

SOLUTION

In the books of Jaipur literary society

Dr **Subscription A/c (for the year ended on 31st March 2022)** **Cr**

Particulars	Amount (₹)	Particulars	Amount (₹)
To outstanding subscriptions (2021)	20,000	By Advance subscriptions (2021)	18,000
To Income from Subscriptions A/c	4,37,000	By Bank A/c	4,50,000
To Advance subscriptions (2023)	26,000	By Outstanding subscriptions (2022)	15,000
	4,83,000		4,83,000

ILLUSTRATION 7

From the following information, calculate amount of subscriptions outstanding for the year ended 31st March, 2022.

A club has 350 members each paying an annual subscription of ₹ 1,050. The Receipts and Payments Account for the year showed a sum of ₹ 4,10,000 received as subscriptions. The following additional information is provided:

Subscriptions Outstanding on 31st March, 2021 – ₹ 45,000

Subscriptions Received in Advance on 31st March, 2022 – ₹ 62,000

Subscriptions Received in Advance on 31st March, 2021 – ₹ 30,000

SOLUTION

Subscription Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Outstanding subscriptions (2021)	45,000	By Advance subscriptions (2021)	30,000
To Income from subscriptions A/c (350*1050)	3,67,500	By Bank A/c	4,10,000
		By Outstanding	
To Advance subscriptions (2023)	62,000	subscriptions (2021)	34,500
	4,74,500		4,74,500

ILLUSTRATION 8

The following was the Receipts and Payments Account of Exe Club for the year ended March. 31, 2022

All the figures in thousands

Receipts	₹	***Payments***	₹
Cash in hand	*100*	*Groundsman's Fee*	*750*
Balance at Bank as per Pass Book:		*Moving Machine*	*1,500*
Deposit Account	*2,230*	*Rent of Ground*	*250*
Current Account	*600*	*Cost of Teas*	*250*
Bank Interest	*30*	*Fares*	*400*
Donations and Subscriptions	*2,600*	*Printing & Office Expenses*	*280*
Receipts from teas	*300*	*Repairs to Equipment*	*500*
Contribution to fares	*100*	*Honorarium to Secretary and*	
Sale of Equipment	*80*	*Treasurer of 2021*	*400*
Net proceeds of Variety		*Balance at Bank as per Pass Book:*	
Entertainment	*780*	*Deposit Account*	*3,090*
Donation for forth coming		*Current Account*	*150*
Tournament	*1,000*	*Cash in hand*	*250*
	7,820		*7,820*

You are given the following additional information:

	April, 1, 2021	*March, 31, 2022*
	₹	₹
Subscription due	*150*	*100*
Amount due for printing etc.	*100*	*80*
Cheques unpresented being payment for repairs	*300*	*260*
Estimated value of machinery and equipment	*800*	*1,750*
Interest not yet entered in the Pass book		*20*
Bonus to Groundsman outstanding		*300*

For the year ended March 31, 2022, the honorarium to the Secretary and Treasurer are to be increased by a total of ₹ 200. Prepare the Income and Expenditure Account and Balance Sheet for period ending 31st March, 2022 .

SOLUTION

Income and Expenditure Account of Exe Club
for the year ending 31st March, 2022

(all figures in thousand)

Expenditure		₹	**Income**	₹
To Groundsman's fee		750	By Donations and Subscription	2,550
To Rent of Ground		250	By Receipts from teas	50
To Fares' Expenses *Less* : Contribution	400 (100)	300	(Fares) less expenses (₹ 300 - ₹ 250)	
To Printing & Office Expenses		260	By Proceeds of Variety Entertainment	780
To Repairs		460	By Interest (₹ 30 + ₹ 20)	50
To Depreciation on Machinery				
Opening balance and Purchases	2,300			
Less: Closing Balance	(1,750)			
	550			
Less: Sale	(80)	470		
To Honorarium to Sect. &				

Treasurer		600		
To Bonus to Groundsman		300		
To Excess of Income over Expenditure		40		
		3,430		3,430

Balance Sheet of Exe Club as on 31st March, 2022

Liabilities		₹	Assets	₹
Outstanding Expenses:				
Groundsman Bonus		300	Cash in hand	250
Printing		80	Cash in Deposit A/c	3,090
Honorarium		600	Subscription Due	100
Bank Overdraft (₹260 – ₹150)		110	Interest Due	20
Capital Fund: Opening	3,080		Machinery & Equipments	1,750
Add: Surplus for the year	40	3,120		
Tournament Fund (Donation)		1,000		
		5,210		5,210

Balance Sheet as on 1st April, 2021

Liabilities	₹	Assets	₹
Outstanding Expenses and		Cash in hand	100
Honorarium (₹100 + ₹400)	500	Cash in Deposit A/c	2,230
Capital Fund (Balancing Figure)	3,080	Cash in Current A/c	300
		Subscription Due	150
		Machinery	800
	3,580		3,580

ILLUSTRATION 9

The Sportwriters Club gives the following Receipts and Payments Account for the year ended March 31, 2022:

Receipts and Payments Account

Receipts	₹	Payments	₹
To Balance b/d	4,820	By Salaries	12,000
To Subscriptions	28,600	By Rent and electricity	7,220
To Miscellaneous income	700	By Library books	1,000
To Interest on Fixed deposit	2,000	By Magazines and newspapers	2,172
		By Sundry expenses	10,278
		By Sports equipments	1,000
		By Balance c/d	2,450
	36,120		36,120

Figures of other assets and liabilities are furnished as follows:

	As at March 31	
	₹	₹
	2021	2022
Salaries outstanding	710	170
Outstanding rent & electricity	864	973
Outstanding for magazines and newspapers	226	340
Fixed Deposit (10%) with bank	20,000	20,000
Interest accrued thereon	500	500
Subscription receivable	1,263	1,575
Prepaid expenses	417	620
Furniture	9,600	
Sports equipments	7,200	
Library books	5,000	

The closing values of furniture and sports equipments are to be determined after charging depreciation at 10% and 20% p.a. respectively inclusive of the additions, if any, during the year. The Club's library books are revalued at the end of every year and the value at the end of March 31, 2022 was ₹ 5,250.

Required

From the above information you are required to prepare:

(a) The Club's Balance Sheet as at March 31, 2021;

(b) The Club's Income and Expenditure Account for the year ended March 31, 2022.

(c) The Club's Closing Balance Sheet as at March 31, 2022.

SOLUTION

(a) Sportswriters Club

Balance Sheet as on 31st March, 2021

Liabilities	₹	₹	Assets	₹
Outstanding expenses:			Furniture	9,600
Salaries	710		Library Books	5,000
Rent & Electricity	864		Sports Equipment	7,200
Magazines & Newspapers	226	1,800	Fixed Deposit	20,000
Capital Fund (Balancing figure)		47,000	Cash in hand & at Bank	4,820
			Prepaid Expenses	417
			Subscription receivable	1,263
			Interest accrued	500
		48,800		48,800

(b) Income and Expenditure Account for the year ending 31st March, 2022

Expenditure		₹	Income	₹
To Salaries		11,460	By Subscription	28,912
To Rent & Electricity		7,329	By Interest on Fixed Deposit	2,000
To Magazines & Newspapers		2,286	By Misc. Income	700
To Sundry Expenses		10,075	By Excess of expenditure	
To Depreciation:			over income	2,888
Furniture	960			
Sports Equipment	1,640			
Library Books	750	3,350		
		34,500		34,500

(c) Balance Sheet of Sports Writers Club

as on 31st March, 2022

Liabilities	₹	₹	**Assets**	₹	₹
Outstanding Expenses:			Furniture		
Salaries	170		Cost	9,600	
Rent & Electricity	973		*Less* : Depreciation	(960)	8,640
Newspapers	340	1,483	Magazines & Sport		
Capital Fund:			Equipment:		
Opening balance	47,000		Opening balance	7,200	
Less : Excess of			Addition	1,000	
exp. over income	(2,888)	44,112		8,200	
			Less : Depreciation	(1,640)	6,560
			Library Books :		
			Opening Balance	5,000	
			Addition	1,000	
				6,000	
			Less : Depreciation	(750)	5,250
			Fixed Deposit		20,000
			Cash in hand & at bank		2,450
			Prepaid Expenses		620
			Subscription Receivable		1,575
			Interest accrued		500
		45,595			45,595

Working Notes:

(i)	**Expenses**	**Salaries** ₹	**Rent & Electricity** ₹	**Magazines & News-Papers** ₹	**Sundry Expenses** ₹
	Paid during the year	12,000	7,220	2,172	10,278
	Add : Outstanding on 31.3.2022	170	973	340	–

	Add : Prepaid on 31.3.2021	–	–	–	417
		12,170	8,193	2,512	10,695
	Less : Outstanding on 31.3.2021	(710)	(864)	(226)	–
	Less : Prepaid on 31.3.2022	–	–	–	(620)
	Expenditure for the year	11,460	7,329	2,286	10,075

			₹
(ii)	Depreciation		
	(a) Furniture @10% on ₹ 9,600		960
	(b) Sports Equipment @ 20% on ₹ 8,200		1,640
	(c) Library books - book value	6,000	
	Revalued at	(5,250)	750
(iii)	Subscription		
	Received in cash		28,600
	Add : Receivable on 31.3.2022		1,575
			30,175
	Less: Receivable on 31.3.2021		(1,263)
			28,912

ILLUSTRATION 10

The Income and Expenditure Account of the Youth Club for the Year 2022 is as follows:

	Expenditure	***₹***		***Income***	***₹***
To	*Salaries*	*4,750*	*By*	*Subscription*	*7,500*
To	*General Expenses*	*500*	*By*	*Entrance Fees*	*250*
To	*Audit Fee*	*250*	*By*	*Contribution for*	
To	*Secretary's Honorarium*	*1,000*		*annual dinner*	*1,000*
To	*Stationery & Printing*	*450*	*By*	*Annual Sport meet*	
To	*Annual Dinner Expenses*	*1,500*		*receipts*	*750*
To	*Interest & Bank Charges*	*150*			
To	*Depreciation*	*300*			
To	*Surplus*	*600*			
		9,500			*9,500*

This account had been prepared after the following adjustments:

	₹
Subscription outstanding at the end of 2021	*600*
Subscription received in advance on 31st December, 2021	*450*
Subscription received in advance on 31st December, 2022	*270*
Subscription outstanding on 31st December, 2022	*750*

Salaries Outstanding at the beginning and the end of 2022 were respectively ₹ 400 and ₹ 450. General Expenses include insurance prepaid to the extent of ₹ 60. Audit fee for 2022 is as yet unpaid. During 2022 audit fee for 2021 was paid amounting to ₹ 200.

The Club owned a freehold lease of ground valued at ₹ 10,000. The club had sports equipment on 1st January, 2022 valued at ₹ 2,600. At the end of the year, after depreciation, this equipment amounted to ₹ 2,700. In 2021, the Club has raised a bank loan of ₹ 2,000. This was outstanding throughout 2022. On 31st December, 2022 cash in hand amounted to ₹ 1,600.

Required

Prepare the Receipts and Payments Account for 2022 and Balance Sheet as at the end of the year.

SOLUTION

The Youth Club

Receipts and Payments Account for the year ended 31st December, 2022

	Receipts	₹	₹		Payments	₹	₹
To	Balance b/d (balancing figure)		1,390	By	Salaries	4,750	
To	Subscriptions as per Income	7500			*Add*: Paid for 2021	400	
	& Expenditure Account					5,150	
	Add: 2021's Received	600			*Less*: Unpaid for 2022	(450)	4,700
	2023's Received	270		By	General Expenses	500	
		8,370			*Add* : Paid for 2023	60	560
	Less: 2022's Received in 2021	(450)		By	Audit fee (2022)		200
				By	Secy. Honorarium		1,000
		7,920		By	Stationery & Printing		450

	Less: 2022's Outstanding	(750)	7,170	By Annual Dinner Expenses		1,500
To	Entrance Fees		250	By Interest & Bank Charges		150
To	Contribution for annual dinner		1,000	By Sports Equipments [2700 - (2600 - 300)]		400
To	Annual sport meet receipt		750	By Balance c/d		1,600
			10,560			10,560
To	Balance b/d		1,600			

Balance Sheet of Youth Club as on December 31, 2022

Liabilities	₹	₹	Assets	₹	₹
Subscription received in advance		270	Freehold Ground		10,000
Audit Fee Outstanding		250	Sport Equipment:		
Salaries Outstanding		450	As per last Balance Sheet	2,600	
Bank Loan		2,000	Additions	400	
Capital Fund :				3,000	
Balance as per previous Balance Sheet	11,540		*Less* : Depreciation	(300)	2,700
Add : Surplus for 2022	600	12,140	Subscription Outstanding		750
			Insurance Prepaid		60
			Cash in hand		1,600
		15,110			15,110

Balance Sheet of Youth Club as on 31st December, 2021

Liabilities	₹	Assets	₹
Subscriptions received in advance	450	Freehold Ground	10,000
Salaries outstanding	400	Sports Equipment	2,600
Audit fees unpaid	200	Subscriptions Outstanding	600
Bank Loan	2,000	Cash in hand	1,390
Capital Fund (balancing figure)	11,540		
	14,590		14,590

ILLUSTRATION 11

Smith Library Society showed the following position on 31st March, 2021:

Balance Sheet as on 31st March, 2021

Liabilities	₹	Assets	₹
Capital fund	7,93,000	Electrical fittings	1,50,000
Expenses payable	7,000	Furniture	50,000
		Books	4,00,000
		Investment in securities	1,50,000
		Cash at bank	25,000
		Cash in hand	25,000
	8,00,000		8,00,000

The receipts and payment account for the year ended on 31st March, 2022 is given below:

		₹		₹
To Balance b/d			By Electric charges	7,200
Cash at bank	25,000		By Postage and stationary	5,000
Cash in hand	25,000	50,000	By Telephone charges	5,000
To Entrance fee		30,000	By Books purchased	60,000
To Membership subscription		2,00,000	By Outstanding expenses paid	7,000
To Sale proceeds of old papers		1,500	By Rent	88,000
To Hire of lecture hall		20,000	By Investment in securities	40,000
To Interest on securities.		8,000	By Salaries	66,000
			By Balance c/d	
			Cash at bank	20,000
			Cash in hand	11,300
		3,09,500		3,09,500

You are required to prepare income and expenditure account for the year ended 31st March, 2022 and a balance sheet as at 31s, March, 2022 after making the following adjustments:

Membership subscription included ₹ 10,000 received in advance and 75% of the entrance fees is to be capitalized.

Rent for ₹ 4,000 and salaries for ₹ 3,000 are outstanding.

Books are to be depreciated @ 10% including additions. Electrical fittings and furniture are also to be depreciated at the same rate.

Interest on securities is to be calculated @ 5% p.a. including purchases made on 1.10.2021 for ₹ 40,000.

SOLUTION

Smith Library Society

Income and Expenditure Account

for the year ended 31st March, 2022

Dr.					Cr.
Expenditure	₹	₹	**Income**		₹
To Electric charges		7,200	By Entrance fee (25% of ₹ 30,000)		7,500
To Postage and stationary		5,000			
To Telephone charges		5,000	By Membership subscription	2,00,000	
To Rent	88,000				
Add: Outstanding	4,000	92,000	*Less*: Received in advance	10,000	1,90,000
To Salaries	66,000		By Sale proceeds of old papers		1,500
Add: Outstanding	3,000	69,000	By Hire of lecture hall		20,000
To Depreciation (W.N.1)					
Electrical fittings	15,000		By Interest on securities(W.N.2)	8,000	
Furniture	5,000				
Books	46,000	66,000	*Add*: Receivable	500	8,500
			By Deficit- excess of expenditure over income		16,700
		2,44,200			2,44,200

Balance Sheet of Smith Library Society

as on 31st March, 2022

Liabilities	₹	₹	***Asset***	₹	₹
Capital fund	7,93,000		Electrical fittings	1,50,000	
Add: Entrance fees	22,500		*Less*: Depreciation	(15,000)	1,35,000
	8,15,500		Furniture	50,000	

Less: Excess of expenditure over income	(16,700)	7,98,800	*Less:* Depreciation	(5,000)	45,000
			Books	4,60,000	
			Less Depreciation	(46,000)	4,14,000
Outstanding expenses:			Investment:		
Rent	4,000		Securities	1,90,000	
Salaries	3,000	7,000	Accrued interest	500	1,90,500
Membership subscription in advance		10,000	Cash at bank		20,000
			Cash in hand		11,300
		8,15,800			8,15,800

Working Notes:

1. Depreciation

		₹
Electrical fittings 10% of ₹ 1,50,000		15,000
Furniture 10% of ₹ 50,000		5,000
Books 10% of ₹ 4,60,000		46,000

2. Interest on Securities

Interest @ 5% p.a. on ₹ 1,50,000 for full year	7,500	
Interest @ 5% p.a. on ₹ 40,000 for half year	1,000	8,500
Less: Received		(8,000)
Receivable		500

5. EDUCATIONAL INSTITUTIONS

Registration

The educational institutions which are functioning in India are mostly registered as Societies under the Indian Societies Registration Act of 1860, in some of the States, where Public Trust Acts have been passed all the Societies registered under the Indian Societies Registration Act, 1860 are required to be simultaneously registered under the Trust Act. Accordingly, in the State of Maharashtra, all the Societies have simultaneously been registered under the Bombay Public Trust Act, 1950.

Organizational Pattern

The Trust Societies are autonomous bodies with office bearers consisting of President, Secretary, Treasurer and Executive Committee Members. The General Body consists of all the Members of the Society. In case of Societies/Trusts which run a number of colleges and schools etc., for managing the affairs of each individual school or college, there is a governing body, wherein the head of the Unit, such as Principal of the college or Head Master of the school as, the case may be, are also members of the Governing Body.

The function of the Governing Body is to supervise the smooth functioning of the individual school or college.

Salient Features

The basic tenets pre-suppose, that part of the expenses of the educational institutions are met from the funds raised by the educational institutions themselves, either from donations, or from charities, collected from benevolent citizens in the country.

The State Governments through grant-in-aid-code have evolved different patterns of giving assistance to the educational institutions. There is, as such, no uniformity in the giving of assistance to the educational institutions in the form of grants.

All the educational institutions follow financial year as their accounting year.

5.1 Sources of Finance for Running the Educational Institution

There are three main sources through which amounts are collected by the educational institutions. These are:

(1) Donation from Public;

(2) Fees in the form of annual tuition fees, term fees, admission fees, laboratory fee etc., and

(3) Grants received from the Government.

The Government grants are of four kinds namely Maintenance Grant, Equipment grant, Building Grant and such other grants as may be sanctioned by the Government from time to time.

5.2 Specific items

5.2.1 Donation from Public

These are received either for recurring or non-recurring purposes. Donations are received either in cash or in kind. The 'in kind' donations are in the form of land and building, shares and securities, utensils, furniture and fixtures and the like, generally with a desire to perpetuate the memory of a distinguished member of the family of the donor.

5.2.2 Capitation fees or admission fees

Amounts are collected from parents/guardians of the students who seek admission in the educational institution. These are either in the form of capitation fees or admission fees and are generally collected by the Parent Body which runs the institution. In recent times, such collections have been a matter of severe attack and ban.

5.2.3 Laboratory and Library deposit

These are generally collected by schools and colleges and they remain with the institution till the student finally leaves it.

The School Code prescribes the rates of tuition and other fees, to be charged from the students.

5.2.4 Use of Term Fees

A separate account of receipts and expenditures shall be maintained and surplus carried over to the next year. The following are main items on which term fee can be used:

(1) Medical Inspection.

(2) School Magazine-manuscript and/or printing.

(3) Examination expenses i.e. printing, of question papers and supply of answer books if there is sufficient balance.

(4) Contribution to athletic and cultural associations, connected with school activities.

(5) School functions and festivals.

(6) Inter-class and Inter-school tournaments.

(7) Sports and Games-major and minor.

(8) Newspapers and magazines.

(9) Extra-curricular excursion and visits.

(10) School competition such as elocution competition etc.

(11) Scouting and Guiding.

(12) School Band.

(13) Social and Cultural activities and equipment required for the same.

(14) Vocational Guidance in general.

(15) Prizes for Co-curricular activities.

(16) Any other extra-curricular or co-curricular activities.

(17) Maintenance of playground.

(18) Purchase of books for Pupils Library.

(19) Drawing and Craft material.

(20) Audio-Visual Education.

(21) Curricular visits and excursions.

(22) Equipment for Physical education.

5.2.5 Recurring grants

Recurring grants in the form of Maintenance Grants are received in instalments spread out throughout the year.

5.2.6 Use of grant-in-aid

The School Code provides a detailed list of items of expenditure which are admissible for grant-in-aid:

(1) Staff salaries and allowances

(2) Leave Allowance.

(3) Bad Climate Allowance.

(4) Water Allowance.

(5) Leave Salary.

(6) Expenditure on training of teachers.

(7) Pension and Gratuity as may be applicable.

(8) Expenditure on the appointment of Librarian.

(9) Rent, Taxes and Insurance.

(10) Other Contingencies: expenditure of printing and stationery, conveyance expenditure, expenditure on purchase of books and furniture equipment.

(11) Current repairs.

(12) Miscellaneous Expenses: e.g. School Garden, Physical Education.

(13) Prizes.

(14) Expenditure on co-operative stores.

(15) Registration fee paid to the Board for recognition.

(16) Maintenance of Tiffin Rooms.

(17) Bonus to Teachers.

(18) Electrical charges.

(19) Telephone Charges.

(20) Expenditure in connection with Conferences.

(21) Subscription to educational Association etc.

(22) Medical charges.

(23) Audit fees of the auditors in accordance with prescribed scale.

(24) Sales-tax and General tax on purchase of the school requirements.

(25) Payments for merit scholarships.

ILLUSTRATION 12

From the following balances and particulars of Republic College, prepare Income & Expenditure Account for the year ended March, 2022 and a Balance Sheet as on the date :

	₹	₹
Seminars & Conference Receipts		*4,80,000*
Consultancy Receipts		*1,28,000*
Security Deposit - Students		*1,50,000*
Capital Fund		*16,06,000*
Research Fund		*8,00,000*
Building Fund		*25,00,000*
Provident Fund		*5,10,000*
Tuition Fee Received		*8,00,000*
Government Grants		*5,00,000*
Donations		*50,000*
Interest & Dividends on Investments		*1,85,000*
Hostel Room Rent		*1,75,000*
Mess Receipts (Net)		*2,00,000*
College Stores-Sales		*7,50,000*
Outstanding expenses		*2,25,000*
Stock of-stores and Supplies (opening)	*3,00,000*	
Purchases - Stores & Supplies	*8,00,000*	
Salaries - Teaching	*8,50,000*	
Research	*1,20,000*	
Scholarships	*80,000*	
Students Welfare expenses	*38,000*	

Repairs & Maintenance	*1,12,000*	
Games & Sports Expenses	*50,000*	
Misc. Expenses	*65,000*	
Research Fund Investments	*8,00,000*	
Other Investments	*18,50,000*	
Provident Fund Investment	*5,10,000*	
Seminar & Conference Expenses	*4,50,000*	
Consultancy Expenses	*28,000*	
Land	*1,00,000*	
Building	*16,00,000*	
Plant and Machinery	*8,50,000*	
Furniture and Fittings	*6,00,000*	
Motor Vehicle	*1,80,000*	
Provision for Depreciation:		
Building		*4,80,000*
Plant & Equipment		*5,10,000*
Furniture & Fittings		*3,36,000*
Cash at Bank	*6,42,000*	
Library	*3,60,000*	
	1,03,85,000	*1,03,85,000*

Adjustments:

		₹
(1)	*Materials & Supplies consumed: (From college stores)*	
	Teaching	*50,000*
	Research	*1,50,000*
	Students Welfare	*75,000*
	Games or Sports	*25,000*
(2)	*Tuition fee receivable from Government for backward class Scholars*	*80,000*
(3)	*Stores selling prices are fixed to give a net profit of 10% on selling price*	
(4)	*Depreciation is provided on straight line basis at the following rates:*	

(1) Building	*5%*
(2) Plant & Equipment	*10%*
(3) Furniture & Fixtures	*10%*
(4) Motor Vehicle	*20%*

SOLUTION

Republic College

Income and Expenditure Account for the year ending 31st March, 2022

Expenditure	₹	₹	Income	₹	₹
To Salaries:			By Tuitions & other fee		8,80,000
Teaching		8,50,000	By Govt. Grants		5,00,000
Research		1,20,000			
To Material & Supplies Consumed:			By Income from Investments		1,85,000
			By Hostel room Rent		1,75,000
Teaching		50,000	By Mess Receipts		2,00,000
Research		1,50,000	By Profit-Stores Sales		75,000
To Repairs & Maintenance		1,12,000	By Seminar and Conferences:		
To Sports & Games Expenses:			Income	4,80,000	
Cash	50,000		*Less* : Expenses	(4,50,000)	30,000
Materials	25,000	75,000	By Consultancy		
To Students Welfare			charges: Income	1,28,000	
Expenses:			*Less* : Expenses	(28,000)	1,00,000
Cash	38,000		By Donations		50,000
Materials	75,000	1,13,000			
To Misc. Expenses		65,000			
To Scholarships		80,000			
To Depreciation:					
Building		80,000			

Plant & Equipment		85,000			
Furniture		60,000			
Motor Vehicle		36,000			
To Excess of Income over Expenditure		3,19,000			
		21,95,000			21,95,000

Republic College

Balance Sheet as on 31st March, 2022

Liabilities	₹	₹	**Assets**	₹	₹
			Fixed Assets:		
Capital Fund			Land		1,00,000
Opening balance	16,06,000		Building Cost	16,00,000	
Add: Excess of Income			*Less*: Depreciation	(5,60,000)	10,40,000
over Expenditure	3,19,000	19,25,000	Equipment Cost	8,50,000	
Other Funds			*Less*: Depreciation	(5,95,000)	2,55,000
Research Fund		8,00,000	Furniture & Fittings:		
Building Fund		25,00,000	Cost	6,00,000	
			Less: Depreciation	(3,96,000)	2,04,000
Current Liabilities :			Motor Vehicles		
Outstanding Expenses		2,25,000	Cost *Less*: Depreciation	1,80,000 (36,000)	1,44,000
Provident Fund		5,10,000	Library		3,60,000
Security Deposit		1,50,000	Investments:		
			Capital Fund Investments		18,50,000
			Research Fund Investment		8,00,000
			P.F. Investment		5,10,000
			Stock (stores)		
			Material & Supplies		1,25,000

			Tuition fees receivable		80,000
			Cash in hand & at Bank		6,42,000
		61,10,000			61,10,000

Working Notes:

			₹	₹
(1)	Material & Supplies - Closing Stock			
	Opening Stock			3,00,000
	Purchases			8,00,000
				11,00,000
	Less : Cost of Material & Supplies [7,50,000*90% (100-10)]		6,75,000	
	Consumed		3,00,000	(9,75,000)
	Balance			1,25,000
(2)	Provisions for Depreciation			
		Building	Plant & Equipment	Furniture & Fitting
		₹	₹	₹
	Opening Balance	4,80,000	5,10,000	3,36,000
	Addition	80,000	85,000	60,000
	Closing Balance	5,60,000	5,95,000	3,96,000
	Note: Expense related to income earned like consultancy charges, conference expenses are shown as net of income.			

SUMMARY

- A non profit organization is a legal accounting entity that is operated for the benefit of the society as a whole, rather than for the benefit of a sole proprietor or a group of partners or shareholders. Financial Statements of such organizations consists of:
  1. Receipts and Payments Account
  2. Income and Expenditure Account
  3. Balance Sheet
- A Receipts and Payments Account is a summary of the cash book.
- The income and expenditure account is equivalent to the Profit and Loss Account of a profit making enterprise and is based on the accrual principle of accounting. Only items of revenue nature pertaining to the current accounting period are recorded.
- Non-profit organizations registered under section 8 of the Companies Act, 2013 are required to prepare their Income and Expenditure account and Balance Sheet as per the Schedule III to the Companies Act, 2013.
- It may be noted that after various accounts have been adjusted as is considered necessary - all the revenue accounts shall be closed by transfer to the Income and Expenditure Account, and the remaining balances of capital accounts will be closed by transferring the balances to the balance sheet. To ascertain the opening capital fund- the opening balance sheet will also be prepared. A balance sheet is thus a complement to such an account.
- Donations, Entrance and Admission Fees, Subscription, Life Membership Fee are some of the sources of incomes for the non-profit organizations. These sources of income are either taken to the Income and Expenditure account or the balance sheet, based on the nature, of the receipt.
- Educational institutions are quite different from other not-for-profit organisations in terms of sources of finance and items of expenditure.

TEST YOUR KNWOLEDGE

True and False

1. *The Receipts and payment account for a non-profit organization follows the accrual concept of accounting.*
2. *Both the revenue and capital nature transactions are recorded in the Income and expenditure account.*
3. *Sale of grass by a sports club is to be treated as sale of an asset.*
4. *Subscriptions outstanding for the current year are disclosed under the Fixed assets side of the Balance sheet.*
5. *Receipts and payments account gives the details about the expenses outstanding for the year.*
6. *Adjustments in the form of additional information shall be adjusted in the final accounts of a Non- profit organisation only in one place.*
7. *Tournament expenses incurred are more than the Tournament fund, then the excess to be shown as an asset in the closing Balance sheet.*
8. *For Non-profit organisation, Excess of income over expenditure in the Income and Expenditure account is termed as profit.*
9. *Surplus of non-profit organizations is distributed among its members.*
10. *Tournament fund, building fund, library fund is based on the fund based accounting.*
11. *Subscription fees refers to the one-time fees paid by the members to get admission for the benefits of the club.*
12. *Token payment made to a person, who voluntarily undertakes a service which would normally be paid in case of profitable organization is termed as Honorarium.*
13. *An Insurance company is an example of non-profit organization.*
14. *Part amount of entrance fees which is to be capitalized shall be disclosed in the income and expenditure account.*
15. *Both the income and expenditure of the current and the previous year are recorded in the Income and Expenditure account.*
16. *Amount received as donation by an Non-profit organisation under the will of a deceased person is termed as legacy.*

17. *Where a Non-profit organisation has a separate trading activity, the profit/loss from the trading account shall be transferred to Income and Expenditure Account at the time of consolidation.*

18. *Not for profit concerns concentrate their efforts to maximize the profit earning avenues.*

19. *All the receipts are of revenue nature in case of Non-profit organisation.*

20. *There is opening balance of Income and expenditure account.*

Multiple Choice Questions

1. *Scholarship granted to students out of specific funds provided by Government will be debited to*

   (a) Income and Expenditure Account.

   (b) Receipts and payments Account.

   (c) Funds granted for Scholarship account.

2. *In case of NPO, excess of total assets over liabilities is known as*

   (a) Profits.

   (b) Surplus.

   (c) Capital Fund.

3. *General donations and legacies are credited to*

   (a) Receipts and Payments Account.

   (b) Income and Expenditure Account.

   (c) Capital Fund.

4. *Interest on prize funds is*

   (a) Credited to Income and Expenditure Account.

   (b) Credited to Receipts and Payments Account.

   (c) Added to prize fund.

5. *Special aids are*

   (a) Treated as capital receipts.

   (b) Treated as revenue receipts.

   (c) Both (a) and (c).

6. *If there exist a specific sports fund, the expenses incurred in relation to sports activities will be taken to*

   (a) *Income and Expenditure Account*

   (b) *Receipt and Payment Account*

   (c) *Sports fund*

Theory Questions

1. *Distinguish between Receipt and Payment and Income and Expenditure Account.*

Practical Questions

1. *The following is the Receipts and Payments Account of Lion Club for the year ended 31st March, 2022.*

Receipts	**₹**	***Payments***	**₹**
Opening balance:		*Salaries*	*1,20,000*
Cash	*10,000*	*Creditors*	*15,20,000*
Bank	*3,850*	*Printing and stationary*	*70,000*
Subscription received	*2,02,750*	*Postage*	*40,000*
Entrance donation	*1,00,000*	*Telephones and telex*	*52,000*
Interest received	*58,000*	*Repairs and maintenance*	*48,000*
Sale of assets	*8,000*	*Glass and table linen*	*12,000*
Miscellaneous income	*9,000*	*Crockery and cutlery*	*14,000*
Receipts at		*Garden upkeep*	*8,000*
Coffee room	*10,70,000*	*Membership fees*	*4,000*
Soft drinks	*5,10,000*	*Insurance*	*5,000*
Swimming pool	*80,000*	*Electricity*	*28,000*
Tennis court	*1,02,000*	*Closing balance:*	
		Cash	*8,000*
		Bank	*2,24,600*
	21,53,600		*21,53,600*

The assets and liabilities as on 1.4.2021 were as follows:

	₹
Fixed assets (net)	*5,00,000*

Stock	*3,80,000*
Investment in 12% Government securities	*5,00,000*
Outstanding subscription	*12,000*
Prepaid insurance	*1,000*
Sundry creditors	*1,12,000*
Subscription received in advance	*15,000*
Entrance donation received pending membership	*1,00,000*
Gratuity fund	*1,50,000*

The following adjustments are to be made while drawing up the accounts:

(i) Subscription received in advance as on 31st March, 2022 was ₹ 18,000.

(ii) Outstanding subscription as on 31st March, 2022 was ₹ 7,000.

(iii) Outstanding expenses are salaries ₹ 8,000 and electricity ₹ 15,000.

(iv) 50% of the entrance donation was to be capitalized. There was no pending membership as on 31st March, 2022.

(v) The cost of assets sold net as on 1.4.2021 was ₹ 10,000.

(vi) Depreciation is to be provided at the rate of 10% on assets.

(vii) A sum of ₹ 20,000 received in October 2021 as entrance donation from an applicant was to be refunded as he has not fulfilled the requisite membership qualifications. The refund was made on 3.6.2022.

(viii) Purchases made during the year amounted ₹ 15,00,000.

(ix) The value of closing stock was ₹ 2,10,000.

(x) The club as a matter of policy, charges off to income and expenditure account all purchases made on account of crockery, cutlery, glass and linen in the year of purchase.

You are required to prepare an Income and Expenditure Account for the year ended 31st March, 2022 and the Balance Sheet as on 31st March, 2022 along with necessary workings.

2. *During the year ended 31st March, 2022, Sachin Cricket Club received subscriptions as follows:*

	₹
For year ending 31st March, 2021	*12,000*
For year ending 31st March, 2022	*6,15,000*

For year ending 31st March, 2023	*18,000*
Total	*6,45,000*

There are 500 members and annual subscription is ₹ 1,500 per member.

On 31st March, 2022, a sum of ₹ 15,000 was still in arrears for subscriptions for the year ended 31st March, 2021.

Ascertain the amount of subscriptions that will appear on the credit side of Income and Expenditure Account for the year ended 31st March, 2022. Also show how the items would appear in the Balance Sheet as on 31st March, 2021 and the Balance Sheet as on 31st March, 2022.

3. *Summary of receipts and payments of Bombay Medical Aid society for the year ended 31.12.2022 are as follows:*

Opening cash balance in hand ₹ 8,000, subscription ₹ 50,000, donation ₹ 15,000 (raised for meeting revenue expenditure), interest on investments @ 9% p.a. ₹ 9000, payments for medicine supply ₹ 30,000 Honorarium to doctor ₹ 10,000, salaries ₹ 28,000, sundry expenses ₹ 1,000, equipment purchase ₹ 15,000, charity show expenses ₹ 1,500, charity show collections ₹ 12,500.

Additional information:

	1.1.2022	***31.12.2022***
Subscription due	*1,500*	*2,200*
Subscription received in advance	*1,200*	*700*
Stock of medicine	*10,000*	*15,000*
Amount due for medicine supply	*9,000*	*13,000*
Value of equipment	*21,000*	*30,000*
Value of building	*50,000*	*48,000*

You are required to prepare receipts and payments account and income and expenditure account for the year ended 31.12.2022 and balance sheet as on 31.12.2022.

ANSWER / HINTS

True and False

1. False: It depicts the cash system of accounting rather than the accrual system, as the cash receipts and payments pertaining to any year are entered in the Receipts and payments account. The principle of accrual is not followed with regard to the receipts and payments account of a non-profit organization.

2. False: The income and expenditure account records only the revenue income and expenditure. The capital transactions are being recorded in the Balance sheet.

3. False: The grass for a sports club is not a capital item, hence the sale of such grass shall be treated as a revenue receipt.

4. False: They are disclosed under the current assets of the Balance sheet as they will be paid within the next year and not to be treated as non-current assets.

5. False: Receipts and payments account gives information about the expenses paid in cash for the current year, previous or the next year. It is only from the additional information we identify the outstanding expenses.

6. False: Additional information means that information which has been identified just before the preparation of the final accounts. As NPO follows the double entry system of book keeping, there shall be 2 effects for each of the additional information.

7. False: The excess of expenditure over the tournament fund shall be debited to the income and expenditure account and not taken to the closing balance sheet.

8. False: The excess of the income over the expenditure is called as Surplus and not profit for an Non-profit organisation.

9. False: The Non-profit organisation credits the surplus earned in a year to the general fund maintained by it.

10. True: It is Fund based accounting that records the fund balances in the balance sheet.

11. False: Subscription is a regular fees paid by the members to keep the membership alive.

12. True: Honorarium refers to the nominal amount paid for the services with a non-commercial intent.

13. False: Insurance Company has a profit motive, hence it is not a non-profit organization.

14. False: It shall be shown in the Balance sheet- where it is to be capitalized.

15. False: It is only the current year income and expenditure which is recorded in the Income and Expenditure account as per the accrual concept.

16. True: While on the death bed, if there is any will written that the assets of a person shall be donated to any NPO- then such a donation to the NPO, is termed as Legacy.

17. True: Where in case of the trading activities, the profit /loss from such activity to be transferred to the Income and expenditure account in case of consolidated accounts.

18. False: The Non-profit organisation has its very existence to serve the members and the society. Profit earning shall never be its motive.

19. False: Receipts can be both of revenue as well as capital nature. Receipts of both the nature are recorded in the receipts and payments account.

20. False: It represents a nominal account and is prepared in accordance with the accrual concept, hence there can be no opening balances.

Multiple Choice Questions

1.	(c)	**2.**	(c)	**3.**	(b)	**4.**	(c)	**5.**	(c)	**6.**	(c)

Theoretical Questions

1. Non-profit making organizations such as public hospitals, public educational institutions, clubs etc., conventionally prepare Receipt and Payment Account and Income and Expenditure Account to show periodic performance for a particular accounting period. For distinguishing features of both the accounts, Refer para 3.2.

Practical Questions

1. **Income and Expenditure Account of Lion Club**

for the year ended 31st March, 2022

Expenditure	₹	Income	₹
To Salaries	1,28,000	By Subscription	1,94,750
To Printing and stationary	70,000	By Entrance donation	90,000
To Postage	40,000	By Interest	60,000
To Telephone and telex	52,000	By Miscellaneous income	9,000
To Repairs and maintenance	48,000	By Profit from operations	92,000
To Glass and table linen	12,000	By Excess of expenditure over income	
To Crockery and cutlery	14,000	(deficit) transferred to capital fund	30,250
To Garden upkeep	8,000		
To Membership fees	4,000		
To Insurance	6,000		

To Electricity charges	43,000		
To Loss on sale of assets	2,000		
To Depreciation	49,000		
	4,76,000		4,76,000

Balance Sheet of Lion Club as on 31st March, 2022

Liabilities	₹	Assets	₹
Capital fund	10,89,600	Fixed assets	4,41,000
Gratuity fund	1,50,000	Stock	2,10,000
Sundry creditors	92,000	Investments	5,00,000
Subscription received in advance	18,000	Subscription outstanding	7,000
Entrance donation refundable	20,000	Interest accrued	2,000
Outstanding expenses	23,000	Bank	2,24,600
		Cash	8,000
	13,92,600		13,92,600

Working Notes:

1. Opening Balance Sheet

Balance Sheet of Lion Club as on 1st April, 2021

Liabilities	₹	Assets	₹
Sundry creditors	1,12,000	Fixed assets	5,00,000
Subscription received in advance	15,000	Stock	3,80,000
Entrance donation received in advance	1,00,000	Investments	5,00,000
Gratuity fund	1,50,000	Subscription outstanding	12,000
Capital fund (balance figure)	10,29,850	Prepaid expenses	1,000
		Cash	10,000
		Bank	3,850
	14,06,850		14,06,850

2. Subscription

	₹
Subscription received during the year	2,02,750
Add: Outstanding subscription on 31.3.2022	7,000
	2,09,750
Add: Received in advance as on 1.4.2021	15,000
	2,24,750
Less: Outstanding subscription as on 1.4.2021	(12,000)
	2,12,750
Less: Received in advance as on 31.3.2022	(18,000)
	1,94,750

3. **Entrance donation**

	₹
Entrance donation received during the year	1,00,000
Add: Received in advance as on 1.4.2021	1,00,000
	2,00,000
Less: Entrance donation in respect of ineligible member	(20,000)
	1,80,000
Less: 50% capitalized	(90,000)
Taken to income and expenditure account	90,000

4. Loss on sale of asset

	₹
Cost of asset sold	10,000
Less: Sale proceeds	(8,000)
Loss on sale of asset	2,000

5. Depreciation

	₹
Fixed asset as per trial balance	5,00,000
Less: Cost of asset sold	(10,000)
	4,90,000
Depreciation on ₹ 4,90,000 @ 10%	49,000

6. Salaries

	₹
Salary paid during the year	1,20,000
Add: Outstanding as on 31.3.2022	8,000
	1,28,000

7. Electricity charges

	₹
Electricity charges paid during the year	28,000
Add: Outstanding as on 31.3.2022	15,000
	43,000

8. Interest

	₹
Interest on 12% Government securities investment (₹ 5,00,000 @ 12% p.a.)	60,000
Less: Interest received during the year	(58,000)
Interest accrued	2,000
Interest credited to Income and Expenditure Account	60,000

9. Profit from operations

	₹
Cost of goods sold:	
Opening stock	3,80,000
Add: Purchases	15,00,000
	18,80,000
Less: Closing stock	(2,10,000)
Cost of goods sold (A)	16,70,000
Receipts from operations:	
Receipts from coffee room	10,70,000
Receipts from soft drinks	5,10,000
Receipts from swimming pool	80,000
Receipts from tennis court	1,02,000
Total receipts (B)	17,62,000
Profits from operations (B-A)	92,000

10. Insurance

	₹
Insurance paid during the year	5,000
Add: Prepaid insurance as on 1.4.2021	1,000
	6,000

11. Sundry creditors

	₹
Opening balance as on 1.4.2021	1,12,000
Add: Purchases made during the year	15,00,000
	16,12,000
Less: Payments made during the year	(15,20,000)
Closing balance as on 31.3.2022	92,000

12. Outstanding expenses

	₹
Outstanding salaries	8,000
Outstanding electricity charges	15,000
Outstanding expenses	23,000

13. Fixed assets

	₹
Fixed assets as on 1.4.2021	5,00,000
Less: Cost of assets sold	(10,000)
	4,90,000
Less: Depreciation	(49,000)
Fixed assets as on 31.3.2022	4,41,000

14. Capital fund

	₹
Capital fund as on 1.4.2021	10,29,850
Add: Entrance donation capitalised	90,000
	11,19,850
Less: Excess of expenditure over income	(30,250)
Balance as on 31.3.2022	10,89,600

2. Income & Expenditure Account (An extract) of Sachin Cricket Club for the year ended 31st March, 2022

	₹		₹
		By Subscription (500 members × ₹ 1,500 per member)	7,50,000

Balance Sheet of Sachin Cricket Club as on 31st March, 2021 (An extract)

Liabilities	₹	Assets	₹
		Subscription Receivable (₹15,000 + ₹12,000)	27,000

Balance Sheet of Sachin Cricket Club as on 31st March, 2022 (An extract)

Liabilities	₹	Assets	₹	₹
Unearned Subscription	18,000	Outstanding Subscription		
		of 2020-21	15,000	
		of 2021-22 ₹ (7,50,000 – 6,15,000)	1,35,000	1,50,000

3. **Receipts and Payments Account of Bombay Medical Aid Society for the year ended 31st December, 2022**

Receipts	₹	Payments	₹
To Cash in hand (opening)	8,000	By Medicine supply	30,000
To Subscription	50,000	By Honorarium to doctors	10,000
To Donation	15,000	By Salaries	28,000
To Interest on investment	9,000	By Sundry expenses	1,000
To Charity show collections	12,500	By Purchase of equipment	15,000
		By Charity show expenses	1,500
		By Cash in hand (closing)	9,000
	94,500		94,500

Income and Expenditure Account of Bombay Medical Aid Society for the year ended 31st December, 2022

Expenditure		₹	Income		₹
To Medicine consumed		29,000	By Subscription		51,200
To Honorarium to doctors		10,000	By Donation		15,000
To Salaries		28,000	By Interest on investments		9,000
To Sundry expenses		1,000	By Profit on charity show:		
To Depreciation on					
To Depreciation on			Show collections	12,500	
Equipment	6,000		*Less:* Show expenses	(1,500)	11,000
Building	2,000	8,000			

To Surplus-excess of income over expenditure		10,200			
		86,200			86,200

Balance Sheet of Bombay Medical Aid Society
as on 31st December, 2022

Liabilities	₹	₹	**Assets**	₹	₹
Capital fund:			Building	50,000	
Opening balance	1,80,300		*Less*: Depreciation	(2,000)	48,000
Add: Surplus	10,200	1,90,500	Equipment	21,000	
Subscription received in advance		700	*Add*: Purchase	15,000	
Amount due for medicine supply		13,000		36,000	
			Less: Depreciation	(6,000)	30,000
			Stock of medicine		15,000
			Investments		1,00,000
			Subscription receivable		2,200
			Cash in hand		9,000
		2,04,200			2,04,200

Working Notes:

Subscription for the year ended 31st December, 2022:		₹
Subscription received during the year		50,000
Less: Subscription receivable on 1.1.2022	1,500	
Less: Subscription received in advance on 31.12.2022	700	(2,200)
		47,800
Add: Subscription receivable on 31.12.2022	2,200	
Add: Subscription received in advance on 1.1.2022	1,200	3,400
		51,200

Purchase of medicine:		
Payment for medicine supply		30,000
Less: Amounts due for medicine supply on 1.1.2022		(9,000)
		21,000
Add: Amounts due for medicine supply on 31.12.2022		13,000
		34,000
Medicine consumed:		
Stock of medicine on 1.1.2022		10,000
Add: Purchase of medicine during the year		34,000
		44,000
Less: Stock of medicine on 31.12.2022		(15,000)
		29,000
Depreciation on equipment:		
Value of equipment on 1.1.2022		21,000
Add: Purchase of equipment during the year		15,000
		36,000
Less: Value of equipment on 31.12.2022		(30,000)
Depreciation on equipment for the year		6,000

Balance Sheet of Medical Aid Society

as on 1st January, 2022

Liabilities	₹	Assets	₹
Capital fund (balancing figure)	1,80,300	Building	50,000
Subscription received in advance	1,200	Equipment	21,000
Amount due for medicine supply	9,000	Stock of medicine	10,000
		Investments (₹ 9,000 x 100/9)	1,00,000
		Subscription receivable	1,500
		Cash in hand	8,000
	1,90,500		1,90,500

NOTES

CHAPTER 9

ACCOUNTS FROM INCOMPLETE RECORDS

LEARNING OUTCOMES

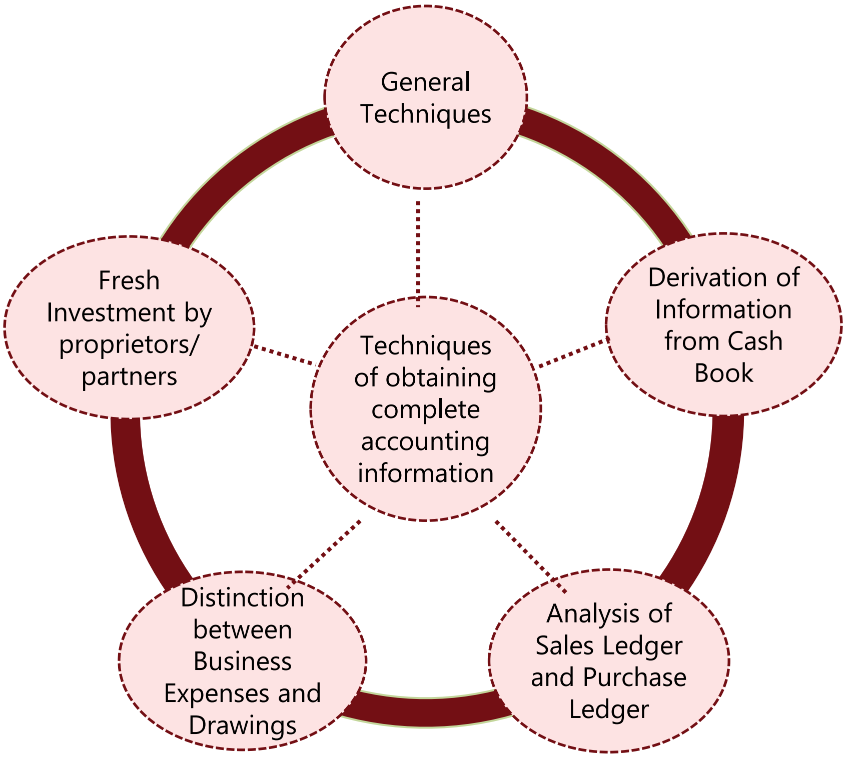
After studying this Chapter, you would be able to:

- Learn how to derive capitals at two different points of time through statement of affairs.
- Learn the technique of determining profit by comparing capital at two different points of time.
- Prepare Trading and Profit and Loss Account and Balance Sheet from incomplete records.

CHAPTER OVERVIEW

- Definition of Single Entry System and its features
- Types of Single entry system
- Determination of profit by comparing capitals at different points of time
- Statement of Affairs and its comparison with Balance sheet
- Technique of obtaining complete information for preparation of financial statements

Incomplete books of accounts → Completion of double entry in all transactions → Accounting process → Preparation of Trial Balance → Preparation of Financial statements



Sources utilized by Accountant	• Collection of necessary information about assets and liabilities
Derivation of opening and closing capitals	• Statement of Affairs at different points of time

1. INTRODUCTION

Very often small sole proprietorship and partnership businesses do not maintain double entry book keeping. There might be reasons like lack of knowledge of accounting, or the business is small and they do not wish to spend time or effort in maintaining the accounting records. As such, they might keep a record of the cash transactions and credit transactions only. But at the end of the accounting period, they will want to know the performance and financial position of their businesses. Think of a grocery-vendor who sells vegetables on a street or runs a small shop. Is he expected to learn accounting formally? No, he is only looking at keeping a record of a few items including:

- What amount is he supposed to pay for items purchased on credit from his supplier?
- What cash has he collected by selling those vegetables?
- In case he runs a shop, how much amount has he paid for rent or electricity expenses?
- In case he sells some items on credit, how much is he supposed to receive from that customer?

There might be other reasons for incomplete records such as:

- Accounting records are destroyed by accident, such as fire;
- Some essential figure is unknown and must be calculated as a balancing figure (for example, due to inventory being damaged or destroyed).

Every person would like to know the profit generated by the business. What we expect to learn is how to use those records to arrive at the profit or loss earned by the business or understand the financial position of that business.

This chapter discusses how to complete the accounts from available incomplete records and addresses the problems faced in a single-entry system.

There is no such formal system as Single-Entry System as the accounts can only be prepared using Double Entry System. It might be appropriate to mention that a single-entry system is truly a system of incomplete or improper records.

The way **"Single Entry System"** operates is that for some transactions the book-keepers complete entries and for some others they complete just one aspect of the transaction. In fact, for some other transactions, they even do not pass any entry. The task of the accountant is to establish link among the available information and to finalize these accounts.

Normally, the businessmen keep a record of cash receipts and cash payments and personal accounts (receivables, payables, capital etc.) Also, information from bank statement (withdrawals, deposits) is easily available as well.

Features of Single Entry System

- It is an inaccurate, unscientific and unsystematic method of recording business transactions.
- There is generally no record of real and nominal accounts and, in most of the cases; a record is kept for cash transactions and personal accounts.
- Cash book mixes up business and personal transactions of the owners.
- There is no uniformity in maintaining the records and the system may differ from firm to firm depending on the requirements and convenience of each firm.
- Profit under this system is only an estimate based on available information and therefore true and correct profits cannot be determined. The same is the case with the financial position in the absence of a proper balance sheet.

2. TYPES OF SINGLE ENTRY SYSTEM

A scrutiny of many procedures adopted in maintaining records under single entry system brings forth the existence of following three types:

(i) **Pure single entry**: In this, only personal accounts are maintained with the result that no information is available in respect of cash and bank balances, sales and purchases, etc. In view of its failure to provide even the basic information regarding cash etc., this method exists only on paper and has no practical application.

(ii) **Simple single entry**: In this, only: (a) personal accounts, and (b) cash book are maintained. Although these accounts are kept on the basis of double entry system, postings from cash book are made only to personal accounts with no other account to be found in the ledger. Cash received from debtors or cash paid to creditors is simply noted on the bills issued or received as the case may be.

For example, M/s Small shop runs a retail shop. It keeps a register of amount receivable from people for items sold (bread, butter, milk etc). as under:

Mr. A – ₹ 300

Mr. B – ₹ 450

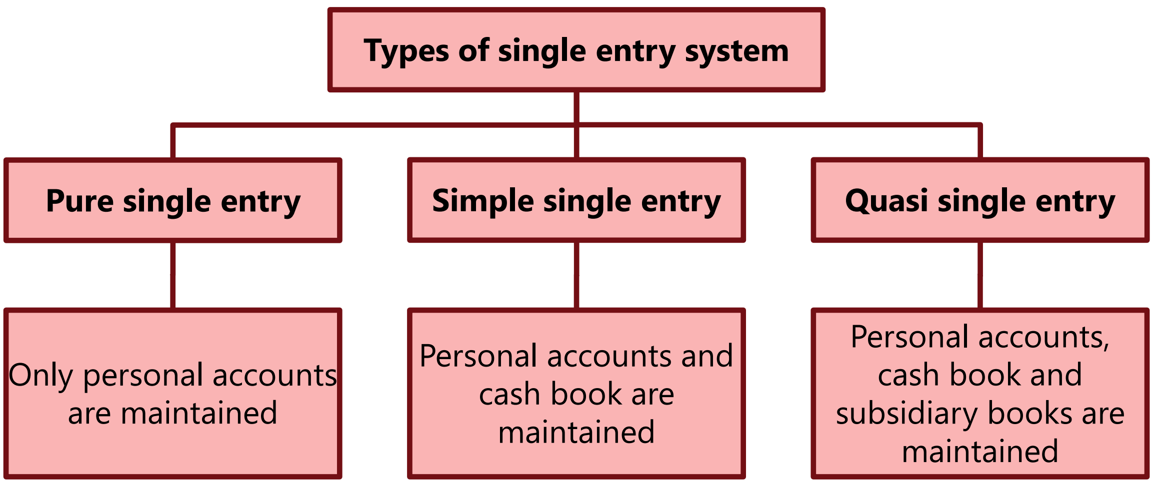
Mr. C – ₹ 260.

The business does not maintain a record of what item has been sold. It is only concerned about the amount receivable (personal account balance) from its customers.

(iii) **Quasi single entry**: In this: (a) personal accounts, (b) cash book, and (c) some subsidiary books are maintained. The main subsidiary books kept under this system are Sales book, Purchases book and Bills book. No separate record is maintained for discounts, which are entered into the personal accounts. In addition, some scattered information is also available in respect of few important items of expenses like wages, rent, rates, etc. In fact, this is the method which is generally adopted as a substitute for double entry system.

Some businesses may also maintain additional records like Bills book or Sales book. This might be required for tax or other purposes. For example, a shop selling t-shirts may want to issue a bill to each customer for the sales made to them. This will help them validate any returns of goods within reasonable time. In addition, they may keep a purchase book to record all purchases.

Also, organisations employing workers keep records of cash wages paid and take acceptance from the workers for the amount paid to them.



3. ASCERTAINMENT OF PROFIT BY CAPITAL COMPARISON

This method is also known as **Net Worth method or Statement of Affairs Method**.

Net Worth method or Statement of Affairs Method.

Profit/(Loss) = Closing Capital − Opening Capital

If detailed information regarding revenue and expenses is not known, it becomes difficult to prepare profit and loss account. Instead by collecting information about assets and liabilities, it is easier to prepare balance sheet at two different points of time. So, while preparing accounts from incomplete records, if sufficient information is not available, it is better to follow the method of capital comparison to arrive at the profit/loss for the current year.

3.1 Methods of Capital Comparison

Closing capital increases if there is profit, while it reduces if there is loss incurred during the year. However, if the proprietor/partners make fresh investments in the business, capital increases; and any withdrawal made by them, decreases the capital.

The following points shall be considered while computing the profit/loss under capital comparison method-

Particulars	₹
Capital at the end (a)	XX
Add: Drawings	XX
Less: Fresh capital introduced	XX
Capital at the beginning (b)	XX
Profit (a-b)	**XX**

ILLUSTRATION 1

Raju does not maintain proper records of his business. However, he provides the following information:

	₹
Opening capital	*10,000*
Closing capital	*12,500*

Drawings during the year	*3,000*
Capital added during the year	*3,750*

You are required to calculate the profit or loss for the year.

SOLUTION

Computation of Profit or Loss during the year	₹
Closing Capital	12,500
Add: Drawings during the year	3,000
	15,500
Less: Additional capital during the year	(3,750)
Less: opening capital	(10,000)
Net Profit for the year	1,750

ALTERNATIVELY

Profit/Loss can also be ascertained as balancing figure by preparing capital account as follows:

Particulars	₹	**Particulars**	₹
To drawings	3,000	By Balance b/d	10,000
To Balance c/d	12,500	By additional capital	3,750
		By Net Profit (Bal Fig)	**1,750**
	15,500		15,500

It is clear from the above discussion that to follow the capital comparison method, one should know the opening capital and closing capital. This should be determined by preparing statement of affairs at the two respective points of time.

Capital = Assets (-) liabilities.

Thus, the preparation of statement of affairs will require listing of assets and liabilities and their amount. The accountant utilizes the following sources for the purpose of finding out the assets and liabilities of a business enterprise:

(i) Cash book for cash balance

(ii) Bank pass book for bank balance

(iii) Personal ledger for debtors and creditors

(iv) Inventory by actual counting and valuation.

(v) As regards fixed assets, he prepares a list of them. The proprietor would help him by disclosing the original cost and date of purchase. After deducting reasonable amount of depreciation, the written down value would be included in the Statement of Affairs.

After obtaining all necessary information about assets and liabilities, the next task of the accountant is to prepare statement of affairs at two different points in time.

The design of the statement of affairs is just like balance sheet as given below:

Statement of affairs as on...........

Liabilities	₹	***Assets***	₹
Capital (Bal. Fig.)	xx	Building	xx
Loans, Bank overdraft	xx	Machinery	xx
Sundry creditors	xx	Furniture	xx
Bills payable	xx	Inventory	xx
Outstanding expenses		Sundry debtors	xx
		Bills receivable	xx
		Loans and advances	xx
		Cash and bank	xx
		Prepaid expenses	xx
	xx		**xx**

Now from the statement of affairs prepared at two different dates, the opening and closing capital balances can be obtained.

ILLUSTRATION 2

Rakesh started his business on 1st of April 2021. He invested a capital of Rs 1,00,000. On 31st March 2022, he has the following information available as per the Single-entry system maintained by him.

	₹
Cash balance (counted)	*3,200*
Inventory (physically verified)	*34,800*
Receivable from Ajay against credit sales	*31,000*
Machine	*85,000*
Payable to Vinod towards credit purchase	*12,000*

Loan taken from Bank	*10,000*
Drawings made during the year	*24,000*

You are required to calculate the profit or loss earned by Rakesh for the year ended 31st March 2022.

SOLUTION

Statement of Affairs as on 31st March, 2022

Liabilities	Amount	Assets	Amount
Sundry Creditors	12,000	Cash balance	3,200
Loan from bank	10,000	Inventory	34,800
Capital (Bal fig)	1,32,000	Sundry Debtors	31,000
		Machine	85,000
	1,54,000		1,54,000

Statement of profit or loss for the year ended 31st March, 2022

Capital as at 31st March 2022	1,32,000
Add: Drawings made during the year	24,000
Total	1,56,000
Less: Opening Capital as at 1st April 2021	(1,00,000)
Profit for the year ended 31st March 2022	56,000

3.2 Difference between Statement of Affairs and Balance Sheet

Basis	*Statement of affairs*	*Balance sheet*
Source	It is prepared on the basis of transactions partly recorded under the double entry book keeping and partly under the single entry. Most of the assets are recorded based on the estimates, assumptions, information gathered from memory rather from the records.	It is based on transactions recorded strictly on the basis of double entry book keeping; each item in the balance sheet can be verified from the relevant subsidiary books, ledger and documentary evidences.
Capital	In this statement, capital is merely a balancing figure	Capital is derived from the capital account in the ledger and therefore the total of

	being excess of assets over liabilities. Hence assets need not be equal to liabilities.	assets side will always be equal to the total of liabilities side.
Omission	Since this statement is prepared from incomplete records, it is very difficult, to identify and record those assets and liabilities, if omitted from the books.	There is no possibility of omission of any item of asset and liability since all items are properly recorded. Moreover, it is easy to locate the missing items since the balance sheet will not agree.
Basis of Valuation	The valuation of assets is generally done in an arbitrary manner; therefore, no method of valuation is disclosed.	The valuation of assets is done on scientific basis, fixed assets are shown at the original costs less depreciation till date. Any change in the method of valuation is properly disclosed.
Objective	The objective of preparing this statement is to identify the capital figures in the beginning and at the end of the accounting period respectively.	The objective of preparing the balance sheet is to ascertain the financial position on a particular date.

3.3 Preparation of Statement of Affairs and Determination of Profit

It has been discussed in Para 3.1 that figures of assets and liabilities should be collected for preparation of statement of affairs. Given below an example:

ILLUSTRATION 3

Assets and Liabilities of Mr. X as on 31-03-2021 and 31-03-2022 are as follows:

	31-03-2021	***31-03-2022***
	₹	₹
Assets		
Building	*1,00,000*	*?*
Furniture	*50,000*	*?*
Inventory	*1,20,000*	*2,70,000*
Sundry debtors	*40,000*	*90,000*
Cash at bank	*70,000*	*85,000*

Cash in hand	*1,200*	*3,200*
Liabilities		
Loans	*1,00,000*	*80,000*
Sundry creditors	*40,000*	*70,000*

Decided to depreciate building by 2.5%p.a. and furniture by 10% p.a. One Life Insurance Policy of the Proprietor was matured during the period and the amount ₹ 40,000 is retained in the business. Proprietor took @ ₹ 2,000 p.m. for meeting family expenses.

Prepare Statement of Affairs as on 31-03-2021 and 31-03-2022.

SOLUTION

Mr. X

Statement of Affairs
as on 31-03-2021 & 31-03-2022

Liabilities	***31-03-2021*** ₹	***31-03-2022*** ₹	***Assets***	***31-03-2021*** ₹	***31-03-2022*** ₹
Capital	2,41,200	4,40,700	Building	1,00,000	97,500
Loans	1,00,000	80,000	Furniture	50,000	45,000
Sundry creditors	40,000	70,000	Inventory	1,20,000	2,70,000
			Sundry debtors	40,000	90,000
			Cash at bank	70,000	85,000
			Cash in hand	1,200	3,200
	3,81,200	5,90,700		3,81,200	5,90,700

ILLUSTRATION 4

Take figures given in Illustration 4. Find out profit of Mr. X for the year ended 31-03-2022.

SOLUTION

Determination of Profit by applying the method of the capital comparison

	₹
Capital Balance as on 31-03-2022	4,40,700
Less: Fresh capital introduced	(40,000)
	4,00,700

Add: Drawings (₹ 2000 × 12)	24,000
	4,24,700
Less: Capital Balance as on 31-03-2021	(2,41,200)
Profit	1,83,500

Note:

- Closing capital is increased due to fresh capital introduction, so it is deducted.
- Closing capital was reduced due to withdrawal by proprietor; so it is added back.

ALTERNATIVELY

Capital account can be prepared as follows:

Particulars	**₹**	**Particulars**	**₹**
To drawings	24,000	By Balance b/d	2,41,200
To Balance c/d	4,40,700	By additional capital	40,000
		By Net Profit (Bal Fig)	1,83,500
	4,64,700		4,64,700

ILLUSTRATION 5

The Income Tax Officer, on assessing the income of Shri Moti for the financial years 2020-2021 and 2021-2022 feels that Shri Moti has not disclosed the full income. He gives you the following particulars of assets and liabilities of Shri Moti as on 1st April, 2020 and 1st April, 2022.

				₹
1-4-2020	*Assets*	*:*	*Cash in hand*	*25,500*
			Inventory	*56,000*
			Sundry debtors	*41,500*
			Land and Building	*1,90,000*
			Wife's Jewellery	*75,000*
	Liabilities	*:*	*Owing to Moti's Brother*	*40,000*
			Sundry creditors	*35,000*
1-4-2022	*Assets*	*:*	*Cash in hand*	*16,000*
			Inventory	*91,500*
			Sundry debtors	*52,500*

	Land and Building	*1,90,000*
	Motor Car	*1,25,000*
	Wife's Jewellery	*1,25,000*
	Loan to Moti's Brother	*20,000*
Liabilities :	*Sundry creditors*	*55,000*

During the two years the domestic expenditure was ₹ 4,000 p.m. The declared incomes of the financial years were ₹ 1,05,000 for 2020-2021 and ₹ 1,23,000 for 2021-2022 respectively.

State whether the Income-tax Officer's contention is correct. Explain by giving your workings.

SOLUTION

Calculation of Capital of Shri Moti

	₹	***1-4-2020₹***	₹	***1-4-2022₹***
Assets				
Cash in hand		25,500		16,000
Inventory		56,000		91,500
Sundry debtors		41,500		52,500
Land & Building		1,90,000		1,90,000
Wife's Jewellery		75,000		1,25,000
Motor Car		—		1,25,000
Loan to Moti's Brother		—		20,000
		3,88,000		6,20,000
Liabilities:				
Owing to Moti's Brother	40,000		—	
Sundry creditors	35,000	75,000	55,000	55,000
Capital		3,13,000		5,65,000
Income during the two years:				
Capital as on 1-4-2022				5,65,000
Add: Drawings – Domestic Expenses for the two years (₹ 4,000 × 24 months)				96,000
				6,61,000

Less: Capital as on 1-4-2020	(3,13,000)
Income earned in 2020-2021 and 2021-2022	3,48,000
Income declared (₹ 1,05,000 + ₹ 1,23,000)	2,28,000
Suppressed Income	1,20,000

The Income-tax officer's contention that Shri Moti has not declared his true income is correct. Shri Moti's true income is in excess of the disclosed income by ₹ 1,20,000 based on the information available

4. TECHNIQUES OF OBTAINING COMPLETE ACCOUNTING INFORMATION

When books of accounts are incomplete, it is essential to complete double entry in respect of all transactions. The whole accounting process should be carefully followed and Trial Balance should be drawn up.

4.1 General Techniques

Where the accounts of a business are incomplete, it is advisable to convert them first to the double entry system and then to draw up the Profit and Loss Account and the Balance Sheet, instead of determining the amount of profit/loss by preparing the statement of affairs. As books of accounts of different firms being incomplete in varying degrees, it is not possible to suggest a formula which could uniformly be applied for preparing final accounts therefrom. As a general rule, it is essential to first start the ledger accounts with the opening balances of assets, liabilities and the capital. Afterwards, each book of original entry should be separately dealt with, so as to complete the double entry by posting into the ledger all entries which have not been posted. For example, If only personal accounts have been posted from the Cash Book, debits and credits pertaining to nominal accounts and real accounts that are not posted, should be posted into the ledger. If there are Discount Columns in the Cash Book, the totals of discounts paid and received should be posted to Discounts Allowed and Discounts Received Accounts respectively, for completing the double entry.

Afterwards, the other subsidiary books, i.e., Purchases Day Book, Sales Day Book, Purchase Return Book, Sales Return Book, Bills Receivable and Bills Payable, etc. should be totaled up and their totals posted into the ledger to the debit or credit of the appropriate nominal or real accounts, as the personal aspect of the transactions have been posted already.

When an Accountant is engaged in posting the unposted items from the Cash Book and other subsidiary books, he may be confronted with a number of problems. The manner in which some of them may be dealt with is described below:

(1) In the Cash Book, there can be several receipt entries which have no connection with the business but which belong to the proprietor, e.g., interest collected on his private investment, legacies received by him, amount contributed by the proprietor from his private resources, etc. All those amounts should be credited to his capital account. Also the Cash Book may contain entries in respect of payments for proprietor's purchases and his personal expenses. All such items should be taken to his capital account on the debit side as drawings.

(2) Amounts belonging to the business after collection may have been directly utilised for acquiring business assets or for meeting certain expenses instead of being recorded in the Cash Book. On the other hand, the proprietor may have met some of the business expenses from his private resources. In that case, the appropriate asset or expense account should be debited and the source of obtaining funds to be credited.

(3) If cash is short, because the proprietor had withdrawn amount without any entry having been made in the cash book the proprietor's capital account should be debited. In fact, it will be necessary to debit or credit the proprietor's capital account in respect of all unidentified amounts which cannot be adjusted anywhere else.

(4) Where the benefit of an item of an expense is received both by the proprietor and business, then it should be allocated between the two on some equitable basis e.g. rent of premises when the proprietor lives in the same premises, should be allocated on the basis of the area occupied by him for residence.

In the end, it will be possible to draw a Trial Balance. Students are advised to prepare a Trial balance as it will bring out any mistakes committed while making the above adjustments.

4.2 Derivation of Information from Cash Book

The analysis of cash as well as bank receipts and payments, should be extensive but under significant heads, so that various items of income and expenditure can be posted therefrom into the ledger. However before posting the information into the ledger the same should be collected in the form of an account, the specimen whereof is shown below:

Cash and Bank Summary Account for the year ended (assumed figures)

	Cash	Bank		Cash	Bank
	₹	₹		₹	₹
To Balance in hand	590	7,400	By Expenses	3,000	-

(opening)			(Sundry payments)		
To Sales	6,500	-	By Purchases	100	6,000
To Collection from			By Sundry creditors	-	5,000
Debtors	-	10,000	By Drawings	1,500	-
			By Petty expenses	800	-
			By Rent	-	1,000
			By Electricity and water	350	-
			By Repairs	350	-
			By Wages	-	1,000
			By Balance in Hand	990	4,400
	7,090	17,400		7,090	17,400

The important point about incomplete records is that much of the information may not be readily available and that the relevant information has to be ascertained. A good point is to prepare Cash and Bank Summary (if not available in proper form with both sides tallied). The cash and bank balance at the end should be reconciled with the cash and bank books. Having done so, the various items detailed on the Summary Statements, should be posted into the ledger.

It is quite likely that some of the missing information will then be available. Consider the following about a firm relating to 31st March 2022.

	₹
Cash Balance on 1st April, 2021	250
Bank overdraft on 1st April, 2021	5,400
Cash purchases	3,000
Collection from Sundry debtors	45,600
Sale of old furniture	750
Purchase of Machinery	12,000
Payment of Sundry creditors	26,370
Expenses	8,450
Fresh Capital brought in	5,000
Drawings	3,230
Cash Balance on 31st March, 2022	310
Bank balance on 31st March, 2022	1,180

Now prepare the cash and Bank Summary.

Cash and Bank Summary

Dr.	₹		₹ *Cr.*
Cash Balance on 1-4-2021	250	Bank overdraft on 1-4-2021	5,400
Collection from Sundry debtors	45,600	Cash purchases	3,000
Sale of old furniture	750	Purchase of Machinery	12,000
Fresh Capital brought in	5,000	Payment to Sundry creditors	26,370
Balancing figure- (Cash sales)	8,340	Expenses	8,450
		Drawings	3,230
		Cash balance on 31-03-2022	310
		Bank balance on 31-03-2022	1,180
	59,940		59,940

See that debit side is short by ₹ 8,340. What may be the possible source of cash inflow? It can be cash sales.

4.3 Analysis of Sales Ledger and Purchase Ledger

Sales Ledger: It would disclose information pertaining to the opening balances of debtors, transactions made with them during the year such as goods sold to them on credit, bills receivable drawn on them, bills dishonored, if any; cash received from them, sales returns, discount, rebate or any other concession allowed to them, receipts of bills receivable, bad debts written off and transfers. Journal entries must be made by debiting or crediting the impersonal accounts concerned with contra credit or debit given to total debtors account.

Analysis of Sales Ledger of the year

Op. Customer Balance	Sales	Bills Disho-nored	Total Debits	Cash Recd.	Dis-counts Allw.	Bills Recd.	Sales Returns	Bad Debts	Total Credit	Balance (cl.)

From the aforementioned, it will be possible to build up information about sales and other accounts which can then be posted in totals, if so desired. It would also be possible to prepare Total Debtors

Account in the following form:

Proforma of Total Debtors Account (assumed figures)

	₹		₹
To Opening balance	5,000	By Cash/Bank	10,000
To Sales	38,000	By Discount	500
To Bills dishonoured	280	By Bills receivable	20,000
To Interest	100	By Bad debts	280
		By Closing balance	12,600
	43,380		43,380

In can be seen from the above format that, if any one figure is not given it can be found out easily as the balancing figure. It can be opening balance, credit sales, cash collected or closing balance etc. For instance, if the information about sales is not available it could be ascertained as the balancing figure, *i.e.,* in the total Debtors Account given above, if all other figures are given, amount of sales on credit basis can be easily ascertained.

ILLUSTRATION 6

Calculate the bad debts from the below information:

Opening balance of Debtors	*₹ 5,00,000*
Closing balance of Debtors	*₹ 7,00,000*
Amount received in Cash	*₹ 6,00,000*
Discount allowed	*₹ 10,000*
Credit Sales	*₹ 11,40,000*
Bills Receivable	*₹ 3,00,000*
Bad Debts	*???*

SOLUTION

Debtors Account

Particulars	Amount	Particulars	Amount
Balance b/f	5,00,000	Cash A/c	6,00,000
Credit Sales	11,40,000	Discount allowed	10,000
		Bills Receivable	3,00,000

		Bad Debts (Bal fig)	30,000
		Balance c/f	7,00,000
	16,40,000		16,40,000

Purchases Ledger: Generally speaking, a Purchases Ledger is not as commonly maintained as the Debtors Ledger for it being convenient to make entries in respect of outstanding liabilities at the time they are paid rather than when they are incurred. The information is available in respect of opening balance of the creditors, goods purchased on credit, bills payable accepted, bills payable dishonored; cash paid to the creditors during the year, discount and other concessions obtained, returns outwards and transfers. Here also, journal entries must be made by debiting or crediting the respective impersonal accounts. Contra credit or debit being given to total creditor's account.

From the available information total creditors account can be prepared as follows

Proforma of Total Creditors Account (assumed figures)

	₹		₹
To Cash/bank	25,000	By Opening Balance	10,000
To Purchase Returns	400	By Purchases	30,400
To Bills Payable	8,700	By Bill payable dishonoured	450
To discount received	100		
To Closing Balance	6,650		
	40,850		40,850

If a proper record of return to creditors, discount allowed by them etc., has not been kept, it may not be possible to write up the Total Creditors A/c. In such a case, net credit purchase can be ascertained as follows:

Cash paid to Creditors including on account of bills payable during the period	XXX
Closing balance of Creditors and Bills Payable	XXX
Total	XXX
Less: Opening balance of Creditors and Bills Payable	XXX
Net credit purchase during the period	XXX

Alternatively

Cash paid to creditors during the period	XXX

Add: Bills Payable issued to them	XXX
Closing balance of Creditors	XXX
Less: Opening balance of creditors	XXX
Credit Purchases during the period	XXX

ILLUSTRATION 7

Calculate the credit purchases from the below information:

Opening balance of creditors	₹ 4,00,000
Closing balance of creditors	₹ 5,00,000
Payments made in Cash	₹ 8,50,000
Discount received	₹ 20,000

SOLUTION

Total Creditors Account

Particulars	Amount	Particulars	Amount
Cash paid	8,50,000	Balance b/d	4,00,000
Discount received	20,000	Credit Purchases (Bal. fig)	
Balance c/d	5,00,000		9,70,000
	13,70,000		13,70,000

Nominal Accounts: It is quite likely that the total expenditure shown by balance of nominal account may contain items of expenditure which do not relate to the year for which accounts are being prepared and, also, there may exist certain items of expenditure incurred but not paid, which have not been included therein. On that account, each and every account should be adjusted in the manner shown below (figures assumed):

	Cash and Particulars	***Amount Bank Payment***	***Paid out of Accrued***	***Total Private Fund***	***Pre Payment***	***Expenses for the period***
1	*2*	*3*	*4*	*5 (2+3+4)*	*6*	*7 (5-6)*
	₹	₹	₹	₹	₹	₹
Rent & Rates	2,200	300	100	2,600	150	2,450
Salaries	4,500	500	1,000	6,000	250	5,750

Only the amount entered as "expenses for the period" should be posted to the respective nominal accounts. A similar adjustment of nominal accounts in respect of revenue receipt should be made.

Let us continue with the example given in para 4.2. Given some other information, how to compute credit purchase and credit sale is discussed below:

Opening balance (1-4-2021)	₹
Inventory	20,000
Sundry creditors	12,300
Sundry debtors	15,000
Closing Balance (31-03-2022)	
Inventory	15,000
Sundry creditors	13,800
Sundry debtors	25,600
Cash paid to creditors	26,370
Cash received from debtors	45,600
Cash sales	8,340
Cash purchases	3,000
Discount received during the year	1,130
Discount allowed	1,870

What are the purchases for 2021-2022? Let us prepare the Sundry Creditors Account.

Sundry Creditors Account

	₹		₹
To Cash	26,370	By Balance b/d	12,300
To Discount (received)	1,130	(opening)	
To Balance c/d (closing)	13,800	By Purchases (balancing figure)	29,000
	41,300		41,300

The credit purchases are ₹ 29,000; cash purchases are ₹ 3,000: hence total purchases are ₹ 32,000.

Likewise prepare the Sundry Debtors Account:

Sundry Debtors Account

	₹		₹
To Balance b/d	15,000	By Cash	45,600
To Credit sales (balancing figure)	58,070	By Discount (allowed)	1,870
		By Balance c/d	25,600
	73,070		73,070

So total sales = credit sales + cash sales

= ₹ 58,070 + ₹ 8,340 = ₹ 66,410

4.4 Distinction between Business Expenses and Drawings

It has been already stated that often the distinction is not made between business expenses and drawings. While completing accounts from incomplete records, it is necessary to scan the business transactions carefully to identify the existence of drawings.

The main items of drawings are (illustrative):

- Rent of premises commonly used for residential as well as business purposes.
- Common electricity and telephone bills.
- Life insurance premiums of proprietor/partners paid from business cash.
- Household expenses met from business cash.
- Private loan paid to friends and relatives out of business cash.
- Personal gifts made to any friends and relatives out of business cash.
- Goods or services taken from the business for personal consumption.
- Cash withdrawals to meet family expenses.
- Amount collected from debtors directly used for meeting personal expenses.

So it is necessary to scan the summary of cash transactions, business resources and their utilization to assess the nature of drawings and its amount.

4.5 Fresh Investment by proprietors / partners

Like drawings, often fresh investments made by proprietors' /partners are not readily identifiable. It becomes necessary to scan the business transactions carefully. Apart from direct cash investment, fresh investments may take the following shape:

- Money collected and put in the business on maturity of Life Insurance Policy of the proprietors.
- Interest and dividend of personal investment of the proprietors collected and put in the business.
- Income from non-business property collected and put in the business.
- Payments made to creditors out of personal cash.

Unless these items are properly identified and segregated, business income will be affected and proper statement of affairs cannot be prepared.

ILLUSTRATION 8

A. Adamjee keeps his books on single entry basis. The analysis of the cash book for the year ended on 31st March, 2022 is given below:

Receipts	₹	***Payments***	₹
Bank Balance as on 1st April, 2021	*2,800*	*Payments to Sundry creditors*	*35,000*
Received from Sundry Debtors	*48,000*	*Salaries*	*6,500*
Cash Sales	*11,000*	*General expenses*	*2,500*
Capital brought during the year	*6,000*	*Rent and Taxes*	*1,500*
Interest on Investments	*200*	*Drawings*	*3,600*
		Cash purchases	*12,000*
		Balance at Bank on 31st March, 2022	*6,400*
		Cash in hand on 31st March, 2022	*500*
	68,000		*68,000*

Particulars of other assets and liabilities are as follows:

	1st April, 2021	***31st March, 2022***
Sundry debtors	*14,500*	*17,600*
Sundry creditors	*5,800*	*7,900*
Machinery	*7,500*	*7,500*
Furniture	*1,200*	*1,200*
Inventory	*3,900*	*5,700*
Investments	*5,000*	*5,000*

Prepare final accounts for the year ending 31st March, 2022 after providing depreciation at 10 per cent on machinery and furniture and ₹ 800 against doubtful debts.

SOLUTION

A. Adamjee

Trading Account for the year ended 31st March 2022

	₹	₹		₹
To Opening Inventory		3,900	By Sales	62,100
To Purchases		49,100	By Closing Inventory	5,700
To Gross profit c/d (b.f.)		14,800		
		67,800		67,800

Profit & Loss Account for the year ended 31st March 2022

	₹	₹		₹
To Salaries		6,500	By Gross Profit b/d	14,800
To Rent and Taxes		1,500	By Interest on investment	200
To General expenses		2,500		
To Dep:				
Machinery@ 10%	750			
Furniture @ 10%	120	870		
To Provision for doubtful debts		800		
To Net profit carried to Capital A/c (b.f.)		2,830		
		15,000		15,000

Balance Sheet as on 31st March 2022

Liabilities	₹	₹	***Assets***	₹	₹
A. Adamjee's Capital			Machinery	7,500	
on 1st April, 2021	29,100		*Less :* Depreciation	(750)	6,750
Add: Fresh Capital	6,000		Furniture	1,200	
Add: Profit for the year	2,830		*Less :* Depreciation	(120)	1,080
	37,930				

Less: Drawings	(3,600)	34,330	Inventory-in-trade		5,700
			Sundry debtors	17,600	
Sundry creditors		7,900	*Less :* Provision for		
			Doubtful debts	(800)	16,800
			Investment		5,000
			Cash at bank		6,400
			Cash in hand		500
		42,230			42,230

Working Notes:

1. Balance sheet of A. Adamjee as on 1st April 2021

Liabilities	₹	Assets	₹
Sundry creditors	5,800	Machinery	7,500
A. Adamjee's capital (balancing figure)	29,100	Furniture	1,200
		Inventory	3,900
		Sundry debtors	14,500
		Investments	5,000
		Bank balance (from Cash statement)	2,800
	34,900		34,900

2. Ledger Accounts

A. Adamjee's Capital Account

		₹			₹
31.03.22	To Drawings	3,600	01.04. 21	By Balance b/d	29,100
			31.03.22	By Net Profit	2,830
31.03.22	To Balance c/d (b.f.)	34,330	31.03.22	By Cash	6,000
		37,930			37,930

Sales Account

		₹			₹
31.03.22	To Trading A/c (b.f.)	62,100	31.03.22	By Cash	11,000
			31.03.22	By Total Debtors Account (Credit Sales)	51,100
		62,100			62,100

Total Debtors Account

		₹			₹
01.04.21	To Balance b/d	14,500	31.03.22	By Cash	48,000
31.03.22	To Credit sales (Balancing figure)	51,100	31.03.22	By Balance c/d	17,600
		65,600			65,600

Purchases Account

		₹			₹
31.03.22	To Cash A/c	12,000	31.03.22	By Trading Account (b.f.)	49,100
	To total Creditors A/c (credit Purchases)	37,100			
		49,100			49,100

Total Creditors Account

		₹			₹
31.03.22	To Cash	35,000	01.04.21	By Balance b/d	5,800
31.03.22	To Balance b/d	7,900	31.03.22	By Credit Purchases (Balancing figure)	37,100
		42,900			42,900

ILLUSTRATION 9

From the following data furnished by Mr. Manoj, you are required to prepare a Trading and Profit and Loss Account for the year ended 31st March, 2022 and Balance Sheet as at that date. All workings should form part of your answer.

Assets and Liabilities	***As on 1st April 2021***	***As on 31st March 2022***
	₹	₹
Creditors	*15,770*	*12,400*
Sundry expenses outstanding	*600*	*330*
Sundry Assets	*11,610*	*12,040*
Inventory in trade	*8,040*	*11,120*
Cash in hand and at bank	*6,960*	*8,080*
Trade debtors	*?*	*17,870*
Details relating to transactions in the year:		
Cash and discount credited to debtors		*64,000*
Sales return		*1,450*
Bad debts		*420*
Sales (cash and credit)		*71,810*
Discount allowed by trade creditors		*700*
Purchase returns		*400*
Additional capital-paid into Bank		*8,500*
Realisations from debtors-paid into Bank		*62,500*
Cash purchases		*1,030*
Cash expenses		*9,570*
Paid by cheque for machinery purchased		*430*
Household expenses drawn from Bank		*3,180*
Cash paid into Bank		*5,000*
Cash drawn from Bank		*9,240*
Cash in hand on 31-3-2022		*1,200*
Cheques issued to trade creditors		*60,270*

SOLUTION

In the books of Mr. Manoj

Trading Account for the year ending 31st March, 2022

	₹	₹		₹	₹
To Opening Inventory		8,040	By Sales		
To Purchases	59,030		Cash	4,600	
(58,000 + 1,030)			Credit	67,210	
Less: Returns	(400)	58,630		71,810	
To Gross profit c/d		14,810	*Less:* Returns	(1,450)	70,360
			By Closing inventory		11,120
		81,480			81,480

Profit & Loss Account for the year ending 31st March, 2022

	₹		₹
To Sundry expenses (W.N.(v))	9,300	By Gross profit b/d	14,810
To Discount	1,500	By Discount	700
To Bad Debts	420		
To Net Profit transfer to Capital	4,290		
	15,510		15,510

Balance Sheet of Mr. Manoj as on 31st March, 2022

Liabilities	₹	₹	***Assets***	₹
Capital			Sundry assets	12,040
Opening balance	26,770		Inventory in trade	11,120
Add: Addition	8,500		Sundry debtors	17,870
Net Profit	4,290		Cash in hand & at bank	8,080
	39,560			
Less: Drawings	(3,180)	36,380		
Sundry creditors		12,400		
Outstanding expenses		330		
		49,110		49,110

Working Notes:

(i) Cash sales

Combined Cash & Bank Account

	₹		₹
To Balance b/d	6,960	By Sundry creditors	60,270
To Sundries (Contra)	5,000	By Sundries (Contra)	5,000
To Sundries (Contra)	9,240	By Sundries (Contra)	9,240
To Sundry debtors	62,500	By Drawings	3,180
To Capital A/c	8,500	By Machinery	430
To Sales (Cash Sales-Balancing Figure)	4,600	By Sundry expenses	9,570
		By Purchases	1,030
		By Balance c/d	8,080
	96,800		96,800

(ii) Total Debtors Account

	₹		₹
To Balance b/d (bal. fig.)	16,530	By Bank	62,500
To Sales (71,810–4,600[1])	67,210	By Discount(64,000 – 62,500)	1,500
		By Return Inward	1,450
		By Bad Debts	420
		By Balance c/d	17,870
	83,740		83,740

(iii) Total Creditors Account

	₹		₹
To Bank	60,270	By Balance b/d (bal. fig.)	15,770
To Discount	700	By Purchases	58,000
To Return Outward	400		
To Balance c/d	12,400		
	73,770		73,770

[1] From combined cash and bank account

(iv) **Balance Sheet as on 1st April, 2021**

Liabilities	₹	***Assets***	₹
Capital (bal. fig.)	26,770	Sundry Assets	11,610
Sundry Creditors	15,770	Inventory in Trade	8,040
Outstanding Expenses	600	Sundry Debtors (from total debtors A/c)	16,530
		Cash in hand & at bank	6,960
	43,140		43,140

(v)

Expenses paid in Cash	9,570
Add: Outstanding on 31-3-2022	330
	9,900
Less: Outstanding on 1-4-2021	(600)
	9,300

(vi) Due to lack of information, depreciation has not been provided on fixed assets.

ILLUSTRATION 10

Mr. Anup runs a wholesale business where in all purchases and sales are made on credit. He furnishes the following closing balances:

	31st March 2021	***31st March 2022***
Sundry debtors	*70,000*	*92,000*
Bills receivable	*15,000*	*6,000*
Bills payable	*12,000*	*14,000*
Sundry creditors	*40,000*	*56,000*
Inventory	*1,10,000*	*1,90,000*
Bank	*90,000*	*87,000*
Cash	*5,200*	*5,300*

Summary of cash transactions during the year 2021- 2022:

(i) *Deposited to bank after payment of shop expenses @ ₹ 600 p.m., salary @ ₹ 9,200 p.m. and personal expenses @ ₹ 1,400 p.m. ₹ 7,62,750.*

(ii) *Cash Withdrawn from bank ₹ 1,21,000.*

(iii) *Cash payment to suppliers ₹ 77,200 for supplies and ₹ 25,000 for furniture.*

(iv) *Cheques collected from customers but dishonoured ₹ 5,700.*

(v) *Bills accepted by customers ₹ 40,000.*

(vi) *Bills endorsed ₹ 10,000.*

(vii) *Bills discounted ₹ 20,000, discount ₹ 750.*

(viii) *Bills matured and duly collected ₹ 16,000.*

(ix) *Bills accepted ₹ 24,000.*

(x) *Paid suppliers by cheque ₹ 3,20,000.*

(xi) *Received ₹ 20,000 on maturity of one LIC policy of the proprietor by cheque.*

(xii) *Rent received ₹ 14,000 by cheque for the premises owned by proprietor.*

(xiii) *A building was purchased on 30-11-2021 for opening a branch for ₹ 3,50,000 and some expenses were incurred on this building, details of which are not maintained.*

(xiv) *Electricity and telephone bills paid by cash ₹ 18,700, due ₹ 2,200.*

Other transactions:

(i) *Claim against the firm for damage ₹ 1,55,000 is under legal dispute. Legal expenses ₹ 17,000. The firm anticipates defeat in the suit.*

(ii) *Goods returned to suppliers ₹ 4,200.*

(iii) *Goods returned by customers ₹ 1,200.*

(iv) *Discount offered by suppliers ₹ 2,700.*

(v) *Discount offered to the customers ₹ 2,400.*

(vi) *The business is carried on at the rented premises for an annual rent of ₹ 20,000 which is outstanding at the year end.*

Prepare Trading and Profit & Loss Account of Mr. Anup for the year ended 31st March 2022 and Balance Sheet as on that date.

SOLUTION

Trading Account of Mr. Anup for the year ended 31st March 2022

	₹	₹		₹	₹
To Opening Inventory		1,10,000	By Sales	9,59,750	
To Purchases	4,54,100		*Less:* Sales Return	(1,200)	9,58,550
Less: Purchases Return			By Closing Inventory		1,90,000
	(4,200)	4,49,900			
To Gross Profit (b.f.)		5,88,650			
		11,48,550			11,48,550

Profit & Loss Account of Mr. Anup for the year ended 31st March 2022

	₹		₹
To salary (9,200 x 12)	1,10,400	By Gross Profit	5,88,650
To Electricity & Tel. Charges (18,700 + 2,200)	20,900	By Discount	2,700
To Legal expenses	17,000		
To Discount (2,400 + 750)	3,150		
To Shop exp. (600 x 12)	7,200		
To Provision for claims for damages	1,55,000		
To Shop Rent	20,000		
To Net Profit (b.f.)	2,57,700		
	5,91,350		5,91,350

Balance Sheet as on 31st March 2022

Liabilities	₹		***Assets***	₹
Capital A/c (W.N.vi) *Add :* Fresh capital introduced	2,38,200		Building (from summary cash and bank A/c)	3,72,000
Maturity value from LIC	20,000		Furniture	25,000
Rent	14,000		Inventory	1,90,000
Add : Net Profit	2,57,700		Sundry debtors	92,000
	5,29,900		Bills receivable	6,000
Less : Drawing(14,00 x12)	(16,800)	5,13,100	Cash at Bank	87,000
Rent outstanding		20,000	Cash in Hand	5,300

Sundry creditors		56,000		
Bills Payable		14,000		
Outstanding expenses				
Legal Exp.	17,000			
Electricity &				
Telephone charges	2,200	19,200		
Provision for claims for damages		1,55,000		
		7,77,300		7,77,300

Working Notes :

(i) **Sundry Debtors Account**

	₹		₹
To Balance b/d	70,000	By Bill Receivable A/c	
To Bill receivable A/c-Bills dishonoured	3,000	Bills accepted by customers	40,000
To Bank A/c-Cheque dishonoured	5,700	By Bank A/c - Cheque received	5,700
To Credit sales (Balancing Figure)	9,59,750	By Cash (from summary cash and bank account)	8,97,150
		By Return inward A/c	1,200
		By Discount A/c	2,400
		By Balance c/d	92,000
	10,38,450		10,38,450

(ii) **Bills Receivable Account**

	₹		₹
To Balance b/d	15,000	By Sundry creditors A/c	
To Sundry Debtors A/c	40,000	(Bills endorsed)	10,000
(Bills accepted)		By Bank A/c (20,000 – 750)	19,250
		By Discount A/c	750
		(Bills discounted)	

		By Bank	
		Bills collected on maturity	16,000
		By Sundry debtors	
		Bills dishonoured (Bal. Fig)	3,000
		By Balance c/d	6,000
	55,000		55,000

(iii) **Sundry Creditors Account**

	₹		₹
To Bank	3,20,000	By Balance c/d	40,000
To Cash	77,200	By Credit purchase	
To Bill Payable A/c	24,000	(Balancing figure)	4,54,100
To Bill Receivable A/c	10,000		
To Return Outward A/c	4,200		
To Discount Received A/c	2,700		
To Balance b/d	56,000		
	4,94,100		4,94,100

(iv) **Bills Payable A/c**

	₹		₹
To Bank A/c (Balance figure)	22,000	By Balance b/d	12,000
To Balance c/d	14,000	By Sundry creditors A/c	
		Bills accepted	24,000
	36,000		36,000

(v) **Summary Cash and Bank A/c**

	Cash	Bank		Cash	Bank
	₹	₹		₹	₹
To Balance b/d	5,200	90,000	By Bank	7,62,750	
To Sundry debtors (Bal. Fig)	8,97,150		By Cash		1,21,000
To Cash		7,62,750	By Shop exp. (600 x 12)	7,200	
To Bank	1,21,000		By Salary (9,200 x 12)	1,10,400	

To Sundry Debtors		5,700	By Drawing A/c (1,400 x 12)	16,800	
To Bills receivable		19,250	By Bills Payable		22,000
To Bills receivable		16,000	By Sundry creditors	77,200	3,20,000
To Capital (maturity value of LIC policy)		20,000	By Furniture	25,000	
To Capital (Rent received)		14,000	By Sundry Debtors		5,700
			By Electricity & Tel. Charges	18,700	
			By Building (Bal. fig)		3,72,000
			By Balance c/d	5,300	87,000
	10,23,350	9,27,700		10,23,350	9,27,700

(vi) **Statement of Affairs as on 31st March 2021**

Liabilities	₹	***Assets***	₹
Sundry Creditors	40,000	Inventory	1,10,000
Bills Payable	12,000	Debtors	70,000
Capital (Balancing figure)	2,38,200	Bills receivable	15,000
		Cash at Bank	90,000
		Cash in Hand	5,200
	2,90,200		2,90,200

SUMMARY

- Single entry system is generally found in sole trading concerns or even in partnership firms to some extent but never in case of limited liability companies on account of legal requirements.
- There are basically 3 types of single entry systems:
  - (i) Pure Single Entry
  - (ii) Simple Single Entry
  - (iii) Quasi Single Entry
- Single entry system ignores the concept of duality and therefore, transactions are not recorded in their two-fold aspects.

TEST YOUR KNOWLEDGE

True and false

1. *A Trial Balance cannot be drawn up from books kept under Single Entry.*
2. *Nominal Accounts are kept under Single Entry System.*
3. *Single Entry System can be adopted by small firms.*
4. *Profit under single entry system is always correct and accurate.*
5. *Profits computed under single entry system by different business entities are not comparable.*

Multiple Choice Questions

1. *In case of net worth method, profit is determined by*
   - (a) *Preparing a trading and profit and loss account.*
   - (b) *Comparing the capital in the beginning with the capital at the end of the accounting period.*
   - (c) *Comparing the net assets in the beginning with the net assets at the end of the accounting period.*
2. *Single entry system can be followed by*
   - (a) *Small firms.*
   - (b) *Joint stock companies.*
   - (c) *Co-operative societies.*
3. *Closing capital is calculated as*
   - (a) *Opening capital +Additional capital -Drawings.*
   - (b) *Opening capital +Additional capital –Drawings + Profit.*
   - (c) *Opening capital +Additional capital +Drawings - Profit.*
4. *Under single entry system, only personal accounts are kept and, in some cases,*
   - (a) *Cash book is maintained*
   - (b) *Fixed assets' accounts are maintained*
   - (c) *Liabilities' accounts are maintained.*

5. *The closing capital of Mr. B as on 31.3.2022 was ₹4,00,000. On 1.4.2021 his capital was ₹ 3,50,000. His net profit for the year ended 31.3.2022 was ₹ 1,00,000. He introduced ₹30,000 as additional capital in February, 2022 Find out the amount drawn by Mr. B for his domestic expenses.*

   (a) ₹ 1,00,000;

   (b) ₹ 80,000;

   (c) ₹ 1,20,000;

6. *Given information:*

Opening capital:	*60,000*
Drawings:	*5,000*
Capital introduced during the period:	*10,000*
Closing capital:	*90,000*
Profit earned during the period	*?*

   (a) ₹ 20,000

   (b) ₹ 25,000

   (c) ₹ 30,000.

Theoretical Questions

1. *What is meant by Single entry System? What are the types of procedures adopted for this system?*

2. *Differentiate between Statement of Affairs and Balance Sheet.*

Practical Questions

1. *A Firm sold 20% of the goods on cash basis and the balance on credit basis. Debtors are allowed 1½ month's credit and their balance as on 31.03.2021 is ₹ 1,25,000. Assume that the sale is uniform throughout the year. Calculate the credit sales and total sales of the company for the year ended 31.03.2022.*

2. *Mr. A runs a business of readymade garments. He closes the books of accounts on 31st March. The Balance Sheet as on 31st March, 2021 was as follows:*

Liabilities	₹	***Assets***	₹
A's capital a/c	*4,04,000*	*Furniture*	*40,000*
Creditors	*82,000*	*Stock*	*2,80,000*

		Debtors	1,00,000
		Cash in hand	28,000
		Cash at bank	38,000
	4,86,000		4,86,000

You are furnished with the following information:

(1) *His sales, for the year ended 31st March, 2022 were 20% higher than the sales of previous year, out of which 20% sales was cash sales.*

Total sales during the year 2020-21 were ₹ 5,00,000.

(2) *Payments for all the purchases were made by cheques only.*

(3) *Goods were sold for cash and credit both. Credit customers pay be cheques only.*

(4) *Deprecation on furniture is to be charged 10% p.a.*

(5) *Mr. A sent to the bank the collection of the month at the last date of the each month after paying salary of ₹ 2,000 to the clerk, office expenses ₹ 1,200 and personal expenses ₹ 500.*

Analysis of bank pass book for the year ending 31st March 2022 disclosed the following:

	₹
Payment to creditors	3,00,000
Payment of rent up to 31st March, 2022	16,000
Cash deposited into the bank during the year	80,000

The following are the balances on 31st March, 2022:

	₹
Stock	1,60,000
Debtors	1,20,000
Creditors for goods	1,46,000

On the evening of 31st March 2022, the cashier absconded with the available cash in the cash book.

You are required to prepare Trading and Profit and Loss A/c for the year ended 31st March, 2022 and Balance Sheet as on that date. All the workings should form part of the answer.

3. *Ram carried on business as retail merchant. He has not maintained regular account books. However, he always maintained ₹ 10,000 in cash and deposited the balance into the bank account. He informs you that he has sold goods at profit of 25% on sales.*

Following information is given to you:

Assets and Liabilities	***As on 1.4.2021***	***As on 31.3.2022***
Cash in Hand	*10,000*	*10,000*
Sundry Creditors	*40,000*	*90,000*
Cash at Bank	*50,000 (Cr.)*	*80,000 (Dr.)*
Sundry Debtors	*1,00,000*	*3,50,000*
Stock in Trade	*2,80,000*	*?*
Ram's capital	*3,00,000*	*?*

Analysis of his bank pass book reveals the following information:

(a) Payment to creditors ₹ 7,00,000

(b) Payment for business expenses ₹ 1,20,000

(c) Receipts from debtors ₹ 7,50,000

(d) Loan ₹ 1,00,000 taken on 1.10.2021 at 10% per annum

(e) Cash deposited in the bank ₹ 1,00,000

He informs you that he paid creditors for goods ₹ 20,000 in cash and salaries ₹ 40,000 in cash. He has drawn ₹ 80,000 in cash for personal expenses. During the year Ram had not introduced any additional capital. Surplus cash if any, to be taken as cash sales. All purchases are on credit basis.

You are required to prepare Trading and Profit and Loss Account for the year ended 31.3.2022 and Balance Sheet as at 31st March, 2022.

ANSWERS/ SOLUTIONS

True and False

1. True: Since incomplete records are maintained, trial balance cannot be prepared

2. False: Under the single entry system of bookkeeping, generally cash book and personal accounts of creditors and debtors are maintained, and no other ledger is maintained.

3. True: A single entry system is the one where financial transactions are recorded as a single entry in a log and is usually used by new small businesses.

4. False: Profit under single entry system is only an estimate based on available information and correct profits cannot be determined.

5. True: Since entry system has no fixed set of principles for recording the financial transaction, different organisations maintain records as per their needs. Hence their accounts are not comparable.

Multiple Choice Questions

1.	**(b)**	2.	**(a)**	3.	**(b)**	4.	**(a)**	5.	**(b)**	6.	**(b)**

Theoretical Questions

1. Single entry system is an inaccurate and unsystematic method of recording business transactions. The procedures adopted are: Pure single entry; Simple entry and Queasy single entry. For details, Refer Para 1 and 2 of the chapter.

2. To understand the difference between Statement of Affairs and Balance Sheet, refer para 3.2 of the chapter.

Practical Questions

1. Calculation of Credit Sales and Total sales

Credit Sales for the year ended 2021-22 $= \text{Debtors} \times \dfrac{12 \text{ months}}{1.5 \text{ months}}$

$= ₹1{,}25{,}000 \times \dfrac{12 \text{ months}}{1.5 \text{ months}}$

$= ₹\ 10{,}00{,}000$

Total sales for the year ended 2021-22 $= \text{Credit sales} \times \dfrac{100\%}{80\%}$

$= ₹\ 10{,}00{,}000 \times \dfrac{100\%}{80\%}$

$= ₹\ 12{,}50{,}000$

2. **In the books of Mr. A**

Trading Account for the year ending 31st March, 2022

Particulars	₹	***Particulars***	₹
To Opening stock	2,80,000	By Sales (W.N. 3)	
To Purchases (W.N. 1)	3,64,000	Credit 4,80,000	

To Gross profit (b.f.)	1,16,000	Cash 1,20,000	6,00,000
		By Closing stock	1,60,000
	7,60,000		7,60,000

Profit and Loss Account for the year ending 31st March, 2022

Particulars	₹	***Particulars***	₹
To Salary (2,000 x 12)	24,000	By Gross profit	1,16,000
To Rent	16,000		
To Office expenses (1,200 x 12)	14,400		
To Loss of cash (W.N. 6)	23,600		
To Depreciation on furniture	4,000		
To Net Profit (b.f.)	34,000		
	1,16,000		1,16,000

Balance Sheet as on 31st March, 2022

Liabilities		₹	***Assets***		₹
A's Capital	4,04,000		Furniture	40,000	
Add: Net Profit	34,000		*Less*: Depreciation	(4,000)	36,000
Less: Drawings			Stock		1,60,000
(500 x 12)	(6,000)	4,32,000	Debtors		1,20,000
Creditors		1,46,000	Cash at bank		2,62,000
		5,78,000			5,78,000

Working Notes:

(1) Calculation of purchases

Creditors Account

Particulars	₹	***Particulars***	₹
To Bank A/c	3,00,000	By Balance b/d	82,000
To Balance c/d	1,46,000	By Purchases (Bal. fig.)	3,64,000
	4,46,000		4,46,000

(2) Calculation of total sales

	₹
Sales for the year 2020-21	5,00,000
Add: 20% increase	1,00,000
Total sales for the year 2021-22	6,00,000

(3) Calculation of credit sales

	₹
Total sales	6,00,000
Less: Cash sales (20% of total sales)	(1,20,000)
	4,80,000

(4) Calculation of cash collected from debtors

Debtors Account

Particulars	₹	*Particulars*	₹
To Balance b/d	1,00,000	By Bank A/c (Bal. fig.)	4,60,000
To Sales A/c	4,80,000	By Balance c/d	1,20,000
	5,80,000		5,80,000

(5) Calculation of closing balance of cash at bank

Bank Account

Particulars	₹	*Particulars*	₹
To Balance b/d	38,000	By Creditors A/c	3,00,000
To Debtors A/c	4,60,000	By Rent A/c	16,000
To Cash A/c	80,000	By Balance c/d (b.f.)	2,62,000
	5,78,000		5,78,000

(6) Calculation of the amount of cash defalcated by the cashier

		₹
Cash balance as on 1st April 2021		28,000
Add: Cash sales during the year		1,20,000
		1,48,000

Less: Salary (₹2,000x12)	24,000	
Office expenses (₹1,200 x 12)	14,400	
Drawings of A (₹500x12)	6,000	
Cash deposited into bank during the year	80,000	(1,24,400)
Cash balance as on 31st March 2022 (defalcated by the cashier)		23,600

3.

Trading Account of Ram for the year ended 31st March, 2022

	₹		₹
To Opening stock	2,80,000	By Sales	
To Purchases	7,70,000	Cash 2,40,000	
To Gross Profit @ 25%	3,10,000	Credit 10,00,000	12,40,000
		By Closing Stock (bal. fig.)	1,20,000
	13,60,000		13,60,000

Profit and Loss Account of Ram for the year ended 31st March, 2022

	₹		₹
To Salaries	40,000	By Gross Profit	3,10,000
To Business expenses	1,20,000		
To Interest on loan (10% of 1,00,000 x 6/12)	5,000		
To Net Profit	1,45,000		
	3,10,000		3,10,000

Balance Sheet of Ram as at 31st March, 2022

Liabilities	₹	₹	***Assets***	₹
Ram's capital:			Cash in hand	10,000
Opening	3,00,000		Cash at Bank	80,000
Add: Net Profit	1,45,000		Sundry Debtors	3,50,000
	4,45,000		Stock in trade	1,20,000
Less: Drawings	(80,000)	3,65,000		

Loan (including interest due)		1,05,000		
Sundry Creditors		90,000		
		5,60,000		5,60,000

Working Notes:

1. Sundry Debtors Account

	₹		₹
To Balance b/d	1,00,000	By Bank A/c	7,50,000
To Credit sales (Bal. fig)	10,00,000	By Balance c/d	3,50,000
	11,00,000		11,00,000

2. Sundry Creditors Account

	₹		₹
To Bank A/c	7,00,000	By Balance b/d	40,000
To Cash A/c	20,000	By Purchases (Bal. fig.)	7,70,000
To Balance c/d	90,000		
	8,10,000		8,10,000

3. Cash and Bank Account

	Cash ₹	Bank ₹		Cash ₹	Bank ₹
To Balance b/d	10,000		By Balance b/d		50,000
To Sales (bal. fig)	2,40,000		By Bank A/c (C)	1,00,000	
To Cash (C)		1,00,000	By Salaries	40,000	
To Debtors		7,50,000	By Creditors	20,000	7,00,000
To Loan		1,00,000	By Drawings	80,000	
			By Business expenses		1,20,000
			By Balance c/d	10,000	80,000
	2,50,000	9,50,000		2,50,000	9,50,000

NOTES

CHAPTER 10

PARTNERSHIP AND LLP ACCOUNTS

UNIT – 1 INTRODUCTION TO PARTNERSHIP ACCOUNTS

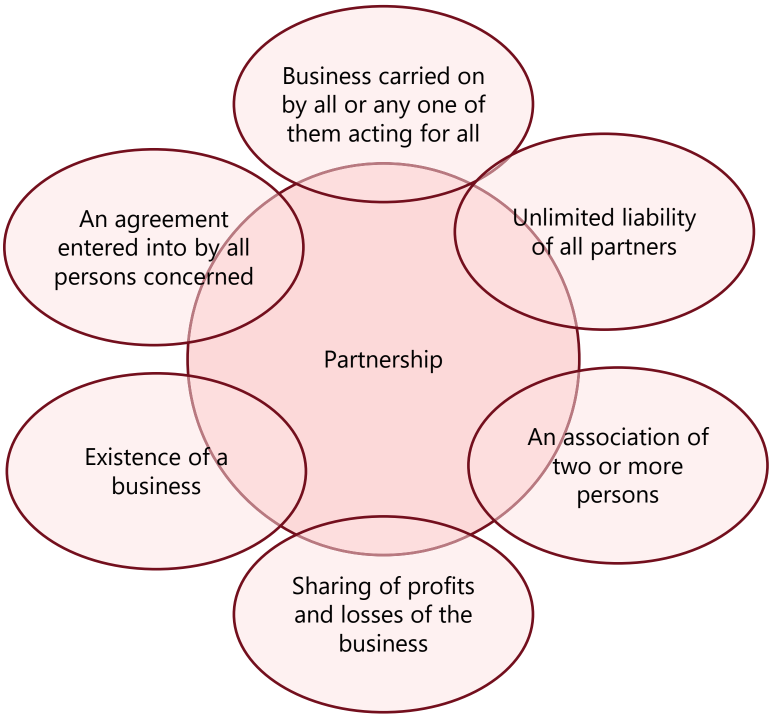
LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the provisions of the Indian Partnership Act, 1932, Limited Liability Partnership Act, 2008 and Limited Liability Partnership Amendment Act, 2021
- Understand the features of a partnership firm and the need for a Partnership Deed.
- Understand the points to be covered in a Partnership Deed regarding accounts.
- Learn the technique of maintaining Profit and Loss Appropriation Account.
- Familiarize with the two methods of maintaining Partners' Capital Accounts, namely Fixed Capital Method and Fluctuating Capital Method.
- Note that Capital Account balance as per Fluctuating Capital method is just equal to the sum of the balances of Capital Account and Current Account as per Fixed Capital Method.

- Learn how to arrive at the corrected net profit figure which is to be taken to be Profit and Loss Appropriation Account after rectification of errors. Rectification of errors may be necessary to arrive at the net profit of the partnership and preparing Profit and loss Appropriation Account.
- Learn that interest on capital and drawings, salaries/commissions are to be shown in the Profit and Loss Appropriation Account and not in the Profit and Loss Account. Also learn that drawings by partners will not appear in the Appropriation Account.

UNIT OVERVIEW



Accounts of Partnership firm		
Trading and Profit and Loss Account and Balance Sheet	**Profit and Loss Appropriation Account**	**Capital accounts of partners (fixed capital method or fluctuating capital method)**

1.1 INTRODUCTION: WHY PARTNERSHIP?

An individual, i.e., a sole proprietor may not be in a position to cope with the financial and managerial demands of the present-day business world. As a result, two or more individuals may decide to pool their financial and non-financial resources to carry on a business. The preparation of final accounts of sole proprietors have already been discussed in chapter 6. The final accounts of partnership firms including basic concepts of accounting for admission of a partner, retirement and death of a partner have been discussed in succeeding units of this chapter.

1.2 DEFINITION AND FEATURES OF PARTNERSHIP

As per **Section 4** of the Partnership Act, 1932:

"Partnership is the relation between persons who have agreed to share the profit of a business carried on by all or any of them acting for all."

Features of a partnership,

(i) **Existence of an agreement: As per section 5 of the Indian Partnership Act, 1932,** The relation of partnership arises from contract between parties and not from status as it happens in case of HUF (Hindu Undivided Family). **A formal or written agreement is not necessary to create a partnership.**

(ii) **Business:** A partnership can exist only in business. Thus, it is not the agreement alone which creates a partnership. A partnership comes into existence only when partners begin to carry on business in accordance with their agreement. **Section 2 (b)of Indian Partnership Act, 1932 only states that business includes every trade, occupation and profession.**

(iii) **Sharing of profit:** The persons concerned must agree to **share the profits of the business.** Because no person is a partner unless he or she has the right to share the profits of the business. **Section 4 of Indian Partnership Act, 1932** does not insist upon sharing of losses. Thus, a provision for sharing of loss is not necessary.

(iv) **Mutual agency:** It means that the business is to be carried on by all or any of them acting for all. Thus, if the person carrying on the business acts not only for himself but for others also so that they stand in the positions of principals and agents, they are partners.

(v) **Minor as a partner:** A minor can be added in partnership firm. But the condition is that he can be admitted to share profit only. He cannot be made to share losses of the firm. If the partnership firm suffers loss than it will be borne by other major partners is their profit-sharing ratio.

Number of Partners: Minimum Partners: Two

Maximum Partners: As per Section 464 of the Companies Act, 2013, no association or partnership consisting of more than 100 number of persons as may be prescribed shall be formed for the purpose of carrying on any business. Rule 10 of Companies (incorporation) Rules 2014 specifies the limit as 50. Thus, maximum number of members in a partnership firm are 50.

1.3 LIMITED LIABILITY PARTNERSHIP

The Indian Partnership Act of 1932 provides for a general form of partnership which has inherent shortcoming of unlimited liability of all partners for business debts and legal consequences, regardless of their holding or profit-sharing ratio, as the firm is not a legal entity. General partners are also jointly and severally liable for tortuous acts of co-partners. In case of liquidation personal assets of partners can be liquidated to meet liabilities of the firm.

With the growth of the Indian economy, the role played by its entrepreneurs as well as its technical and professional manpower has been acknowledged internationally. Entrepreneurship, knowledge, risk and capital may be combined to provide a further impetus to India's economic growth. In this background, a need has been felt for a new corporate form that would provide an alternative to the traditional partnership, with unlimited personal liability on the one hand, and, the statute-based governance structure of the limited liability company on the other. This would enable professional expertise and entrepreneurial initiative to combine, organize and operate in flexible, innovative and efficient manner.

The Government felt that with Indian professionals increasingly transacting with or representing multi-nationals in international transactions, the extent of the liability they could potentially be exposed to, is extremely high. Hence, in order to encourage Indian professionals to participate in the international business community without apprehension of being subject to excessive liability, the need for having a legal structure like the LLP is encouraged. Thus, in convergence towards global scenario, Limited Liability Partnership Act, 2008 was introduced.

The Limited Liability Partnership (LLP) is viewed as an alternative corporate business proposal that provides the benefits of limited liability but allows its members, the flexibility of organizing their internal structure as a partnership, which is based on a mutually arrived agreement.

The LLP will be a separate legal entity, liable to the full extent of its assets, with the liability of the partners being limited to their agreed contribution in the LLP which may be of tangible or intangible nature or both tangible and intangible in nature. No partner would be liable on account of the independent or un-authorized actions of other partners or their misconduct. The liabilities of the LLP and partners who are found to have acted with intent to defraud Creditors or for any fraudulent purpose shall be unlimited for all or any of the debts or other liabilities of the LLP.

The main benefit in an LLP is that it is taxed as a partnership, but has the benefits of being a corporate, or more significantly, a juristic entity with limited liability. An LLP has the special characteristic of being a separate legal personality distinct from its partners. The LLP is a body corporate in nature.

Summary of key advantages and challenges associated with formation of LLP could be presented as below:

Advantages:

(i) LLP is organized and operates on the basis of an agreement.

(ii) Enables professional/technical expertise and initiative to combine with financial risk taking capacity in an innovative and efficient manner.

(iii) Limited liability of partners as in case of corporate entities along with flexibility of a partnership without imposing detailed legal and procedural requirements;

(iv) Lower registration costs as compared to corporate entities;

(v) Audit not mandatory (subject to turnover / capital contribution benchmark)

Challenges:

(i) Public disclosure of financial statements;

(ii) No option for Equity investments;

(iii) Extensive penal provisions for non-compliance

The Limited Liability Partnerships (LLPs) in India were introduced by Limited Liability Partnership Act, 2008 which lay down the law for the formation and regulation of Limited Liability Partnerships. Later, the Ministry of Law and Justice made amendments to the Limited Liability Partnership Act, 2008 (LLP Act) through the LLP (Amendment) Act, 2021.

1.3.1 Definition of LLP

Section 2 of the Limited Liability Partnership (LLPs) Act, 2008 defines **limited liability partnership"** as a partnership formed and registered under this Act; and **"limited liability partnership agreement"** means any written agreement between the partners of the limited liability partnership or between the limited liability partnership and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation to that limited liability partnership.

"Small limited liability partnership" means a limited liability partnership—

(i) the contribution of which, does not exceed twenty-five lakh rupees or such higher amount, not exceeding five crore rupees, as may be prescribed; and

(ii) the turnover of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, does not exceed forty lakh rupees or such higher amount, not exceeding fifty crore rupees, as may be prescribed; or

1.3.2 Nature of Limited Liability Partnership

(1) A limited liability partnership is a body corporate formed and incorporated under this Act and is a legal entity separate from that of its partners.

(2) A limited liability partnership should have perpetual succession.

(3) Any change in the partners of a limited liability partnership should not affect the existence, rights, or liabilities of the limited liability partnership.

1.3.3 Non-applicability of the Indian Partnership Act, 1932

Save as otherwise provided, the provisions of the Indian Partnership Act, 1932 shall not apply to a limited liability partnership.

1.3.4 Minimum number of partners in case of LLP

As per the LLP Act, any individual or body corporate may be a partner in a limited liability partnership; provided that an individual shall not be capable of becoming a partner of a limited liability partnership, if-

(a) he has been found to be of unsound mind by a Court of competent jurisdiction and the finding is in force;

(b) he is an undischarged insolvent; or

(c) he has applied to be adjudicated as an insolvent and his application is pending.

Every limited liability partnership shall have at least two partners.

If at any time the number of partners of a limited liability partnership is reduced below two and the limited liability partnership carries on business for more than six months while the number is so reduced, the person, who is the only partner of the limited liability partnership during the time that it so carries on business after those six months and has the knowledge of the fact that it is carrying on business with him alone, shall be liable personally for the obligations of the limited liability partnership incurred during that period.

1.3.5 Designated partners

As per Section 7 of the LLP Act, every limited liability partnership should have at least two designated partners who are individuals and at least one of them should be a resident in India:

Provided that in case of a limited liability partnership in which all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such limited liability partnership or nominees of such body corporate will act as designated partners.

Explanation. -For the purposes of this section, the term "resident in India" means a person who has stayed in India for a period of not less than 120[1] days during the immediately preceding one year.

Subject to the provisions of the Act,

(1) if the incorporation document-

  (a) specifies who are to be designated partners, such persons should be designated partners on incorporation; or

  (b) states that each of the partners from time to time of limited liability partnership is to be designated partner, every such partner will be a designated partner;

(2) any partner may become a designated partner by and in accordance with the limited liability partnership agreement and a partner may cease to be a designated partner in accordance with limited liability partnership agreement.

(3) An individual will not become a designated partner in any limited liability partnership unless he has given his prior consent to act as such to the limited liability partnership in such form and manner as may be prescribed.

(4) Every limited liability partnership should file with the registrar the particulars of every individual who has given his consent to act as a designated partner in such form and manner as may be prescribed within thirty days of his appointment.

(5) An individual eligible to be a designated partner should satisfy such conditions and requirements as may be prescribed.

[1] *Amended as per Limited Liability Partnership (Amendment) Act, 2021*

1.3.6 Liabilities of designated partners

As per LLP Act, unless expressly provided otherwise in this Act, a designated partner should be-

(a) responsible for the doing of all acts, matters, and things as are required to be done by the limited liability partnership in respect of compliance of the provisions of this Act including filing of any document, return, statement, and the like report pursuant to the provisions of this Act and as may be specified in the limited liability partnership agreement; and.

(b) liable to all penalties imposed on the limited liability partnership for any contravention of those provisions.

1.3.7 Limitation of Liability of an LLP and its partners

- Under the LLP Act, 2008 an obligation of an LLP arising out of a contract or otherwise, will be solely the obligation of the LLP;
- The Liabilities of an LLP should be met out of the properties of the LLP;
- A partner is not personally liable, directly or indirectly, for an obligation referred to above, solely by reason of being a partner in the LLP;
- an LLP is not bound by anything done by a partner in dealing with a person, if:
  - The partner does not have the authority to act on behalf of the LLP in doing a particular act; and
  - The other person knows that the partner has no authority or does not know or believe him to be a partner in the LLP

  The liability of the LLP and the partners perpetrating fraudulent dealings will be unlimited for all or any of the debts or other liabilities of the LLP. However, in case any such act is carried out by a partner, the LLP is liable to the same extent as the partner unless it is established by the LLP that such act was without the knowledge or the authority of the LLP.
- The LLP is liable if a partner of LLP is liable to any person as a result of wrongful or omission on his part in the course of business of the LLP or with his authority.

1.3.8 Financial Disclosures & Returns

- Every LLP should maintain such proper books of accounts as may be prescribed relating to its affairs for each year of its existence on cash basis or accrual basis and according to the double-entry system of accounting and should maintain the same at its registered office for such period as may be prescribed;
- Every LLP should within six months of the end of each financial year prepare a Statement of Account and Solvency for the said financial year as at the last day of the said financial year, in such form as may be prescribed, and such statement should be signed by the designated partners of the LLP;
- Every LLP should file within the prescribed time, the Statement of Account and Solvency with the Registrar every year in such form and manner and accompanied by such fee as may be prescribed;
- The accounts of an LLP must be audited in accordance with such rules as may be prescribed. Provided that the Central Government may, by notification in the Official Gazette, exempt any class or classes of limited liability partnerships from the requirements of this sub-section.

1.4 DISTINCTION BETWEEN AN ORDINARY PARTNERSHIP FIRM AND AN LLP

	Basis	LLP	Partnership firm
1.	**Regulating Act**	The Limited Liability Partnership Act, 2008.	The Indian Partnership Act, 1932.
2.	**Body corporate**	It is a body corporate.	It is not a body corporate,
3.	**Separate legal entity**	It is a legal entity separate from its members.	It is a group of persons with no separate legal entity.
4.	**Creation**	It is created by a legal process called registration under the LLP Act, 2008.	It is created by an agreement between the partners.
5.	**Registration**	Registration is mandatory. LLP can sue and be sued in its own name.	Registration is voluntary. Only the registered partnership firm can sue the third parties.
6.	**Perpetual succession**	The death, insanity, retirement or insolvency of the partner(s) does not	The death, insanity, retirement or insolvency of the partner(s) may

		affect its existence of LLP. Members may join or leave but its existence continues forever.	affect its existence. It has no perpetual succession.
7.	**Name**	Name of the LLP to contain the word limited liability partners (LLP) as suffix.	No guidelines. The partners can have any name as per their choice.
8.	**Liability**	Liability of each partner limited to the extent to agreed contribution except in case of willful fraud.	Liability of each partner is unlimited. It can be extended upto the personal assets of the partners.
9.	**Mutual agency**	Each partner can bind the LLP by his own acts but not the other partners.	Each partner can bind the firm as well as other partners by his own acts.
10.	**Designated partners**	At least two designated partners and atleast one of them shall be resident in India.	There is no provision for such partners under the Partnership Act, 1932.
11.	**Number of Partners**	Minimum 2 but no maximum limit	Minimum 2 and maximum 50.
12.	**Legal compliances**	Only designated partners are responsible for all the compliances and penalties under this Act.	All partners are responsible for all the compliances and penalties under the Act.
13.	**Foreign partnership**	Foreign nationals can become a partner in a LLP.	Foreign nationals cannot become a partner in a partnership firm.
14.	**Minor as partner**	Minor cannot be admitted to the benefits of LLP.	Minor can be admitted to the benefits of the partnership with the prior consent of the existing partners.

1.5 MAIN CLAUSES IN A PARTNERSHIP DEED

The relation between the partners is governed by mutual agreement known as partnership deed. It should be comprehensive to avoid disputes later on. It is usual therefore, to find the following clauses in a Partnership Deed which may or may not be registered.

1. Name of the firm and the partners;

2. Commencement and duration of business;
3. Amount of capital to be contributed by each partner;
4. Amount to be allowed to each partner as drawings and the timings of such drawings;
5. Rate of interest to be allowed to each partner on his capital and on his loan to the firm, and to be charged on his drawings;
6. The ratio in which profits or losses are to be shared;
7. Whether a partner will be allowed to draw any salary;
8. Any variations in the mutual rights and duties of partners;
9. Method of valuing goodwill on the occasions of changes in the constitution of the firm;
10. Procedure by which a partner may retire and the method of payment of his dues;
11. Basis of the determination of the executors of a deceased partner and the method of payment;
12. Treatment of losses arising out of the insolvency of a partner;
13. Procedure to be allowed for settlement of disputes among partners;
14. Preparation of accounts and their audit.

Registration of the firm is not compulsory, but non-registration restricts the partners or the firm from taking any legal action. Often there is no written Partnership Deed or, if there is one, it may be silent on a particular point. In that case the relevant sections of the Partnership Act will apply. If on any point the Partnership Deed contains a clause, it will hold good; otherwise the provisions of the Act relating to the questions will apply.

Rules in the absence of Partnership Deed

In the absence of any agreement to the contrary;

- No partner has the right to a salary,
- No interest is to be allowed on capital,
- No interest is to be charged on the drawings,
- Interest at the rate of 6%.p.a is to be allowed on a partner's loan to the firm, and
- Profits and losses are to be shared equally.

Note: In the absence of an agreement, the interest and salary payable to a partner will be paid only if there is profit.

Example

A and B commenced business in partnership on 1 January 2022. No partnership agreement was made either oral or written. They contributed ₹ 40,000 and ₹ 10,000 respectively as capital. In addition, A also advanced ₹ 20,000 on 1 July 2022. A met with an accident on 1 April 2022 and could not attend to the partnership business upto 30 June 2022. The profits for the year ended on 31 December 2022 amounted to ₹ 50,600. Disputes having been arisen between them for sharing the profits.

A claims: (i) He should be given interest at 10% p.a. on capital and loan (ii) Profit should be distributed in proportion of capital.

B claims: (i) Net profit should be shared equally. (ii) He should be allowed remuneration of ₹ 1,000 p.m. during the period of A's illness. (iii) Interest on capital and loan should be given @ 6% p.a. You are required to settle the dispute between them and distribute the profits according to law. State reasons for your answer.

Answer

Since there is no written or oral partnership agreement, allowing rules are applicable as per Indian partnership act 1932

(a) No interest is allowed on capital.

(b) 6% p.a. interest is allowed on the loan advanced.

(c) Profits and losses shall be shared equally.

(d) No remuneration is allowed to any partner for taking part in the conduct of the business.

Thus

a) neither of A nor B will be allowed interest on capital

b) 6% interest will be allowed to both A and B

c) Profit and losses shall be shared equally between A and B

d) No remuneration shall be allowed to B.

Net profit for the year		=	50,600
Less: Int. on A's loan 20,000 × 6% × 6/12		=	600
Net Profit		=	50,000
A's 50%	25,000		
B's 50%	25.000		

Example

A, B and C are partners in a firm sharing profits and losses in the ratio of 2:3:5. Their fixed capitals were ₹ 15,00,000, ₹ 30,00,000 and ₹ 60,00,000 respectively. For the year 2022 interest on capital was credited to them @ 12% instead of 10%. Pass the necessary adjustment entry.

Particulars	A	B	C	Firm
Interest that should have been credited @ 10%	1,50,000	3,00,000	6,00,000	10,50,000
Interest already credited @ 12%	1,80,000	3,60,000	7,20,000	12,60,000
Excess credit in partners account	(30,000)	(60,000)	(1,20,000)	(2,10,000)
By recovering the extra amount paid, the share of profits will increase and it will be credited in the ratio of 2:3:5	42,000	63,000	105,000	2,10,000
Net effect	12,000	3,000	(15,000)	-

The necessary journal entry will be:

Particulars	Debit (₹)	Credit (₹)
C's Current A/c	15,000	
To A's Current A/c		12,000
To B's Current A/c		3,000
(Interest less charged now rectified)		

1.6 POWERS OF PARTNERS

The Partners are supposed to have the power to act in certain matters and not to have such powers in others. In other words, unless a public notice has been given to the contrary, certain contracts entered into by a partner on behalf of the partnership, even without consulting other partners are binding on the firm and the provisions of the Act relating to the question will apply. In case of a trading firm, the implied powers of partners are the following:

(a) Buying and selling of goods;

(b) Receiving payments on behalf of the firm and giving valid receipt;

(c) Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm;

(d) Borrowing money on behalf of the firm with or without pledging the inventories-in-trade;

(e) Engaging servants for the business of the firm.

In certain cases an individual partner has no power to bind the firm. This is to say that third parties cannot bind the firm unless all the partners have agreed. These cases are:

(a) Submitting a dispute relating to the firm arbitration;

(b) Opening a bank account on behalf of the firm in the name of a partner;

(c) Compromise or relinquishment of any claim or portion of claim by the firm;

(d) Withdrawal of a suit or proceeding filed on behalf of the firm;

(e) Admission of any liability in a suit or proceedings against the firm;

(f) Acquisition of immovable property belonging to the firm;

(g) Entering into partnership on behalf of the firm.

The rights, duties and powers of partners can be changed by mutual consent.

1.7 ACCOUNTS

Partnership Act doesn't specify any format for preparation of accounts of Partnership Firm and thus accounts are prepared as per Basic rules of accounts. There is not much difference between the accounts of a partnership firm and that of sole proprietorship (provided there is no change in the firm itself). The only difference to be noted is that instead of one Capital Account there will be as many Capital Accounts as there are partners. If, for instance, there are three partners; A, B, and C, then there will be a Capital Account for each one of the partners; A's Capital Account will be credited by the amount contributed by him as capital and similarly B's and C's Capital Accounts will be credited with the amounts brought in by them respectively as capital.

When a partner takes money out of the firms for his domestic purpose, either his Capital Account can be debited or a separate account, named as Drawings Account, can be opened in his name and the account may be debited. In a Trial Balance of a partnership firm, therefore, one may find Capital Accounts of partners as well as Drawings Accounts. Finally the Drawings Account of a partner may be transferred to his Capital Account so that a net figure is available. But, often the Drawings Account or Current Account (as it is usually called) remains separate.

1.8 PROFIT AND LOSS APPROPRIATION

During the course of business, a partnership firm will prepare Trading Account and a Profit and Loss Account at the end of every year. The final accounts of a sole proprietorship concern will not differ from the accounts of a partnership firm. The Profit and Loss Account will show the profit earned by the firm or loss suffered by it. This profit or loss has to be transferred to the Capital Accounts of partners according to the terms of the Partnership Deed or according to the provisions of the Indian Partnership Act (if there is no Partnership Deed or if the Deed is silent on a particular point). Suppose the Profit and Loss Account reveals a profit of ₹ 90,000. There are two partners, A and B. A devotes all his time to the firm; B does not. A's capital is ₹ 50,000 and B's is ₹ 20,000. There is no Partnership Deed. In such a case the profit will be distributed among A and B equally. This is irrespective of the fact that B does not work as much as A does and B's capital is much less than that of A. But if the Partnership Deed lays down that A is to get a salary and interest is to be allowed on the capital, then first of all, from the profit earned, A's salary must be deducted and interest on the Capital Accounts of both partners will be deducted. The remaining profit will be divided equally between A and B. Further if the Partnership Deed says that profits are to be divided in the ratio of, say, three-fourth to A and one-fourth to B, then this will be the ratio to be adopted.

In a partnership, profit has to be divided between the partners in a certain profit sharing ratio after making necessary adjustments stated in the partnership deed such as interest on capitals, drawings and loans; salaries or/and commission to partners etc. Accordingly, an additional account is prepared and net profit is transferred from the debit side of the profit and loss account to the credit side of this new account which is called Profit and Loss Appropriation Account and before the profit is divided between partners, it is necessary to record the above stated adjustments in this account.

The student can see for himself that if salary is to be allowed to a partner, the Profit and Loss Appropriation Account will be debited and the Partner's Capital Account will be credited. Similarly, if interest is to be allowed on capital, the Profit and Loss Appropriation Account will be debited and the respective Capital Accounts will be credited.

Let us take an illustration to understand how to divide profits among partners.

ILLUSTRATION 1

A and B start business on 1st January, 2022, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2022 the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes.

Give journal entries relating to division of profit.

SOLUTION

Journal Entries

2022	Particulars		Dr. (₹)	Cr. (₹)
Dec. 31	Profit and Loss Appropriation Account	Dr.	6,000	
	To B's Capital Account			6,000
	(Salary due to B @ ₹ 500 per month)			
	Profit and Loss Appropriation Account	Dr.	3,000	
	To A's Capital Account			1,800
	To B's Capital Account			1,200
	(Interest due on Capital @ 6% per month)			
	Profit and Loss Appropriation Account	Dr.	16,000	
	To A's Capital Account			10,000
	To B's Capital Account			6,000
	(Remaining profit of ₹ 16,000 divide between A and B in the ratio of 5:3)			

Now, let us learn the preparation of profit and loss appropriation account with the help of same illustration of partnership firm consisting of partners A and B.

ILLUSTRATION 2

Ram, Rahim and Karim are partners in a firm. They have no agreement in respect of profit-sharing ratio, interest on capital, interest on loan advanced by partners and remuneration payable to partners. In the matter of distribution of profits they have put forward the following claims:

(i) *Ram, who has contributed maximum capital demands interest on capital at 10% p.a. and share of profit in the capital ratio. But Rahim and Karim do not agree.*

(ii) *Rahim has devoted full time for running the business and demands salary at the rate of ₹ 500 p.m. But Ram and Karim do not agree.*

(iii) *Karim demands interest on loan of ₹ 2,000 advanced by him at the market rate of interest which is 12% p.a.*

How shall you settle the dispute and prepare Profit and Loss Appropriation Account after transferring 10% of the divisible profit to Reserve. Net profit before taking into account any of the above claims amounted to ₹ 45,000 at the end of the first year of their business

SOLUTION

There is no partnership deed. Therefore, the following provisions of the Indian Partnership Act are to be applied for settling the dispute.

(i) No interest on capital is payable to any partner. Therefore, Ram is not entitled to interest on capital.

(ii) No remuneration is payable to any partner. Therefore, Rahim is not entitled to any salary.

(iii) Since interest on loan payable to partner is not an appropriation of profit. It will be charged to Profit and Loss Account.

(iv) The profits should be distributed equally.

Profit and Loss Appropriation Account for the year ended...

	Particulars		₹	Particulars	₹
To	Reserve A/c – 10% of			By Profit and Loss A/c -	44,880
	₹ 44,880		4,488	₹ (45,000-120)	
To	Share of Profit A/c:			(Net profit)	
	Ram capital A/c	₹ 13,464			
	Rahim capital A/c	₹ 13, 464			
	Karim capital A/c	₹ 13, 464	40,404		
			44,880		445,880

ILLUSTRATION 3

A and B start business on 1st January, 2022, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on opening capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2022 the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes.

Prepare Profit and Loss Appropriation Account.

SOLUTION

Profit and Loss Appropriation Account for the year ended 31-Dec-22

Particulars	₹	Particulars	₹
To B's Capital Account-Salary	6,000	By Net Profit	25,000
To A's Capital Account-interest	1,800		
To B's Capital Account-interest	1,200		
To Profit transferred to:			
A's Capital Account (5/8)	10,000		
B's Capital Account (3/8)	6,000		
	25,000		25,000

NOTE: Since date of drawing & rate of interest on drawing is not given, it is assumed drawings are made on last day of year.

Let us also learn the preparation of capital accounts of partners with the help of same illustration of partnership firm consisting of partners A and B.

ILLUSTRATION 4

A and B start business on 1st January, 2022, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on opening capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2022, the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes.

Prepare Capital Accounts of Partners A and B.

SOLUTION

Dr. **A's Capital Account** **Cr.**

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Bank A/c-(Drawings)	8,000	Jan. 1	By Bank A/c	30,000
	To Balance c/d	33,800	Dec. 31	By Profit and Loss appropriation A/c	
				Interest	1,800

				By Profit and Loss appropriation A/c-(5/8 Profit)	10,000
		41,800			41,800
			2023 Jan. 1	By Balance b/d	33,800

Dr. **B's Capital Account** **Cr.**

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Bank A/c (Drawings)	10,000	Jan. 1	By Bank A/c	20,000
Dec. 31	To Balance c/d	23,200	Dec. 31	By Profit and Loss appropriation A/c	
				- Salary	6,000
				-Interest	1,200
				By Profit and Loss appropriation A/c - (3/8 Profit)	6,000
		33,200			33,200
			2023 Jan. 1	By Balance b/d	23,200

1.9 FIXED AND FLUCTUATING CAPITAL

You have seen in the above example that the Capital Account of A has changed from ₹ 30,000 at the beginning to ₹ 33,800 and B's Capital A/c from ₹ 20,000 to ₹ 23,200. This is because we have made entries in respect of interest, salary, profit earned during the year and money taken out by the partners in the Capital Account itself. If the Capital Accounts are prepared on this basis, capitals are said to be fluctuating. Some firms, however, prefer to continue to show the Capital Accounts of the partners at the same old figure. This means that no entry is to be made in the Capital Account in respect of interest, salary, profit and drawings etc. A separate account is to be opened for this purpose. This account is known as the Current Account or even as Drawings Account. Under this system interest on capital if allowed, should be calculated only on the amount of the fixed capital. If the capital Accounts are prepared on this basis, capitals are said to be fixed.

Thus, there are two methods of accounting –

i) **Fixed capital method and**

ii) **Fluctuating capital method.**

In Fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed.

In Fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.

1.9.1 Interest on Capital:

A partner is not entitled to interest on his capital as a matter of right. But if there is an agreement, that partner would receive interest on his capital it is paid at the agreed rate only out of profits. Interest on capital is generally calculated on the opening balance and allowance is made for any additions of capital or withdrawals there from during the accounting period.

- The amount of interest is debited to interest on capital accounts and credited to the capital accounts, if capitals are fluctuating and current accounts, if capitals are fixed. Interest on capital account is then closed by transfer to profit and loss appropriation account.
- Alternatively, credit the capital (or current) account of the partner concerned and debit the profit and loss appropriation account.

  For interest on capital

  Profit and Loss Appropriation Account Dr.

  To (Individual) Capital (or Current) Accounts of Partners

Interest is generally allowed on capitals of the partners. Interest on capital of partners is calculated for the relevant period for which the amount of capital has been used in the business. Normally, it is charged for full year on the balance of capital at the beginning of the year unless some fresh capital is introduced during the year. On the additional capital introduced, interest for the relevant period of utilization is calculated. For example, A has ₹30,000 capital in the beginning of the year and introduces ₹10,000 during the year. If rate of interest on capital is 20 % p.a., interest on A's capital is calculated as follows:

$$\left[30{,}000 \times \frac{20}{100}\right] + \left[10{,}000 \times \frac{20}{100} \times \frac{6}{12}\right] = ₹\ 6{,}000 + ₹\ 1{,}000 = ₹\ 7{,}000$$

In case of fixed capital accounts, interest is calculated on the balance of capital accounts only and no interest is payable / chargeable on the balance of current accounts.

Net loss and Interest on Capital: *Subject to contract between the partners, interest on capitals is to be provided out of profits only. Thus in case of loss, no interest is provided. But in case of insufficient profits (i.e., net profit less than the amount of interest on capital), the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only.*

Example

Shilpa and Sanju are partners with a capital of ₹1,00,000 and ₹1,60,000 on January 1,2022 respectively. Shilpa introduced additional capital of ₹30,000 on July 1, 2022 and another ₹20,000 on October 31,2022. Calculate interest on capital for the year ending 2022. The rate of interest is 9% p.a.

Solution

Interest on Capital (Shilpa):

On ₹1,00,000 for 12 month @ 9% = 1,00,000 × 9/100 × 12/12

= ₹ 9,000

On ₹30,000 for 6 month @ 9% = 30,000 × 9/100 × 6/12

= ₹ 1,350

On ₹20,000 for 2 month @ 9% = 20,000 × 9/100 × 2/12

= ₹300

Total interest on shilpa capital = ₹ 9,000 + ₹ 1350 + ₹ 300

= ₹10,650

By product method

Amount (₹)	Months	Product
1,00,000	12	12,00,000
30,000	6	1,80,000
20,000	2	40,000
Total product		14,20,000

Interest on capital 14,20,000 × 09/100 × 1/12 = ₹ 10,650

Interest on Capital (Sanju):

On ₹1,60,000 for 12 month @ 9% = 1,60,000 × 9/100 × 12/12 = ₹14,400

By product method: = 1,60,000 × 12 = 19,20,000 = $19{,}20{,}000 \times \frac{9}{100} \times \frac{1}{12}$ = 14,400

1.9.2 Interest on Drawings

Sometimes interest is not only allowed on the capitals, but is also charged on drawings. In such a case, interest will be charged according to the time that elapses between the taking out of the money and the end of the year.

Method 1: Product Method: When Unequal amount is withdrawn at different time period.

Suppose X, a partner, has drawn the following sum of money –

	₹
On 29th February, 2022	500
On 31st March, 2022	400
On 30th June, 2022	600
On 31st October, 2022	800

Accounts are closed on 31st December every year. Interest is chargeable on drawings at 6% per annum. The interest on X's drawings will be calculated as shown below:

		₹
1.	On ₹ 500 for 10 months, i.e.	25
2.	On ₹ 400 for 9 months, i.e.	18
3.	On ₹ 600 for 6 months, i.e.	18
4.	On ₹ 800 for 2 months, i.e.	8
	Total	69

Alternatively, it can be calculated as follows:

Amount (₹)	Number of months	Product
500	10	5,000
400	9	3,600
600	6	3,600
800	2	1,600
2,300		13,800

Interest on ₹ 13,800 for one month at 6% per annum is ₹ 69.

If the dates on which amounts are drawn are not given, the student will do well to charge interest for six months on the whole of the amount on the assumption that the money was drawn evenly through out the year. In the above example, the total drawings come to ₹ 2,300; and at 6% for 6 months, the interest comes to ₹ 69. The entry to record interest on drawings is- debit the Capital Account of the partner concerned (or his Current Account if the capital is fixed) and credit the Profit and Loss Appropriation Account.

If withdrawals are made evenly in the beginning of each month, interest can be calculated easily for the whole of the amount of 6-1/2 months; if withdrawals are made at the end of each month, interest should be calculated for 5-1/2 months. If withdrawals are mode at the beginning of each quarter, interest can be calculated by Total drawings × Rate × 100 × 7.5/12.

However, if withdrawals are at end of each quarter, the formula : Total drawings × Rate × 100 × 4.5/12 will apply.

1.9.3 Guarantee of Minimum Profit

Sometimes, one partner can enjoy the right to have minimum amount of profit in a year as per the terms of the partnership agreement. In such case, allocation of profit is done in a normal way if the share of partner, who has been guaranteed minimum profit, is more than the amount of guaranteed profit. However, if share of the partner is less than the guaranteed amount, he takes minimum profit and the excess of guaranteed share of profit over the actual share is borne by the remaining partners as per the agreement.

There are three possibilities as far as share of deficiency by other partners is concerned. These are as follows:

- Excess is payable by one of the remaining partners.
- Excess is payable by at least two or all the partners in an agreed ratio.
- Excess is payable by remaining partners in their mutual profit sharing ratio.

If the question is silent about the nature of guarantee, the burden of guarantee is borne by the remaining partners in their mutual profit sharing ratio.

1.9.4 Capital ratio

Partners may agree to share profits and losses in the capital ratio. When capitals are fixed, profits will be shared in the ratio of given capitals. But if capitals are fluctuating and partners introduce or withdraw capitals during the year, the capitals for the purpose of ratio would be determined with reference to time on the basis of weighted average method.

Example

A and B formed a partnership with a capital contribution of ₹50,000 and ₹30,000 respectively on 1st January 2022. The profits were to be shared in the capital ratio. Calculate the capital ratio on the basis of following details:

	Capital Introduced		Capital Withdrawn	
	A (₹)	B (₹)	A (₹)	B (₹)
31 March	5,000	–	–	2,000
1 July	–	9,000	3,000	–
1 September	5,500	–	–	1,000
1 November	–	4,000	4,500	–

Answer

Total Capital Employed by A for one Month

Capital (₹)	Months for which capital has been used in the business	Product (₹)
50,000	3	1,50,000
55,000	3	1,65,000
52,000	2	1,04,000
57,500	2	1,15,000
53,000	2	1,06,000
Total		6,40,000

Total Capital Employed by B for one Month

Capital	Months for which capital has been used in the business	Product
(₹)		(₹)
30,000	3	90,000
28,000	3	84,000
37,000	2	74,000
36,000	2	72,000
40,000	2	80,000
Total		4,00,000

On the basis of products of both the partners, the capital ratio between A and B is 64: 40 or 8 : 5.

LLUSTRATION 5

A and B are partners sharing profits and losses in the ratio of their effective capital. They had ₹ 1,00,000 and ₹ 60,000 respectively in their Capital Accounts as on 1st January, 2022.

A introduced a further capital of ₹ 10,000 on 1st April, 2022 and another ₹ 5,000 on 1st July, 2022. On 30th September, 2022 A withdrew ₹ 40,000.

On 1st July, 2022, B introduced further capital of ₹ 30,000.

The partners drew the following amounts in anticipation of profit.

A drew ₹ 1,000 per month at the end of each month beginning from January, 2022. B drew ₹ 1,000 on 30th June, and ₹ 5,000 on 30th September, 2022.

12% p.a. interest on capital is allowable and 10% p.a. interest on drawings is chargeable. Date of closing 31.12.2022. Calculate: (a) Profit-sharing ratio; (b) Interest on capital; and (c) Interest on drawings.

SOLUTION

(a) Calculation of Effective Capital

A		B	
₹ 1,00,000 invested for 3 months i.e.,		₹ 60,000 invested for 6 months i.e.,	
₹ 3,00,000 invested for 1 month	3,00,000	₹ 3,60,000 invested for 1 month	3,60,000
₹ 1,10,000 invested for 3 months i.e.,		₹ 90,000 invested for 6 months, i.e.,	
₹ 3,30,000 invested for 1 month.	3,30,000	₹ 5,40,000 invested for 1 month	5,40,000
			9,00,000
₹ 1,15,000 invested for 3 months i.e.,			
₹ 3,45,000 invested for 1 month.	3,45,000		
₹ 75,000 invested for 3 months, i.e.,			
₹ 2,25,000 invested for 1 month.	2,25,000		
	12,00,000		

(b) Calculation of Interest on Capital

A = ₹ 12,00,000 x 12/100 x 1/12 = ₹ 12,000 B = ₹ 9,00,000 x 12/100 x 1/12 = ₹ 9,000

(c) Calculation of Interest on Drawings

A = ₹ 12,000 x 10/100 x 5.5/12 = ₹ 550 B = ₹ 1,000 x 10/100 x 6/12 = ₹ 50

₹ 5,000 x 10/100 x 3/12 = ₹ 125

Effective capital is in the ratio 12 : 9 therefore profit sharing ratio is 12 : 9 *i.e.* 4 : 3.

ILLUSTRATION 6

Ram and Rahim start business with capital of ₹ 50,000 and ₹ 30,000 on 1st January, 2022. Rahim is entitled to a salary of ₹ 400 per month. Interest is allowed on capitals and is charged on drawings at 6% per annum. Profits are to be distributed equally after the above noted adjustments. During the year, Ram withdrew ₹ 8,000 and Rahim withdrew ₹ 10,000. The profit for the year before allowing for the terms of the Partnership Deed came to ₹ 30,000. Assuming the capitals to be fixed, prepare the Profit and Loss Appropriation Account and the Capital and Current Accounts relating to the partners.

SOLUTION

Profit & Loss (Appropriation) Account

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Rahim's Current A/c		Dec. 31	By Net Profit	30,000
	Salary	4,800		By Sundries-Interest on	
	To Sundries-Interest on			Drawings:	
	Capitals :			Ram's Current A/c	
	Ram's Current A/c	3,000		(6% on ₹ 8,000 for	
	Rahim's Current A/c	1,800		6 months)	240
	To Profit transferred to			Rahim's Current A/c	
	Ram's Current A/c (1/2)	10,470		(6% on ₹ 10,000 for	
	Rahim's Current A/c (1/2)	10,470		6 months)	300
		30,540			30,540

ILLUSTRATION 7

With the help of same information given in illustration 6, let us prepare the Capital and Current Accounts of Ram and Rahim.

SOLUTION

Ram's Capital Account

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Balance c/d	50,000	Jan. 1	By Bank A/c	50,000
			2023		
			Jan. 1	By Balance b/d	50,000

Rahim's Capital Account

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Balance c/d	30,000	Jan. 1	By Bank A/c	30,000
			2023		
			Jan. 1	By Balance b/d	30,000

Ram's Current Account

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Cash Bank A/C (Drawings)	8,000	Dec. 31	By Profit and Loss appropriation A/c - Interest	3,000
	To Profit and Loss appropriation A/c -			By Profit and Loss appropriation A/c -1/2 profit	10,470
	Interest on Drawings	240			
	To Balance c/d	5,230			
		13,470			13,470
			2023		
			Jan. 1	By Balance b/d	5,230

Rahim's Current Account

2022	Particulars	₹	2022	Particulars	₹
	To Cash Bank A/c (Drawings)	10,000	Dec. 31	By Profit and Loss appropriation A/c Salary	4,800
Dec. 31	To Profit and Loss appropriation A/c			Interest	1,800
				By Profit and Loss appropriation	
	Interest on Drawings	300		A/c Profit	10,470
	To Balance c/d	6,770			
		17,070			17,070
			2023		
			Jan. 1	By Balance b/d	6,770

ILLUSTRATION 8

A and B were partners in a firm sharing profits and losses in the ratio of 3:2. They admit C for 1/6th share in profits and guaranteed that his share of profits will not be less than ₹ 250,00,000. Total profits of the firm for the year ended 31st March, 2022 were ₹ 900,00,000. Calculate share of profits for each partner when:

1. *Guarantee is given by firm.*
2. *Guarantee is given by A*
3. *Guarantee is given by A and B equally.*

SOLUTION

Case1. When Guarantee is given by firm.

Profit and Loss Appropriation Account

For the year ending on 31st March, 2022

Particulars	₹	Particulars	₹
To A's Capital A/c (3/5 of ₹ 650,00,000)	3,90,00,000	By Profit and Loss, A/c	9,00,00,000
To B's Capital A/c (2/5 of ₹ 650,00,000)	2,60,00,000		
To C's Capital A/c (1/6 of ₹ 9,00,00,000 or ₹ 25,000,000 which ever is more	2,50,00,000		
	9,00,00,000		9,00,00,000

Case2. When Guarantee is given by A

Profit and Loss Appropriation Account

For the year ending on 31st March, 2022

Particulars		₹	Particulars	₹
To A's Capital A/c (3/6 of ₹ 9,00,00,000)	4,50,00,000		By Profit and Loss, A/c (net profits)	9,00,00,000
Less: Deficiency borne for C	(1,00,00,000)	3,50,00,000		
To B's Capital A/c (2/6 of ₹ 9,00,00,000)		3,00,00,000		
To C's Capital A/c (1/6 of ₹ 9,00,00,000)	1,50,00,000			
Add: Deficiency Recovery from A	1,00,00,000	2,50,00,000		
		9,00,00,000		9,00,00,000

Case3. When Guarantee is given by A and B equally.

Profit and Loss Appropriation Account

For the year ending on 31st March, 2022

Particulars		₹	Particulars	₹
To A's Capital A/c (3/6 of ₹ 9,00,00,000)	4,50,00,000		By Profit and Loss, A/c (net profits)	9,00,00,000
Less: Deficiency borne for C (1/2 of 1,00,00,000)	(50,00,000)	4,00,00,000		
To B's Capital A/c (2/6 of ₹ 9,00,00,000)	3,00,00,000			
Less: Deficiency borne for C (1/2 of 1,00,00,000)	(50,00,000)	2,50,00,000		
To C's Capital A/c (1/6 of ₹ 9,00,00,000)	1,50,00,000			
Add: Deficiency Recovery from A	50,00,000			
Add: Deficiency Recovery from B	50,00,000	2,50,00,000		
		9,00,00,000		9,00,00,000

SUMMARY

- The Indian Partnership Act defines partnership as "the relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all."
- The LLP will be a separate legal entity, liable to the full extent of its assets, with the liability of the partners being limited to their agreed contribution in the LLP which may be of tangible or intangible nature or both tangible and intangible in nature.
- In the partnership firm relations among the partners will be governed by mutual agreement. The agreement is known as Partnership Deed which is to be properly stamped.
- In the absence of an agreement, the interest and salary payable to a partner will be paid only if there is profit.
- During the course of business, a partnership firm will prepare Trading Account and a Profit and Loss Account at the end of every year.
- There are two methods of accounting –

  i. Fixed capital method and

  ii. Fluctuating capital method.

  In fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed.

  In fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.
- Interest on capital of partners is calculated for the relevant period for which the amount of capital has been used in the business.
- Subject to contract between the partners, interest on capitals is to be provided out of profits only. Thus in case of loss, no interest is provided. But in case of insufficient profits (i.e., net profit less than the amount of interest on capital), the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only.

- Sometimes, one partner can enjoy the right to have minimum amount of profit in a year as per the terms of the partnership agreement. In such case, allocation of profit is done in a normal way if the share of partner, who has been guaranteed minimum profit, is more than the amount of guaranteed profit. However, if share of the partner is less than the guaranteed amount, he takes minimum profit and the excess of guaranteed share of profit over the actual share is borne by the remaining partners as per the agreement.

TEST YOUR KNOWLEDGE

True and False

1. *In absence of any agreement partners share profits of the business in the ratio of their capital contribution.*
2. *Profit sharing ratio and capital contribution ratio need not be same.*
3. *Every partnership firm must register itself with Registrar of firms.*
4. *A partner can advance loan to the partnership firm in addition to capital contributed by him.*
5. *A partner can demand interest on capital even if it is not provided in the partnership deed.*
6. *If a partner does not take part in day to day business activities of the firm then he is not entitled to any share of profit.*
7. *Interest should be paid @ 6% p.a. on partners' loan even if it is not provided in the partnership deed.*
8. *Husband and wife cannot be partners in the same firm.*
9. *One senior partner is Principal and other partners are his agents.*
10. *Partners are the agents of the firm and each other.*

Multiple Choice Questions

1. *If a firm prefers Partners' Capital Accounts to be shown at the amount introduced by the partners as capital in firm then entries for salary, interest, drawings, interest on capital and drawings and profits are made in*

   (a) Trading Account

   (b) Profit and Loss Account

   (c) Partners' Current Account

2. *In the absence of any agreement, partners are liable to receive interest on their Loans @*

   (a) *12% p.a.*

   (b) *10% p.a.*

   (c) *6% p.a.*

3. *The relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all is known as ....*

   (a) *Partnership.*

   (b) *Joint Venture.*

   (c) *Association of Persons.*

4. *Firm has earned exceptionally high profits from a contract which will not be renewed. In such a case the profit from this contract will not be included in ....*

   (a) *Profit sharing of the partners.*

   (b) *Calculation of the goodwill.*

   (c) *Both.*

5. *In the absence of an agreement, partners are entitled to*

   (a) *Interest on Loan and Advances.*

   (b) *Commission.*

   (c) *Salary.*

6. *Partners are supposed to pay interest on drawings only when .... by the ....*

   (a) *Provided, Agreement.*

   (b) *Agreed, Partners*

   (c) *Both (a) & (b) above.*

7. *When a partner is given a guarantee by the other partner, loss on such guarantee will be borne by*

   (a) *Partner who gave the guarantee*

   (b) *All the other partners.*

   (c) *Partnership firm.*

8. *A, B and C had capitals of ₹ 50,000; ₹ 40,000 and ₹ 30,000 respectively for carrying on business in partnership. The firm's reported profit for the year was ₹ 80,000. As per provisions of the Indian Partnership Act, 1932, find out the share of each partner in the above amount after taking into account that no interest has been provided on an advance by A of ₹ 20,000, in addition to his capital contribution.*

   (a) ₹ 26,267 for Partner B and C & ₹ 27,466 for partner A.

   (b) ₹ 26,667 each partner.

   (c) ₹ 33,333 for A, ₹ 26,667 for B and ₹ 20,000 for C.

9. *X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and X wanted interest on capital @ 20% as his capital contributions was ₹ 1,00,000 as compared to that of Y and Z which was ₹ 75,000 and ₹ 50,000 respectively.*

   (a) Profits of ₹ 6,000 will be distributed equally with no interest on either Capital.

   (b) X will get the interest of ₹ 20,000 and the loss of ₹ 14,000 will be shared equally.

   (c) All the partners will get interest on capital and the loss of ₹ 39,000 will be shared equally.

10. *X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and Y determined interest @ 24% p.a. on his loan of ₹ 80,000. There was no agreement on this point.*

    Calculate the amount payable to X, Y and Z respectively.

    (a) ₹ 2,000 to each partner.

    (b) Loss of ₹ 4,400 for X and Z & Y will take home ₹ 14,800.

    (c) ₹ 400 for X, ₹ 5,200 for Y and ₹ 400 for Z.

11. *X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and Z demanded minimum profit of ₹ 5,000 as his financial position was not good. However, there was no written agreement. Profits to be distributed to X, Y and Z will be*

    (a) Other partners will pay Z the minimum profit and will suffer loss equally.

    (b) Other partners will pay Z the minimum profit and will suffer loss in capital ratio.

    (c) ₹ 2,000 to each of the partners.

Theory questions

1. *Write short notes on:*

   (a) *Features of Partnership*

   (b) *Powers of Partners*

2. *Distinguish between fixed capital and fluctuating capital.*

3. *What are the liabilities of designated partners in case of LLP.*

Practical questions

1. *Weak, Able and Lazy are in partnership sharing profits and losses in the ratio of 2:1:1. It is agreed that interest on capital will be allowed @ 10% per annum and interest on drawings will be charged @ 8 % per annum. (No interest will be charged/allowed on Current Accounts).*

   The following are the particulars of the Capital and Drawings Accounts of the partners:

	Weak	Able	Lazy
	₹	₹	₹
Capital (1.1.2022)	75,000	40,000	30,000
Current Account (1.1.2022)	10,000	5,000	(Dr.) 5,000
Drawings	15,000	10,000	10,000

   The draft accounts for 2022 showed a net profit of ₹ 60,000 before taking into account interest on capitals and drawings and subject to following rectification of errors:

   (a) *Life Insurance premium of Weak amounting to ₹ 750 paid by the firm on 30th June, 2022 has been charged to Miscellaneous Expenditure A/c.*

   (b) *Repairs of Machinery amounting to ₹ 10,000 has been debited to Plant Account and depreciation thereon charged @ 20%.*

   (c) *Travelling expenses of ₹ 3,000 of Able for a pleasure trip to U.K. paid by the firm on 30th June, 2022 has been debited to Travelling Expenses Account.*

   You are required to prepare the Profit and Loss Appropriation Account, Current Accounts of partners Weak, Able and Lazy for the year ended 31st December, 2022.

2. *Ram and Rahim are in partnership sharing profits and losses in the ratio of 3:2. As Ram, on account of his advancing years, feels he cannot work as hard as before, the chief clerk of the firm, Ratan, is admitted as a partner with effect from 1st January, 2022, and*

becomes entitled to 1/10th of the net profits and nothing else, the mutual ratio between Ram and Rahim remaining unaltered.

Before becoming a partner, Ratan was getting a salary of ₹ 500 p.m. together with a commission of 4% on the net profits after deducting his salary and commission.

It is provided in the partnership deed that the share of Ratan's profits as a partner in excess of the amount to which he would have been entitled if he had continued as the chief clerk, should be taken out of Ram's share of profits.

The net profit for the year ended December 31, 2022 is ₹ 1,10,000. Show the distribution of net profit amongst the partners.

3. *X and Y are partners. As per terms of agreement interest is allowed on capital at 8% p.a. and charged on drawings at 10% p.a. X withdrew ₹ 40,000 pm at the end of each month and Y withdrew ₹ 120,000 at the end of each quarter. You are required to fill the missing figures in following accounts:*

Profit and Loss Appropriation Account for the year ended March 31, 2022

Particulars		₹	Particulars		₹
To ...?			By Profit and Loss A/c (Net profit)		?
To Interest on Capital A/c			By Interest on Drawings A/c		?
X	160,000		X	?	
Y	?	288,000	Y	?	
To profit transferred to Capital A/c					
X (2/3)	?				
Y (1/3)	280,000	?			
		?			?

Partner's Capital Accounts

Particulars	X	Y	Particulars	X	Y
To ...?	?	?	By ...?	?	?
To ...?	?	?	By Salary A/c	3,60,000	?
To ...?	?	?	By ...?	?	
			By ...?	?	?
	?	?		?	?

ANSWERS/HINTS

True and False

1. False: In absence of any agreement partners share profits equally and not in capital contribution ratio.

2. True: Profit sharing can be different from the that of the capital introduced by each of the partner. Not necessary that partner contributing more capital should have a higher profit sharing ratio and vice versa.

3. False: Registration of firms is not compulsory under Indian Partnership Act, 1932.

4. True: Where the partnership deed is absent, then the interest shall be paid at 6% per annum. So the interest on the loan to be paid to the partner.

5. False: Interest on capital can be paid only if it is provided in the partnership deed.

6. False: Every partner need not take part in the business. Even if a partner does not take part in the business he is entitled for his share of profit.

7. True: In absence of Partnership deed, Interest at the rate of 6%.p.a is to be allowed on a partner's loan to the firm.

8. False: Husband and wife can be partners in the same firm.

9. False: There is no senior or junior partner. Every partner is agent/principal of other partners.

10. True: Concept of agency applies to every partner and the firm as well. So each partner is a principal to and agent of every other partner and to the firm.

Multiple Choice Questions

1.	**(c)**	2.	**(c)**	3.	**(a)**	4.	**(b)**	5.	**(a)**	6.	**(c)**
7.	**(a)**	8.	**(a)**	9.	**(a)**	10.	**(c)**	11.	**(c)**		

Theoretical Questions

1. **(a)** The following four essential features of a partnership, namely:

(i) Partnership is the result of an agreement: It means that the relation of partnership arises from contract and not from status.

(ii) Business: A partnership can exist only in business.

(iii) Sharing of profit: The persons concerned must agree to share the profits of the business.

(iv) Mutual agency: It means that the business is to be carried on by all or any of them acting for all. Thus, if the person carrying on the business acts not only for himself but for others also so that they stand in the positions of principals and agents, they are partners.

(b) Powers of partners are the following:

(i) Buying and selling of goods;

(ii) Receiving payments on behalf of the firm and giving valid receipt;

(iii) Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm;

(iv) Borrowing money on behalf of the firm with or without pledging the inventories-in-trade;

(v) Engaging servants for the business of the firm.

2. **(a)** In fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed.

In fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.

3. Please refer para 1.3.6

Practical Problems

1. **Weak, Able & Lazy**

Profit and Loss Appropriation Account for the year ended 31st December, 2022

	₹	₹		₹	₹
To Interest on Capital:			By Net Profit (Adjusted)		55,750
Weak	7,500		By Interest on Drawings:		

Able	4,000		Weak	630	
Lazy	3,000	14,500	Able	520	
			Lazy	400	1,550
To Partner's Current A/cs-					
Share of profit :					
Weak	21,400				
Able	10,700				
Lazy	10,700	42,800			
		57,300			57,300

Working Notes:

(i) Adjusted Profit

	₹	₹
Net Profit as per Profit & Loss A/c	60,000	
Add : Drawings by Weak : Life Insurance Premium of Weak charged to Miscellaneous Expenditure A/c of the Firm	750	
Drawings by Able : Travelling expenses of Able in connection with pleasure trip to U.K. charged to travelling expenses A/c of the firm	3,000	63,750
Less: Repairs to Machinery wrongly capitalised	10,000	
Less : Depreciation charged @ 20%	(2,000)	(8,000)
		55,750

(ii) Interest on Drawings :

	Weak	Able	Lazy
	₹	₹	₹
Drawings	15,000	10,000	10,000
Add : Rectification adjustments	750	3,000	–
	15,750	13,000	10,000
Interest @ 8% p.a. for 6 months	630	520	400

Partners' Current Accounts

	Weak	Able	Lazy		Weak	Able	Lazy
	₹	₹	₹		₹	₹	₹
To Balance b/d	–	–	5,000	By Balance b/d	10,000	5,000	–
To Drawings	15,000	10,000	10,000	By Profit & Loss App. A/c	7,500	4,000	3,000
To Life Insurance				(Int. on capital)			
Premium	750	–	–	By Profit & Loss App. A/c	21,400	10,700	10,700
To Travelling Expenses.	–	3,000	–	(Share of profit)			
To Profit & Loss App. A/c							
(Int. on drawings)	630	520	400				
To Balance c/d	22,520	6,180	–	By Balance c/d	–	–	1,700
	38,900	19,700	15,400		38,900	19,700	15,400

2. **Amount due to Ratan as a Chief Clerk**

	₹
Salary	6,000
Add: Commission 4/104 (₹ 1,10,000 - ₹ 6,000)	4,000
	10,000
Less: Share of Profit as a partner (1/10th of 1,10,000)	(11,000)
Excess chargeable to Ram	(1,000)

Profit and Loss Appropriation Account for the year ended December 31,2022

	Particulars	₹	Particulars	₹
To	Share of Profit A/c		By Profit and Loss A/c	
	Ram [3/5 of (₹ 1,10,000 – ₹ 10,000) – ₹ 1,000]	59,000	(Net profit)	1,10,000

	Rahim [2/5 of (₹ 1,10,000 – ₹ 10,000)]	40,000		
	Ratan [1/10 of ₹ 1,10,000]	11,000		
		1,10,000		1,10,000

3. Profit and Loss Appropriation Account for the year ended March 31, 2022

Particulars	₹	Particulars	₹
To Salary to X	3,60,000	By Profit and Loss A/c (Net profit)	14,48,000
To Interest on Capital A/c		By Interest on Drawings A/c	40,000
X 1,60,000		X 22,000	
Y 1,28,000	2,88,000	Y 18,000	
To profit transferred to Capital A/c			
X (2/3) 5,60,000			
Y (1/3) 2,80,000	8,40,000		
	14,88,000		14,88,000

Partner's Capital Accounts

Particulars	X	Y	Particulars	X	Y
To Drawing A/c	4,80,000	4,80,000	By Balance b/d	20,00,000	16,00,000
To Interest on Drawings A/c	22,000	18,000	By Salary A/c	3,60,000	1,28,000
To Balance c/d	25,78,000	15,10,000	By Interest on Capital A/c	1,60,000	
			By Profit and Loss App A/c	5,60,000	2,80,000
	30,80,000	20,08,000		30,80,000	2,008,000

Working Notes:

1. X's Share of Profit 2,80,000 x 3/1 x 2/3 = 5,60,000
2. Interest on Drawings

   X = 4,80,000 x 11/2 x 1/12 x 10/100 = 22,000

   Y = 4,80,000 x 9/2 x 1/12 x 10/100 = 18,000
3. Y's Interest on Capital 2,88,000 – 1,60,000 = 128,000

UNIT – 2: TREATMENT OF GOODWILL IN PARTNERSHIP ACCOUNTS

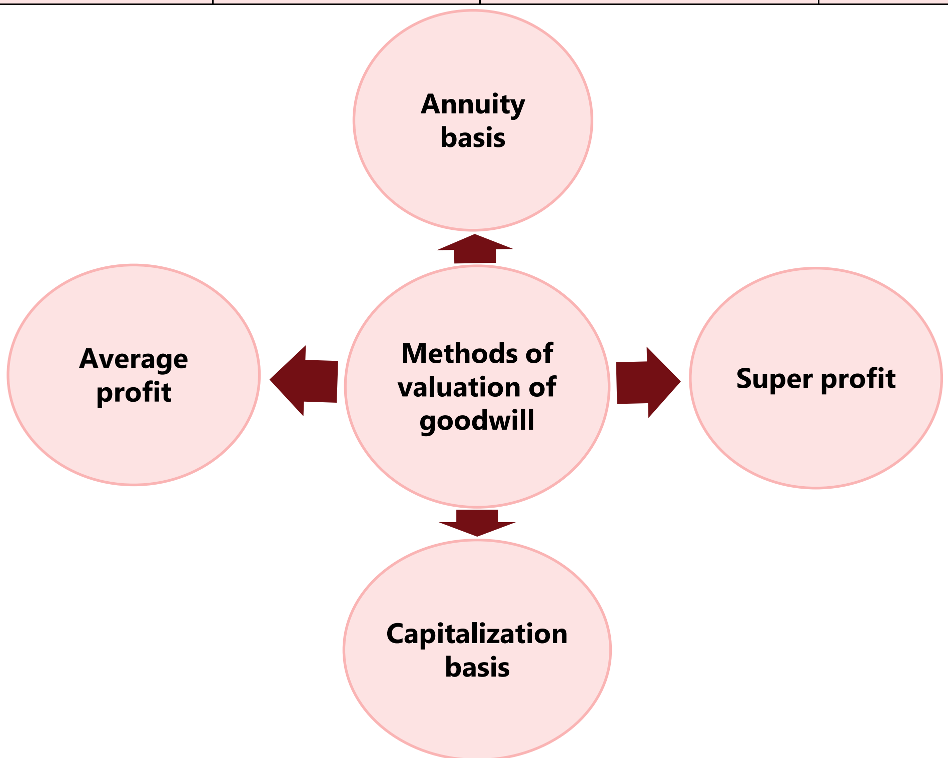
LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand when does the need for valuation of goodwill arise.
- Learn the accounting of goodwill.

UNIT OVERVIEW

Necessity for valuation of goodwill			
Change in profit sharing ratio	Admission of partner	Retirement or death of partner	When business is dissolved or sold



2.1 GOODWILL

Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits.

In simpler terms, Goodwill is nothing more than the probability that old customer will resort to old place again and again. The capacity of a business to earn super profits in the future is basically what is meant by term goodwill. **Goodwill is an intangible asset;** it cannot be seen; it cannot be felt; it cannot be transported physically. **Even then it is very real.** From accounting point of view, it is necessary that it has some monetary or saleable value. The implication of the term over and above is that there is always a certain normal rate of profits earned by similar firms in the same locality. The excess profit earned by a firm may be due to its locational advantage, better customer service, possession of a unique patent right, personal reputation of the partner or for similar other reasons. The necessity for valuation of goodwill in a firm arises in the following cases:

a) When the profit sharing ratio amongst the partners is changed;

b) When a new partner is admitted;

c) When a partner retires or dies; and

d) When the business is dissolved or sold.

Let us take a simple example. There is a small Book business owned by a firm. Its net worth i.e. Asset–liabilities, is ₹ 140,000. Now if a purchaser is willing to pay ₹ 150,000 for it, the extra ₹ 10,000 is known in accounting as goodwill. The next question is: Why the purchaser is willing to pay ₹ 10,000 for goodwill.

One reason may be the future capability of the business to earn more profit than the normal profit. It may be on account of favourable location.

The major factors which affect value of goodwill are as follows:

The list is in no way exhaustive but only provides the basic guidelines:

(i) The quality of the goods sold.

(ii) The personal reputation of the owners i.e., their ability to attract the customers.

(iii) The location of the business premises e.g., a good position in a congested market.

(iv) The possession of near monopoly right e.g. main agent for a particular vehicle like, Maruti car, Bajaj scooter, etc.

(v) The possession of trademarks and patents.

(vi) The presence of managerial skill.

(vii) The cost of research and development which enables the production at low cost and of good quality.

(viii) The possession of special contracts for the availability of materials

RECOMMENDATION OF ACCOUNTING STANDARD

Accounting Standards require an enterprise to recognize an intangible asset, only if and only if, certain conditions are satisfied, namely:

(i) An intangible asset must have the **characteristics of an asset.** It means that it must have some value and must be clearly identifiable, so that it can be sold without disposing other assets or future benefits flowing from other assets.

(ii) An intangible asset should be recognized only if the **future probable economic benefits** (i.e., increased revenue from sales) will flow to the business enterprise and not to others. It means that management can make reasonable estimates of future benefits.

(iii) The cost of the intangible asset can **be measured reliably,** that is, the cost is objectively verifiable. If the cost cannot be measured reliably, then it cannot be recognized as an asset.

It is thus clear that none of the conditions is satisfied by internally generated goodwill or inherent goodwill. The reasons are simple to explain. First, it is not an identifiable resource like patent, trademark or copyright. Second, it is very difficult to assess its future benefits. Finally, the cost of internally generated goodwill cannot be reliably measured in the absence of any consideration in money or money' worth. There is no documentary evidence to support the value of goodwill as a resource.

Goodwill should be recorded in the books only when some consideration in money or money' worth has been paid for it. Accordingly, on admission or retirement/death of a partner or even when there is a change in profit sharing ratio amongst the existing partners, goodwill should not be raised in the books of account of the partnership firm because no consideration in money or money' worth has been paid for it. The conclusion is that only purchased goodwill should be recorded in the books of account whether the payment is made directly in cash or money' worth. For example, 'A' and 'B' purchase the net assets (assets minus liabilities) of 'C' amounting to ₹ 2,50,000 for ₹ 3,00,000 in cash, the additional payment of ₹ 50,000 is a payment for goodwill in cash. It is a case of purchased goodwill (an asset) and can be validly recorded in the books of A and B. When no payment is made for the purchase of goodwill and goodwill account is raised in the books, it is a case of internally generated goodwill or inherent goodwill and as per Accounting Standards, it is not permitted. For example, in the event of reconstitution of the firm due to admission, or retirement or death of a partner or even a change in the profit sharing ratio without reconstitution, goodwill of the firm is evaluated. In such a situation, the value of goodwill should not be brought into books of account because it is inherent or self-generated goodwill since no money or money' worth has been paid for it. The only way out is that the value of goodwill as calculated with the help of different valuation methods should be adjusted through capital accounts of the partner(s) of the firm. In no case the goodwill account is to be raised in the books of account, either on the reconstitution of the firm or change in the profit sharing ratio.

The amount of goodwill is written off over a period of time. In case when the goodwill account exists at the time of reconstitution of firm, it should be written off immediately whether it is internally generated or goodwill has been bought for some consideration.

2.2 METHODS FOR GOODWILL VALUATION

There are three methods for valuation of goodwill

1) Average profit basis,-Simple and Weighted

2) Super profit basis,-Number of Year Purchase, Annuity basis, and Capitalization of Super Profit

3) Capitalization basis- Average Profits

(1) Average Profit Basis: In this case the average profits of past years are adjusted for any expected change in future. The number of year are decided on the basis of judgement and negotiation.

♦ For averaging the past profit, either simple average or weighted average may be employed depending upon the circumstances. If there exists clear increasing or decreasing trend of profits, it is better to give more weight to the profits of the recent years than those of earlier years. But, if there is no clear trend of profit, it is better to go by simple average.

♦ Let us suppose profits of a partnership firm for the last five years were ₹ 30,000, ₹ 40,000,₹ 50,000, ₹ 60,000 and ₹ 70,000. In this case, a clear increasing trend is noticed and therefore, average profit may be arrived at by assigning appropriate weights as shown below :

1	2	3	4 = 2 × 3
Year	**Profit**	**Weight**	**Weighted Profit**
	₹		₹
1	30,000	1	30,000
2	40,000	2	80,000

3	50,000	3	1,50,000
4	60,000	4	2,40,000
5	70,000	5	3,50,000
		15	8,50,000

So, Weighted Average Profit = $\frac{8,50,000}{15}$ = ₹ 56,667 (approx)

If goodwill is valued at three years' purchase of profit, then in this case the value of goodwill is ₹ 56,667 (approx) × 3 = ₹ 1,70,000.

However, if any such trend is not visible from the figures of past profits, then one should take simple average profit and calculate goodwill accordingly. Let us suppose, profits of a partnership firm for five years were ₹ 30,000, ₹ 25,000, ₹ 20,000, ₹ 30,000 and ₹ 28,000. In this case, there is no clear increasing or decreasing trend of profit. So average profit comes to ₹ 26,600 (arrived at by taking simple average). If the goodwill is valued by taking three years' of purchase of profit, the ninth is case, value of goodwill becomes ₹ 79,800.

Weighted average is used when profit has increasing or decreasing Trend. Highest weight is always given to current year, as it reflects the more realistic view of the future profitability

Example

The past profits of five years of a partnership firm are: ₹ 50,000; ₹ 40,000; ₹ 52,000; ₹ 48,000 and ₹ 56,000 respectively. Calculate the value of goodwill on the basis of 4 years' purchase of the average profits of the last five years.

Answer

Total profits for five years = ₹ (50,000 + 40,000 + 52,000 + 48,000 + 56,000) = ₹ 2,46,000

Average profit = Sum of profits/No. of years

Average Profit = ₹ 2,46,000 ÷ 5 = ₹ 49,200

Value of goodwill (being four years' purchase of the average profit of five years) = 4 × ₹ 49,200 = ₹ 1,96,800.

(2) Super Profit Basis: In case of super profit method, goodwill is valued on the basis of super profits earned by the firm.

Super Profit=Actual Profit-Normal Profit

Actual Profit is average maintainable profit

Normal Profit=Normal rate of Return (NRR) x Capital Employed

The rationale for using the super profit is the partner who gains excess earning owing to reconstitution of firm should compensate to partners sacrificing their share in the reconstitution. Super profit means, excess profit that can be earned by a firm over and above the normal profit usually earned by similar firms under similar circumstances. Under this method, the partner who gains in terms of profit sharing ratio has to contribute only for excess profit because normal profit he can earn by joining any partnership firm. Under super profit method, what excess profit a partnership firm can earn is to be determined first.

Calculation of super profit:

(i) Identify the capital employed by the partnership firm;

(ii) Identify the average profit earned by the partnership firm based on past few years' figures;

(iii) Determine normal rate of return prevailing in the locality of similar firms;

(iv) Apply normal rate of return on capital employed to arrive at normal profit;

(v) Deduct normal profit from the average profit of the firm. If the average profit of the firm is more than the normal profit, there exists super profit and goodwill.

Let us suppose, total capital employed by a partnership firm was ₹ 1,00,000 and its average profit was ₹ 25,000. Normal rate of return is 22% in case of similar firms working under similar conditions. So, normal profit is ₹ 22,000 and average profit is ₹ 25,000. The partnership firm earns ₹ 3,000 super profit.

(a) Number of Years Purchase Method: Goodwill is generally valued by multiplying the amount of super profit by certain number of years depending upon the expectation about the maintenance of such profit in future. If it is expected that the super profit can be maintained for another five years in future, then value of goodwill may be taken as ₹ 3,000 × 5 = ₹ 15,000.

Example

A firm of A, B and C has a total capital investment of ₹ 4,50,000. The firm earned net profits during the last four years as: I-₹ 70,000; II-₹ 80,000; III-₹ 1,20,000 and IV-₹ 1,00,000. The reasonable expected return is 15 per cent having regard to the risk involved. The value of goodwill of the business, if it is based on 3 years' purchase of the average super profits of the past four years is as follows:

Average Profit = Sum of profits/no. of years

Normal Profit = NRR x Capital Employed

Super Profit = Average maintable profit- Normal Profit

	₹
Total profits earned during four years :	3,70,000
Average annual profit ₹ 3,70,000 ÷ 4	92,500
Normal Profit (15% of ₹ 4,50,000)	67,500
Super Profit ₹ 92,500–₹ 67,500	25,000

Value of goodwill (being 3 years' purchase of the average super profit:

₹ 25,000 x 3 = 75,000

(b) **Annuity Method:** The major drawback of number of number of years purchase method is that time value of money is not considered. Although it was expected that super profit would be earned in five future years, still no devaluation was done on the value of money for the time difference. In fact when money will be received in different points of time, its value should be different depending upon the rate of interest. If 15% rate of interest is considered appropriate, then discounted value of super profit to be earned in different future years will be as follows:

Year	Super Profit ₹	Discount Factor @15%	Discounted value of Super Profit
1	3,000	.8696	2,608.80
2	3,000	.7561	2,268.30
3	3,000	.6575	1,972.50
4	3,000	.5718	1,715.40
5	3,000	.4972	1,491.60
		3.3522	10,056.60

So, under the annuity method, discounted value of total super profit becomes ₹ 10,056.60 and not ₹ 15,000 as was done under super profit method.

The word annuity is used to mean identical annual amount of super profit. So, for discounting it is possible to refer to annuity table. As per the annuity table, present value of ₹ 1 to be received at the end of each year for 5 years @15% interest p.a. is 3.3522. So value of goodwill under annuity method is ₹ 3,000×3.3522 = ₹ 10,056.60.

Example

Calculate the goodwill by annuity method of super profit from the following facts:

(a) Annual maintainable profit after tax is ₹ 65,000.

(b) Capital employed is ₹ 4,00,000.

(c) Normal rate of return is expected at 12% p.a.

(d) Present value of an annuity of ₹ 1 for five years @ 12% interest is 3.604776.

Answer

	₹
Annual maintainable profit	65,000
Less: Normal profit based on capital employed and normal rate of return i.e., 12% of ₹ 4,00,000	(48,000)
Super profit	17,000
The present value of an annuity of ₹ 1 for five years at 12% compound interest is	3.604776

The present value of annuity of ₹ 17,000 for five years at 12% compound interest = 17,000 x 3.604776 = ₹ 61,281 (Approx.)

Capitalization of Super Profit:

$$\text{Goodwill} = \frac{\text{Super Profit}}{\text{Normal Rate of Return (NRR)}} = \frac{17,000}{12\%} = ₹\ 14,1667$$

3 **Capitalization Basis:** Under this basis, value of whole business is determined applying normal rate of return. If such value (arrived at by applying normal rate of return) is higher than the capital employed in the business, then the difference is goodwill. The steps to be followed under this method are given below:

a. Determine the normal rate of return.

b. Find out the average profit of the partnership firm for which goodwill is to be determined.

c. Determine the capital employed by the partnership firm for which goodwill is to be determined.

d. Find out normal value of the business by dividing average profit by normal rate of return.

e. Deduct average capital employed from the normal value of the business to arrive at goodwill.

Goodwill = Normal Capital-Actual Capital

Normal capital = Average Profit/NRR

Let us suppose capital employed by a partnership firm is ₹ 1,00,000. Its average profit is ₹ 20,000. Normal rate of return is 15%.

Normal Value of business= $\frac{20,000}{15\%}$= ₹ 1,33,333 Value of goodwill = ₹ 1,33,333 – ₹ 1,00,000 = ₹ 33,333

Example

The net tangible assets of a firm are worth ₹ 4,10,000 and the average profit of last four years amounts to ₹ 60,000. Find out of the value of goodwill under capitalization method if the reasonable return on capital invested is 12%.

Answer

	₹
Capital invested in the business	4,10,000
Normal rate of return	12%
Average profit earned by the firm	60,000
Value of the firm (Capitalization of average profit): 60,000/12%=	5,00,000
Goodwill = Value of the firm –Net Assets = ₹ 5,00,000 – ₹ 4,10,000	90,000

Above methods are explained below with the help of following illustrations:

ILLUSTRATION 1

Lee and Lawson are in equal partnership. They agreed to take Hicks as one-fourth partner. For this it was decided to find out the value of goodwill. M/s. Lee and Lawson earned profits during 2019-2022 as follows:

Year	***Profits (₹)***
2019	*1,20,000*
2020	*1,25,000*
2021	*1,30,000*
2022	*1,50,000*

On 31.12.2022 capital employed by M/s. Lee and Lawson was ₹ 5,00,000. Rate of normal profit is 20%.

Required

Find out the value of goodwill following various methods.

SOLUTION

Average Profit:

Year	Profit	Weight	Weighted Profit ₹
2019	1,20,000	1	1,20,000
2020	1,25,000	2	2,50,000
2021	1,30,000	3	3,90,000
2022	1,50,000	4	6,00,000
		10	13,60,000

Weighted Average Profit = ₹ 13,60,000 divided by 10 = ₹ 1,36,000

Method (1): Average Profit Basis

Assumption: Goodwill is valued at 3 year's purchase

Valuation of Goodwill: ₹ 1,36,000 ×3 = ₹ 4,08,000

Method (2): Super Profit Basis

	₹
Average Profit	1,36,000
Less: Normal Profit	
20% on ₹ 5,00,000	(1,00,000)
	₹ 36,000

Assumption: Goodwill is valued at 3 years' purchase.

Value of Goodwill = ₹ 36,000 × 3 = ₹ 1,08,000

Method (3): Annuity Basis

Assumptions:

(a) Interest rate is equivalent to normal profit rate i.e. 20%p.a.

(b) Goodwill is valued at 3 years' purchases

Valuation of Goodwill: ₹ 36,000 × 2.1065 =₹ 75,834

Method (4): Capitalisation Basis

Normal Value of business: $\frac{₹\ 1,36,000}{20} \times 100$	=	₹ 6,80,000
Less: Capital Employed in M/s. Lee and Lawson	=	(₹ 5,00,000)
Goodwill	=	₹ 1,80,000

ILLUSTRATION 2

The following particulars are available in respect of the business carried on by Rathore

			₹
(1)	*Capital Invested*		*1,50,000*
(2)	*Trading Results:*		
	2019	*Profit*	*40,000*
	2020	*Profit*	*36,000*
	2021	*Loss*	*6,000*
	2022	*Profit*	*50,000*
(3)	*Market Rate of interest on investment*	*10%*	
(4)	*Rate of risk return on capital invested in business*	*2%*	
(5)	*Remuneration from alternative employment of the proprietor (if not engaged in business).*	*₹ 6,000 per annum*	

You are required to compute the value of goodwill on the basis of 5years' purchase of super profit of the business calculated on the average profits of the last four years.

SOLUTION

Average maintainable profits:		₹
Trading profit during	2019	40,000
	2020	36,000
	2021	50,000
		1,26,000

Less: Loss during	2022	(6,000)
Total		1,20,000
Average Profits		30,000
Less: Remuneration for the proprietor		(6,000)
Average maintainable Profit		24,000
Less: Normal Profit (12% on capital employed of ₹ 1,50,000)		(18,000)
Super Profit		6,000
Goodwill at 5 year's purchase of super Profit		30,000

Hidden or Inferred or implied Goodwill

Sometimes the value of goodwill is not specifically given and has to be inferred or implied from the arrangement of capital or profit-sharing ratio. For example A's capital is ₹ 20,000 and B's Capital is ₹ 15,000 and they share profits equally. C is admitted as a partner with ₹ 18,000 as his capital for 1/4 share in the profits. The total capital of the firm now ought to be ₹ 72,000 for the simple reason that if C contributes ₹ 18,000 for 1/4 share, then for full or unit profit he ought to have contributed ₹ 72,000 (18,000 x 4). But the total capital of A, B and C becomes only ₹ 53,000. So the hidden value of the goodwill should be taken as ₹ 19,000 so that the total capital becomes ₹ 72,000

2.3 NEED FOR VALUATION OF GOODWILL

Whenever there is any change in the existing relationship of the partners in terse, some partners have to sacrifice their future profit and some others would gain. Those who are sacrificing future profit should be compensated by the others who are gaining. This adjustment of the partnership rights may arise due to admission of a new partner, change in the profit sharing ratio, retirement or death of a partner and a dissolution of the partnership. The partners, who gain in terms of profit sharing ratio, have to pay for such gain as a proportion to the value of goodwill. The partners, who lose in terms of profit sharing ratio, receive payments for the sacrifice as a proportion to the value of goodwill.

2.4 VALUATION OF GOODWILL IN CASE OF ADMISSION OF A PARTNER

When a new partner is admitted into a partnership, certain adjustments in accounts become necessary. Chiefly, this is because the new partner will acquire a share in the profits of the firm and because of this, the old partners will stand to lose. Suppose, A and B are partners sharing profits in the ratio of 3:2. If their profits are ₹ 20,000, A will get ₹ 12,000 and B will get ₹ 8,000. If C is admitted and given one fourth share in profits, then out of ₹ 20,000 he will get ₹ 5,000. The remaining ₹ 15,000 will be divided between A and B; A will get ₹ 9,000 and B will get ₹ 6,000. Thus on C's admission A loses ₹ 3,000 per year and B loses ₹ 2,000 per year. C will have to compensate A and B for this loss. It is no argument to say that on C's admission the profits will not remain at ₹ 20,000; extra profits will arise and therefore, A and B will both get more than what they previously got. But it should be noted that the additional profits will be earned by the combined efforts of all the partners A, B and C. Therefore, if A and B get a share of the extra profits they are not particularly obliged to C. Out of the present profits of ₹ 20,000 they have to give up a share in favour of C and, therefore, they are entitled to a compensation. The problem of compensation is the chief problem while dealing with admission of a partner. This is tackled through goodwill.

But one point should be made clear here. Goodwill is a compensation to old partners for their sacrifice in connection with admission of a new partner. So it is to be credited to the partners according to their profit sacrificing ratio. Whatever share the new partner is getting, it may be sacrificed by the old partners in proportion to their old profit sharing ratio or in different proportion.

For example, Nigam and Dhameja are in partnership sharing profits and losses equally. They agreed to take Ghosh as one-third partner. Now one-third share of Ghosh may come out of sacrifice made by Nigam and Dhameja equally (i.e. at their old profit sharing ratio). See the following profit sharing pattern:

Profit Sharing Pattern

Partners	Old Share	New Share	Sacrifice	Gain
Nigam	$\frac{1}{2}$	$\frac{1}{2}\left[1-\frac{1}{3}\right]=\frac{2}{3}\times\frac{1}{2}=\frac{1}{3}$	$\frac{1}{2}-\frac{1}{3}=\frac{1}{6}$	–
Dhameja	$\frac{1}{2}$	$\frac{1}{2}\left[1-\frac{1}{3}\right]=\frac{2}{3}\times\frac{1}{2}=\frac{1}{3}$	$\frac{1}{2}-\frac{1}{3}=\frac{1}{6}$	–
Ghosh	–		–	$\frac{1}{3}$

In other words, one-third share of Ghosh was borne by Nigam and Dhameja at their old profit sharing ratio. By this process Nigam sacrificed 1/2–1/3 = 1/6 in share and Dhameja sacrificed

1/2–1/3 = /1/6 in share. So the profit sacrificing ratio becomes:

Nigam	=	Dhameja
1/6	=	1/6
1	:	1

Which is the same as old profit sharing ratio.

But if the new profit sharing ratio of Nigam, Dhameja and Ghosh becomes 4:2:3, then profit sacrificed by Nigam and Dhameja on Ghosh's admission is not at the old profit sharing ratio. In this case profit sacrificing ratio is as follows:

Nigam	=	1/2 – 4/9 = 1/18
Dhameja	=	1/2 – 2/9 = 5/18
i.e. 1	:	5

If Ghosh pays goodwill of ₹ 24,000, then in the first case, Nigam and Dhameja should share it equally; but in second case Nigam should get ₹ 4,000 and Dhameja should get ₹ 20,000.

Take another example: Nigam and Dhameja are equal partners. They agreed to take Ghosh as one-third partner. The new profit sharing ratio is 4:2:3. Nigam and Dhameja agreed ₹ 27,000 as value of goodwill.

Journal Entry

Ghosh's Capital Account	Dr.	9,000	
To Nigam's Capital Account			1,500
To Dhameja's Capital Account			7,500
(Goodwill adjustment in the profit sacrificing ratio)			

Nigam - ₹ 27,000 × 1/18

Dhameja - ₹ 27,000 × 5/18

As per the Accounting Standards, it is not recommended to raise goodwill account but to show the adjustment of goodwill through partners' capital accounts.

2.5 ACCOUNTING TREATMENT OF GOODWILL IN CASE OF ADMISSION OF A NEW PARTNER

The goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Therefore, only purchased goodwill should be recorded in the books of the firm. In case of admission of a partner, goodwill cannot be raised in the books of the firm because no consideration in money or money's worth is paid for it. If the incoming partner brings any premium over and above his capital contribution at the time of his admission, such premium should be distributed to other existing partners. When a new partner is admitted to a firm, the old partners generally sacrifice in favour of the new partner in terms of lower profit sharing ratio in the future. Therefore, the premium for goodwill brought in by the new partner shall be given to the existing partners on the basis of profit sacrificing ratio. The profit sacrificing ratio is computed by deducting the new profit sharing ratio from the old profit sharing ratio. If the difference is positive, then there is a profit sacrifice and in case the difference is negative, then there is a gain in terms of higher future profit sharing ratio. In case of admission of a partner, only those existing partners are entitled to a share for goodwill who have sacrificed a part of their profits in favour of the new partner. Sometimes, goodwill may be evaluated in case of admission of a partner when incoming partner is unable to bring in cash any premium for goodwill. In that situation also, the value of goodwill should not be raised in the books since it is inherent goodwill. Rather it is preferable that such value of goodwill should be adjusted through partners' capital accounts. It may also be noted that when the incoming partner pays any premium for goodwill privately to the existing partners, no entry is required in the books of the firm. In that case, the amount to be paid to each partner should be calculated as per the profit sacrificing ratio. If only new partner's profit sharing is given then profit sacrificing ratio of old paterns would be same as old profit sharing ratio.

Example 1: A, B & C are in partnership sharing profits and losses in the ratio 2:2:1. They want to admit D into partnership with one-fifth share. D brings in ₹ 30,000 as capital and ₹ 10,000 as premium for goodwill.

The necessary journal entry will be:

Bank A/c	Dr.	₹ 40,000	
To A's Capital A/c			₹ 4,000
To B's Capital A/c			₹ 4,000
To C's Capital A/c			₹ 2,000

To D's Capital A/c (Amount brought in by D as Capital and premium for goodwill which is credited to the old partners' Capital accounts in profit sacrificing ratio which is same as old profit sharing ratio)		₹ 30,000

Example 2: A & B are equal partners. They wanted to take C as a third partner and for this purpose goodwill was valued at ₹ 1,20,000. The journal entry for adjustment of value of goodwill through partners' capital accounts will be:

C's Capital A/c Dr.	₹ 40,000	
To A's Capital A/c		₹ 20,000
To B's Capital A/c		₹ 20,000
(Adjustment for goodwill)		

The net effect in partners' capital accounts is shown on the basis of profit sacrificing ratio:

A = 1/6 × ₹ 1,20,000 = ₹ 20,000 (Cr.)

B = 1/6 × ₹ 1,20,000 = ₹ 20,000 (Cr.)

C = 1/3 × ₹ 1,20,000 = ₹ 40,000 (Dr.)

Example 3: A & B are equal partners. They wanted to admit C as 1/6th partner who brought ₹ 60,000 as goodwill. The new profit sharing ratio is 3:2:1. Profit sacrificing ratio is to be computed as follows:

Old Share – New Share = Share Sacrificed

A = 1/2 – 3/6 = 0

B = 1/2 – 2/6 = 1/6

So the entire goodwill should be credited to B's Capital A/c.

Cash A/c	Dr.	₹ 60,000	
To B's Capital A/c			₹ 60,000
(Goodwill brought in by C credited to B's Capital A/c)			

Example 4: A, B & C are equal partners. They decided to take D who brought in ₹ 36,000 as goodwill. The new profit sharing ratio is 3:3:2:2.

Old Share – New Share = Share Sacrificed

A = 1/3 – 3/10 = 1/30

B = 1/3 – 3/10 = 1/30

C = 1/3 – 2/10 = 4/30

So goodwill should be shared in the ratio 1:1:4

Bank A/c	Dr.	₹ 36,000	
To A's Capital A/c			₹ 6,000
To B's Capital A/c			₹ 6,000
To C's Capital A/c			₹ 24,000
(Goodwill brought in by D credited to old partners' accounts in their profit sacrificing ratio 1:1:4)			

ILLUSTRATION 3

The following is the Balance Sheet of Yellow and Green as at 31st December, 2022:

Liabilities	₹	***Assets***	₹
Trade payables	*20,000*	*Cash at Bank*	*10,000*
Capital:		*Sundry Assets*	*55,000*
Yellow	*25,000*		
Green	*20,000*		
	65,000		*65,000*

The partners shared profits and losses in the ratio 3:2. On the above date, Black was admitted as partner on the condition that he would pay ₹ 20,000 as Capital. Goodwill was to be valued at 3 years' purchase of the average of four years' profits which were:

	₹		₹
2019	*9,000*	*2021*	*12,000*
2020	*14,000*	*2022*	*13,000*

The new profit sharing ratio is 6:5:5.

Give journal entries and Balance Sheet if goodwill is adjusted through partners' capital accounts.

SOLUTION

			₹	₹
(i)	Bank Account	Dr.	20,000	
	To Black's Capital Account			20,000
	(Amount brought in by Black as capital)			
(ii)	Black's Capital Account	Dr.	11,250	
	To Yellow's Capital Account			8,100
	To Green's Capital Account			3,150
	(Black's share of goodwill adjusted through old partners' capital accounts in the profit sacrificing ratio 18:7)			

Balance Sheet as on.31st December, 2022

Liabilities	₹	₹	Assets	₹
Trade payables		20,000	Cash at Bank	30,000
Capital:			Sundry Assets	55,000
Yellow	33,100			
Green	23,150			
Black	8,750	65,000		
		85,000		85,000

Note: Calculation of Profit Sacrificing Ratio

Old Share – New Share = Share Sacrificed

Yellow $\frac{3}{5} - \frac{6}{16} = \frac{18}{80}$

Green $\frac{2}{5} - \frac{5}{16} = \frac{7}{80}$

Calculation of Goodwill

Average profit $= \frac{9{,}000+14{,}000+12{,}000+13{,}000}{4} = 12{,}000$

Goodwill of the firm = 3 × 12,000 = 36,000

Black share $= \left(\frac{36{,}000}{16}\right) \times 5 = 11{,}250$

ILLUSTRATION 4

With the information given in illustration 3, let us give journal entries and prepare balance sheet assuming that goodwill is brought in cash.

SOLUTION

Goodwill brought in cash

Bank Account	Dr.	31,250	
To Black's Capital Account			20,000
To Yellow's Capital Account			8,100
To Green's Capital Account			3,150
(Amount brought in by Black as capital and as goodwill; goodwill credited to Yellow and Green's Capital accounts in the profit sacrificing ratio)			

Balance Sheet as on 31st December, 2022

Liabilities	₹	₹	Assets	₹
Trade payables		20,000	Cash at Bank	41,250
Capital:			Sundry Assets	55,000
Yellow	33,100			
Green	23,150			
Black	20,000	76,250		
		96,250		96,250

ILLUSTRATION 5

Continuing with the same illustration 3, let us give journal entries and prepare balance sheet assuming that goodwill is brought in cash, but withdrawn.

SOLUTION

Goodwill brought in cash, but withdrawn

In addition to the treatment under Illustration 3 the following additional entry will be made:

Yellow's Capital Account	Dr.	8,100	
Green's Capital Account	Dr.	3,150	
To Bank Account			11,250
(Amount withdrawn by Yellow and Green in respect of goodwill credited to them)			

Balance Sheet as on 31st December, 2022

Liabilities	₹	₹	Assets	₹
Trade payables		20,000	Cash at Bank	30,000
Capital:			Sundry Assets	55,000
Yellow	25,000			
Green	20,000			
Black	20,000	65,000		
		85,000		85,000

ILLUSTRATION 6

On the basis of information given in illustration 3, let us give journal entries and prepare balance sheet assuming that goodwill is paid privately.

SOLUTION

There will be no entry for goodwill but Black will pay ₹ 8,100 to Yellow and ₹ 3,150 to Green. For capital brought in by Black, the entry is:

Bank Account	Dr.	20,000	
To Black's Capital Account			20,000
(Amount brought in by Black as capital)			

Balance Sheet as on....................

Liabilities	₹	₹	Assets	₹
Trade payables		20,000	Cash at Bank	30,000
Capital:			Sundry Assets	55,000
Yellow	25,000			
Green	20,000			
Black	20,000	65,000		
		85,000		85,000

2.6 ACCOUNTING TREATMENT OF GOODWILL IN CASE OF CHANGE IN PROFIT SHARING RATIO

In case of change in profit sharing ratio, the value of goodwill should be determined and preferably adjusted through capital accounts of the partners on the basis of profit sacrificing ratio.

ILLUSTRATION 7

A, B & C are equal partners. They wanted to change the profit sharing ratio into 4:3:2. Make the necessary journal entries. Goodwill of the firm is valued at ₹ 90,000.

SOLUTION

Journal Entry

	₹	₹
A's Capital Dr.	10,000	
To C's Capital A/c		10,000

In this case due to change in profit sharing ratio

A's gain is = 4/9 less 1/3 = 1/9

B's gain is = 1/3 less 1/3 = 0

C's loss is = 1/3 less 2/9 = 1/9

So, A should compensate C to the extent of 1/9th of goodwill i.e. ₹ 90,000 × 1/9 = ₹ 10,000

ILLUSTRATION 8

A, B and C are in partnership sharing profits and losses in the ratio of 4:3:3. They decided to change the profit sharing ratio to 7:7:6. Goodwill of the firm is valued at ₹20,000. Calculate the sacrifice / gain by the partners and make the necessary journal entry.

SOLUTION

Partner	New Share		Old Share		Difference
A	$\frac{7}{20}$	—	$\frac{4}{10}$	=	$\left(\frac{1}{20}\right)$
B	$\frac{7}{20}$	—	$\frac{3}{10}$	=	$\frac{1}{20}$
C	$\frac{6}{20}$	—	$\frac{3}{10}$	=	0

Thus, B gained 1/20th share while A sacrificed 1/20th share i.e. ₹ 20,000 x $\frac{1}{20}$ = ₹ 1,000. For C there was no loss no gain.

Journal Entry

	₹	₹
B's Capital A/c Dr.	1,000	
To A's Capital A/c		1,000
(Being goodwill adjusted through partners' capital accounts in sacrificing/gaining ratio)		

ILLUSTRATION 9

A, B, C and D are in partnership sharing profits and losses equally. They mutually agreed to change the profit sharing ratio to 3:3:2:2. Goodwill of the firm is valued at ₹ 20,000. Give necessary journal entry.

SOLUTION

A gains by $\frac{3}{10} - \frac{1}{4} = \frac{1}{20}$

B gains by $\frac{3}{10} - \frac{1}{4} = \frac{1}{20}$

C loses by $\frac{1}{4} - \frac{2}{10} = \frac{1}{20}$

D loses by $\frac{1}{4} - \frac{2}{10} = \frac{1}{20}$

A and B should pay @₹ 1,000 each (i.e., ₹ 20,000×1/20) as compensation to C and D respectively for their sacrifice.

Journal Entry

A's Capital Account Dr.	1,000	
B's Capital Account Dr.	1,000	
To C's Capital Account		1,000
To D's Capital Account		1,000
(Being goodwill adjusted through partners' capital A/cs at sacrificing/gaining ratio)		

2.7 ACCOUNTING TREATMENT OF GOODWILL IN CASE OF RETIREMENT OR DEATH OF A PARTNER

In case of retirement of a partner, the continuing partners will gain in terms of profit sharing ratio. Therefore, they have to pay to retiring partner for his share of goodwill in the firm in the gaining ratio. Similarly, in case of death of the partner, the continuing partners should bear the share of goodwill due to the heirs of the deceased partner. For this purpose, the goodwill is valued on the date of the retirement or death and adjusted through the capital accounts of the partners.

Example: A, B & C are equal partners. C wanted to retire for which value of goodwill is considered as ₹ 90,000. The necessary journal entry will be:

A's Capital A/c	Dr.	₹ 15,000	
B's Capital A/c	Dr.	₹ 15,000	
To C's Capital A/c			₹ 30,000
(C's share of goodwill adjusted to existing partners' capital accounts in profit gaining ratio)			

ILLUSTRATION 10

Antoo, Bantoo and Chintoo were in partnership sharing profits and losses 3:4:3 respectively. The accounts of the firm are made up to 31st March every year. The partnership provided, interalia, that: On the retirement of a partner the goodwill was to be valued at three years' purchase of average profits of the past four years up to the date of the retirement after deducting interest @12%p.a. on capital employed and remuneration of ₹ 2,000 p.m.to each partner. On 1st April 2022, Antoo retired and it was agreed on his retirement to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance Sheet. It was agreed that the capital employed would be ₹ 6,50,000. Bantoo and Chintoo were to continue the partnership, sharing profits and losses equally after the retirement of Antoo. The following were the amounts of profits of earlier years before charging salary to partners and interest on capital employed.

Year	*Profit*
2018-19	*2,60,000*
2019-20	*2,75,000*
2020-21	*2,65,000*
2021-22	*2,80,000*

You are required to compute the value of goodwill and show the adjustment there of in the books of the firm.

SOLUTION

Valuation of Goodwill

Calculation of Average Profit

2018-19	2,60,000	
2019-20	2,75,000	
2020-21	2,65,000	
2021-22	2,80,000	
Total	10,80,000	
Average Profit (10,80,000/4)		2,70,000
Less: Interest on capital @ 12%p.a.		78,000
Less: Salaries of partners'(3 x 12 x 2,000)		72,000
Adjusted Average profit		1,20,000
Goodwill (3 years purchase =3 x 1,20,000)		3,60,000
Antoo's Share of Goodwill (3/10) *i.e.*		1,08,000

Adjustment Journal entry for Goodwill

Particulars		Dr. ₹	Cr. ₹
Bantoo's Capital Account	Dr.	36,000	
Chintoo's Capital Account	Dr.	72,000	
To Antoo's Capital Account			1,08,000
(Adjusting entry passed for share of goodwill of Antoo through remaining partners' capital accounts in gaining ratio)			

Working Note:

Partner	New Share		Old Share		Difference
Antoo	0	–	3/ 10	=	–3/ 10
Bantoo	1/ 2	–	4/ 10	=	1/ 10
Chintoo	1/ 2	–	3/ 10	=	2/ 10

ILLUSTRATION 11

Cu and Au were in partnership sharing profits and losses in the ratio 5:3. On 1st April 2022, they decided to admit Ag the partnership on the following terms:

1. *Ag will bring ₹ 2,00,000/- as capital for ¼ share.*
2. *New profit sharing ratio shall be 2:1:1 among Cu, Au and Ag.*
3. *Cu was entitled to salary of ₹ 2,000/- p.m., it was revised to ₹ 3,000 p.m. from 1st October 2020.*
4. *Interest on capital was paid at 8% p.a.*
5. *Capitals as on 31st March 2022 were Cu ₹ 4,00,000 Au ₹ 3,00,000, which had remained unchanged since last four years.*
6. *Goodwill was to be valued on the basis of 3 years purchase of average adjusted weighted average profits of past 4 years. The profits of previous four years, before charging interest on capital and salary to Cu were as follows:*

Year	*Profit*
2018-19	*2,10,000*
2019-20	*2,60,000*
2020-21	*2,10,000*
2021-22	*3,05,000*

These profits were subject to following rectification

(a) *A machine costing ₹ 40,000 purchased on 1st October, 2020 was wrongly charged to revenue. The machinery was depreciated at 20% p.a. on written down value method*

(b) *Stock on 31st March 2020 was over valued by ₹ 20,000/-*

(c) *There was a loss by fire amounting to ₹ 10,000/- in the year 2018-19 which was not considered in trading account but correctly debited in the Profit & Loss a/c for that year.*

(d) *Debtors as on 31st March 2022 included bad debts of ₹ 5 ,800/-*

7. *Ag shall bring his share of goodwill in cash.*

You are required to calculate amount of goodwill Ag is supposed to bring and journal entry for the same.

SOLUTION

Valuation of goodwill

Particulars	2018-19	2019-20	2020-21	2021-22
Profits	2,10,000	2,60,000	2,10,000	3,05,000
Less: Salary to Cu	(24,000)	(24,000)	(30,000)	(36,000)
Less: Interest on Capital of Partners	(56,000)	(56,000)	(56,000)	(56,000)
Add: Machine to be capitalised			40,000	
Less: Depreciation on above			(4,000)	(7,200)
Less: Over valuation of closing stock		(20,000)		
Add: Over valuation of opening stock			20,000	
Add: Loss by fire	10,000			
Less: Bad debts to be written off				(5,800)
Adjusted profits	1,40,000	1,60,000	1,80,000	2,00,000
Weights	1	2	3	4
Product	1,40,000	3,20,000	5,40,000	8,00,000

Weighted Average profit = total product/ total weights

= 18,00,000/10 = 1,80,000

Goodwill (3 years purchase) = 3 x 1,80,000 = 5,40,000

Ag's share ¼th = 5,40,000/4 = 1,35,000

Adjustment Journal entry for Goodwill

Particulars		Dr. ₹	Cr. ₹
Bank A/c	Dr.	1,35,000	
To Cu's Capital Account			67,500
To Au's Capital Account			67,500
(Adjusting amount brought in by Ag towards goodwill credited to remaining partners' capital accounts in sacrifice ratio)			

Working Note:

Partner	New Share		Old Share		Difference
Cu	2/4	–	5/8	=	1/8
Au	1/4	–	3/8	=	1/8
Ag	1/ 4	–		=	1/4

SUMMARY

- **Goodwill** is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits.
- **Necessity for valuation of goodwill in a firm arises in the following cases:**
  - When the profit sharing ratio amongst the partners is changed;
  - When a new partner is admitted;
  - When a partner retires or dies, or
  - When the business is dissolved or sold.
- **Methods for valuation of goodwill:-**

  (1) Average profit basis :

  Average Profit = Total profit/Number of years

  Goodwill = Average Profit x No. of Years' purchased

  The profits taken into consideration are adjusted with abnormal losses, abnormal gains, return on non-trade investments and errors. The average can be simple average or weighted average depending upon the circumstances.

  (2) Super profit basis:

  Calculate Capital Employed

  Assets ....

  Less: Liability ....

  Capital Employed ....

  - Find the normal Rate of Return (NRR)
  - Find Normal Profit=Capital Employed X Normal rate of Return
  - Find Average Actual Profit
  - Find Super Profit=Average Actual Profit-Normal Profit
  - Find Goodwill=Super Profit X Number of Years Purchased

  (3) Annuity basis:

  Goodwill=Super Profit x Annuity Number

  (4) Capitalization basis:

  Goodwill = Super Profit / Normal Rate of Return

TEST YOUR KNOWLEDGE

True and False

1. *Goodwill is intangible asset therefore it cannot be valued.*
2. *Goodwill is valued whenever there is change in the profit sharing ratio among the partners.*
3. *Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits.*
4. *At the time of admission or retirement of a partner, goodwill can be raised in the books of accounts and shown as an asset.*
5. *Only simple average method can be used for valuation of goodwill.*
6. *Super profit means excess of actual average profit over normal profit.*
7. *Normal profit means profit earned by similar companies in the same industry.*
8. *Normal profit depends upon Normal Rate of Return and past profits.*
9. *At the time of admission/retirement of a partner, since goodwill can not be raised in the books of accounts is recorded through capital accounts of the partners.*
10. *At the time of admission of a partner, goodwill brought in by the new partner is shared equally by old partners.*

Multiple Choice Questions

1. *Goodwill brought in by incoming partner in cash for joining in a partnership firm is taken away by the old partners in their.........ratio.*

   (a) Capital.

   (b) New Profit Sharing.

   (c) Sacrificing.

2. *A & B are partners sharing profits and losses in the ratio 5:3. On admission, C brings ₹70,000 cash and ₹48,000 against goodwill. New profit sharing ratio between A, B and C are 7:5:4. Find the sacrificing ratio of A:B.*

   (a) 3:1.

   (b) 4:7.

   (c) 5:4.

3. *Following are the factors affecting goodwill except:*

   (a) *Nature of business.*

   (b) *Efficiency of management.*

   (c) *Location of the customers.*

4. *Weighted average method of calculating goodwill should be followed when:*

   (a) *Profits has increasing trend.*

   (b) *Profits has decreasing trend.*

   (c) *Either 'a' or 'b'.*

5. *In the absence of any provision in the partnership agreement, profits and losses are shared*

   (a) *In the ratio of capitals.*

   (b) *Equally.*

   (c) *In the ratio of loans given by them to the partnership firm.*

6. *The profits and losses for the last 4 years are 2018-19 Losses ₹ 10,000; 2019-20 Losses ₹ 2,500; 2020-21 Profits ₹ 98,000 & 2021-22 Profits ₹ 76,000. The average capital employed in the business is ₹ 2,00,000. The rate of interest expected from capital invested is 12%.*

   The remuneration of partners is estimated to be ₹ 1,000 per month not charged in the above losses/profits. Calculate the value of goodwill on the basis of two years purchase of super profits based on the average of four years.

   (a) *₹ 9,000.*

   (b) *₹ 8,750.*

   (c) *₹ 8,250.*

7. *A, B and C are partners sharing profits and losses in the ratio 3:2:1. They decide to change their profit sharing ratio to 2:2:1. To give effect to this new profit sharing ratio they decide to value the goodwill at ₹ 30,000. Pass the necessary journal entry if Goodwill not appearing in the old balance sheet and should not appear in the new balance sheet.*

   (a) *B's Capital Account Dr. ₹ 2,000*

   C's Capital Account Dr. ₹ 1,000

   To A's Capital Account ₹ 3,000

(b) *Goodwill Account Dr. ₹ 30,000*

To A's Capital Account ₹ 15,000

To B's Capital Account ₹ 10,000

To C's Capital Account ₹ 5,000

(c) *A's Capital Account Dr. ₹ 12,000*

B's Capital Account Dr. ₹ 12,000

C's Capital Account Dr. ₹ 6,000

To Goodwill Account ₹ 30,000

Theory questions

1. *Write short note on methods for valuation of goodwill.*
2. *Explain Accounting treatment of goodwill in case of change in profit sharing ratio. Distinguish between Super profit basis and Capitalisation Basis.*

Practical questions

1. *Wise, Clever and Dull were trading in partnership sharing profits and losses 4:3:3 respectively. The accounts of the firm are made upto 31st December every year.*

   The partnership provided, interalia, that:

   On the death of a partner the goodwill was to be valued at three years' purchase of average profits of the three years upto the date of the death after deducting interest @8 percent on capital employed and a fair remuneration of each partner. The profits are assumed to be earned evenly throughout the year.

   On 30th June, 2022, Wise died and it was agreed on his death to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance Sheet.

   It was agreed for the purpose of valuation of goodwill that the fair remuneration for work done by each partner would be ₹ 15,000 per annum and that the capital employed would be ₹ 1,56,000. Clever and Dull were to continue the partnership, sharing profits and losses equally after the death of Wise.

   The following were the amounts of profits of earlier years before charging interest on capital employed.

	₹
2019	67,200
2020	75,600
2021	72,000
2022	62,400

You are required to compute the value of goodwill and show the adjustment there of in the books of the firm.

ANSWERS/HINTS

True and False

1. False: Even though Goodwill is intangible asset it can be valued in terms of money.

2. True: Goodwill has to be valued every time whenever there is a reconstitution.

3. True: Goodwill is the brand image the firm has in the market due to which it enjoys an advantageous position over the other players in the market.

4. False: At the time of admission or retirement of a partner, goodwill should not be raised in the books of account of partnership firm because no consideration in money or money worth has been paid for it.

5. False: Weighted average profit method, capitalisation method, super profits methods also can be used for valuation of Goodwill.

6. True: Super profit means excess profit that can be earned by the firm over and above the normal profit usually earned by similar firms under similar circumstances.

7. True: The rate of return is considered as an average for the industry, which is applied to the capital employed in the concerned firm.

8. False: Normal profit depends upon Normal rate of return only and not on past profits.

9. True: Generally, the goodwill at the time of admission is adjusted through the capital accounts and not shown in the books of the firm.

10. False: Goodwill brought in by new partner is shared by old partners in sacrificing ratio and not equally.

Multiple Choice Questions

1.	**(c)**	2.	**(a)**	3.	**(c)**	4.	**(c)**	5.	**(b)**	6.	**(b)**
7.	**(a)**										

Theoretical Questions

1. There are three methods for valuation of goodwill

(i) Average profit basis - Simple and Weighted

(ii) Super profit basis - Number of Year Purchase, Annuity basis, and Capitalization of Super Profit

(iii) Capitalization basis

2. In case of change in profit sharing ratio, the value of goodwill should be determined and preferably adjusted through capital accounts of the partners on the basis of profit sacrificing ratio.

3. **Super Profit Basis:** In case of average profit basis, goodwill is calculated on the basis of average profit multiplied by certain number of years.

Super Profit=Actual Profit-Normal Profit

Actual Profit is average profit and Normal Profit = Normal rate of Return (NRR)

Capitalization Basis: Under this basis, value of whole business is determined applying normal rate of return. If such value (arrived at by applying normal rate of return) is higher than the capital employed in the business, then the difference is goodwill.

Practical Questions

1. **Computation of the value of goodwill:**

(i)	Average Profit for three years, ending 30th June; before death:		
	Year ending 30th June, 2020:	₹	₹
	1/2 of 2019 profits	33,600	
	1/2 of 2020 Profits	37,800	71,400

	Year ending 30th June, 2021:		
	1/2 of 2020	37,800	
	1/2 of 2021 Profits	36,000	73,800
	Year ending 30th June, 2022:		
	1/2 of 2021	36,000	
	1/2 of 2022 Profits	31,200	67,200
	Total		2,12,400
	Average Profits Alternatively it can be calculated as below : 1/2 profit of 2019 + profit of 2020 + profit of 2021 + profit of 2022 = $\frac{33,600+75,600+72,000+31,200}{3}$ = 70,800		70,800
(ii)	Average future maintainable profit :		
	Average profits earned		70,800
	Less : Partner's remuneration	45,000	
	Less: 8% on capital employed	12,480	(57,480)
			13,320
(iii)	Goodwill of the firm @ three years' purchase		39,960
(iv)	Wise's share of Goodwill = 4/10 of 39,960 =15,984		

Adjustment entry for Goodwill

Journal Entry

		Dr. ₹	Cr. ₹
Clever's Capital Account	Dr.	7,992	
Dull's Capital Account	Dr.	7,992	
To Wise's Capital Account			15,984
(Adjusting entry passed for share of goodwill of Wise through remaining partners' capital accounts in gaining ratio)			

Working Note:

Partner	New Share	Old Share	Difference
Wise	-	4/10	4/10
Clever	1/2	3/10	2/10
Dull	1/2	3/10	2/10

There is no change in profit sharing ratio of containing partners therefore gain ratio will be same as profit sharing ratio.

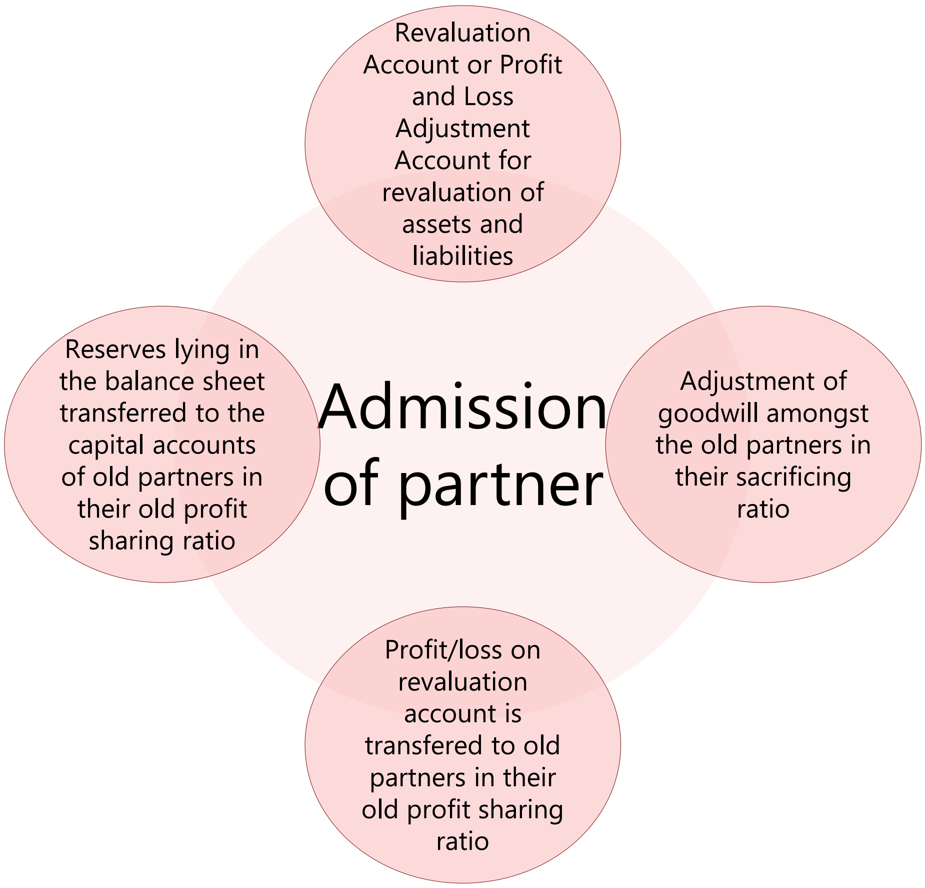
UNIT – 3: ADMISSION OF A NEW PARTNER

LEARNING OUTCOMES

After studying this unit, you would be able to:

- Understand the reasons for which revaluation of assets and re computation of liabilities is required in case of admission of a new partner. Also understand the logic of revaluation of assets and re computation of liabilities at the time of admission of a partner.
- Learn the accounting treatments under two circumstances:
  - (a) When revalued assets and recomputed liabilities are shown in the Balance Sheet, and
  - (b) When revalued assets and recomputed liabilities are not shown in the Balance Sheet.
- Learn the technique of treating reserve balance on admission of a partner.
- See the technique of arriving at new profit-sharing ratio.
- Observe the technique of inferring goodwill although figure of goodwill is not mentioned clearly.

UNIT OVERVIEW



3.1 INTRODUCTION

New partners are admitted for the benefit of the partnership firm. New partner is admitted either for increasing the partnership capital or for strengthening the management of the firm. When a new partner joins a firm, it is desirable to bring all appreciation or reduction in the value of assets into accounts as on the date of admission. Similarly, if the books contain any liability which has not been paid or if the books do not contain a liability which has to be paid, suitable entries should be passed. The purpose of such entries is to make an updated Balance Sheet on the date of admission. Also, all profits which have accrued but not yet brought into books and similarly, all losses which have occurred but not recorded, should now be brought into books so that the Capital Accounts of the old partners reflect the proper figure. As a result of passing of such entries, any subsequent profits or losses will be automatically shared by the incoming partner along with old partners.

Also the value of goodwill is to be assessed and proper accounting treatment is required to bring the value of goodwill into books of accounts. Treatment for goodwill has already been discussed in unit 2 of this chapter.

3.2 REVALUATION ACCOUNT OR PROFIT AND LOSS ADJUSTMENT ACCOUNT

When a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for the purpose. This account is debited with all reduction in the value of assets and increase in liabilities and credited with increase in the value of assets and decrease in the value of liabilities. The difference in two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit sharing ratio. The entries to be passed are:

1.	Revaluation Account	Dr.	
	To Assets Account (individually which show a decrease)		with the reduction in the value of the assets
	To the Liabilities Accounts (Individually which have to be increased)		with the increase in the liabilities.
2.	Assets Account (Individually)	Dr.	with the increase in the value of the of assets.
	Liabilities Accounts	Dr.	with the reduction in the amount liabilities.
	To Revaluation Account		
3.	Revaluation Account	Dr.	with the profit in the old profit sharing ratio.
	To Capital A/cs of the old partners		
	or		
	Capital A/cs of the old partners	Dr.	with the loss in old profit sharing ratio.
	To Revaluation Account		

As a result of the above entries, the capital account balances of the old partners will change and the assets and liabilities will have to be adjusted to their proper values. They will now appear in the Balance Sheet at revised figures.

When the revised values are not to be Recognised in the books

Sometimes all the partners including the new partner may agree to keep the assets and liabilities at the old values even when they agree to revalue them. To record these, a Memorandum Revaluation Account is opened. This account is divided into two parts.

(a) In the first part the entries for the revaluation of assets and liabilities are made in the usual way as explained earlier. No record for the revaluation of assets and liabilities is made through the respective ledger accounts. The resultant profit or loss on revaluation in the first part of this account is transferred to the capital accounts of old partners only in the old profit and loss sharing ratio.

(b) In order to complete the double entry, entries made in the first part of Memorandum Revaluation Account are reversed in the second part so that the values of the assets and liabilities remain unchanged. The balance of the second part is transferred to the capital accounts of all the partners including new partner in their new profit and loss sharing ratio. Thus if there is a profit in the first part there will be a loss of the same amount in the second part. The only point to be remembered is that the result of the first part of Memorandum Revaluation Account is shared by old partners in the old profit sharing ratio, while the result of the second part is shared by all partners including the new one in the new profit sharing ratio.

Alternatively, the partners may agree that revalued figures will not be shown in the Balance Sheet and Assets and liabilities would appear in the Balance Sheet at their old values.

In this case, Memorandum Revaluation Account is opened. Any increase in the value of assets and/or decrease in the liabilities is credited to Memorandum Revaluation Account. The journal entry will be:

Assets Accounts	Dr.	(with increase in the value of individual assets)
Liabilities Accounts	Dr.	(With decrease in the value of individual liabilities)
To Memorandum Revaluation Account		

Similarly, any decrease in the value of assets and/or increase in the liabilities is debited to Memorandum Revaluation Account. The journal entry will be:

Memorandum Revaluation Account	Dr.	
To Assets Accounts		(with increase in the value of individual assets)
To Liabilities Accounts		(with decrease in the value of individual liabilities)

If the credit side of the Memorandum Revaluation Account is more than the debit side, there is a profit. This profit should be transferred to old Partner's Capital Accounts in the old profit sharing ratio. The journal entry will be:

Memorandum Revaluation Account	Dr.	
To Old Partners' Capital Accounts		

If the debit side of the Memorandum Revaluation Account is more than the credit side, there is a loss which is transferred to old Partner's Capital Accounts in the old profit sharing ratio. The journal entry will:

Old Partners' Capital Accounts	Dr.	
To Memorandum Revaluation Account		

After completing the above procedure, reverse entries are made for increase in the values of assets and/or decrease in the liabilities, and decrease in the values of assets and/or increase in the liabilities) in the later portion of the Memorandum Revaluation Account. The profit on revaluation is to be transferred to all Partners' Capital Accounts in the new profit sharing ratio. The journey entry will be:

Memorandum Revolution Account	Dr.	
To All Partners' Capital Accounts		(New profit and loss sharing ratio)

The loss on revaluation should be transferred to all Partners' Capital Accounts in the new profit sharing ratio. The journal entry will be:

All Partners' Capital Accounts	Dr.	(New profit and loss sharing ratio)
To Memorandum Revaluation Account		

It should be noted that if there is a profit in the first half of the Memorandum Revaluation Account, the later half of the Memorandum Revaluation Account must show a loss. Conversely, if the first half of the Memorandum Revaluation Account shows a loss, the later half of the Memorandum Revaluation Account must show a profit.

When a Memorandum Revaluation Account is prepared, the book values of assets and liabilities do not change. In effect, the resultant profit or loss on revaluation is adjusted through the Partners' Capital Accounts. In this way, the amount invested as a capital by the incoming partner may be set at a level that reflects the current fair value of the partnership, even though the book values of assets and liabilities of the existing partnership remain unchanged in the books of accounts.

In case partners desire to disclose assets and liabilities in the balance sheet at old figures without opening Revaluation account then the change (i.e. increase or decrease) in the value of assets and liabilities may be adjusted through Partners' Capital Accounts directly.

Difference between Revaluation Account and Memorandum Revaluation Account

1. Revaluation account is prepared to find out the profit or loss on revaluation of assets and liabilities which appear in the new balance sheet at the new or revalued figures. Memorandum revaluation account is also prepared to record the effect of revaluation of assets and liabilities which of course are recorded at their old figures in the new balance sheet.

2. Revaluation account is not divided into two parts. But the memorandum revaluation account has two parts: first part for old partners and second part for all partners including the new partner.

3. The net result of revaluation of assets and liabilities in the revaluation account is transferred to old partners' capital accounts in the old profit sharing ratio. In the case of memorandum revaluation account the first part is used to record the changes in the values of assets and liabilities due to revaluation and in the second part the effect of the first part is cancelled. The balance of the first part is transferred to old partner's capital accounts in the old profit sharing ratio while the balance of the second part is transferred to all partners including the new partner in the new profit sharing ratio.

ILLUSTRATION 1

The following is the Balance Sheet of Ram and Mohan, who share profits in the ratio of 3:2 as on 1st January, 20222:

Liabilities	₹	*Assets*	₹
Trade payables	*15,000*	*Buildings*	*18,000*
Ram's Capital	*20,000*	*Plant and Machinery*	*15,000*
Mohan's Capital	*25,000*	*Inventories*	*12,000*
		Trade receivables	*10,000*
		Bank	*5,000*
	60,000		*60,000*

On this date Shyam was admitted on the following:

1. *He is to pay ₹ 25,000 as his capital and ₹ 10,000 as his share of goodwill for one fifth share in profits.*
2. *The new profits sharing ratio will be 5:3:2.*
3. *The assets are to be revalued as under:*

	₹
Building	*25,000*
Plant and Machinery	*12,000*
Inventories	*12,000*
Trade receivables (because of doubtful debts)	*9,500*

4. *It was found that there was a liability for ₹ 1,500 for goods received but not recorded in books.*

Give journal entries to record the above. Also, give the Balance Sheet of the partnership firm after Shyam's admission.

SOLUTION

Journal Entries

2022			Dr. (₹)	Cr. (₹)
Jan. 1	Bank Account	Dr.	35,000	
	To Shyam's Capital Account			35,000
	(Being amount brought in by Shyam for capital and goodwill)			
	Shyam's Capital Account	Dr.	10,000	
	To Ram's Capital Account			5,000
	To Mohan's Capital Account			5,000
	(Being Shyam's share of goodwill adjusted to existing partners' capital accounts in the profit sacrificing ratio 1:1)			
	Revaluation Account	Dr.	5,000	
	To Plant and Machinery Account			3,000
	To Provisions for Doubtful Debts Account			500
	To Trade payables Account			1,500
	(Being recording of the reduction in the value of assets and the liability which had been previously omitted)			
	Building Account	Dr.	7,000	
	To Revaluation Account			7,000
	(Being increase in the value of building brought into account)			

	Revaluation Account Dr.		2,000	
	To Ram's Capital Account			1,200
	To Mohan's Capital Account			800
	(Being profit on revaluation credited to Ram and Mohan in the old profit sharing ratio)			

Working Note:

Profit sacrificing ratio:

Ram = 3/5 - 1/2 = 1/10

Mohan = 2/5 - 3/10 = 1/10

Balance Sheet of Ram, Mohan and Shyam as at January 1, 2022

Liabilities	₹	₹	Assets	₹	₹
Trade payables		16,500	Buildings		25,000
Capital Accounts :			Plant and Machinery		12,000
Ram	26,200		Inventories		12,000
Mohan	30,800		Trade receivables	10,000	
Shyam	25,000	82,000	*Less* : Provision for		
			Doubtful Debts	(500)	9,500
			Bank		40,000
		98,500			98,500

ILLUSTRATION 2

A and B are partners sharing profits and losses in the ratio of 3:2. Their Balance Sheet as on 31.3.2022 is given below:

Liabilities	₹	*Assets*	₹
Trade payables	*50,000*	*Freehold premises*	*2,00,000*
Capital Accounts:		*Plant*	*40,000*
A	*2,00,000*	*Furniture*	*20,000*
B	*1,00,000*	*Office equipment*	*25,000*
		Inventories	*30,000*
		Trade receivables	*25,000*
		Bank	*10,000*
	3,50,000		*3,50,000*

On 1.4.2022 they admit C on the following terms:

(1) C will bring ₹ 50,000 as a capital and ₹ 10,000 for goodwill for 1/5 share;

(2) Provision for doubtful debts is to be made on Trade receivables @ 2%

(3) Inventory to be written down by 10%.

(4) Freehold premises is to be revalued at ₹ 2,40,000, plant at ₹ 35,000, furniture ₹ 25,000 and office equipment ₹ 27,500.

(5) Partners agreed that the values of the assets and liabilities remain the same and, as such, there should not be any change in their book values as a result of the above mentioned adjustments.

You are required to make necessary adjustment in the Capital Accounts of the partners and show the Balance Sheet of the New Firm.

SOLUTION

Memorandum Revaluation Account

	Particulars	₹		Particulars	₹
To	Provision for Bad Debts A/c	500	By	Freehold premises A/c	40,000
To	Inventory A/c	3,000	By	Furniture A/c	5,000
To	Plant A/c	5,000	By	Office equipment A/c	2,500
To	Profit on Revaluation A/c				
	A's Capital-3/5	23,400			
	B's Capital-2/5	15,600			
		47,500			47,500
To	Freehold premises A/c	40,000	By	Provision for Bad Debts A/c	500
To	Furniture A/c	5,000	By	Inventory A/c	3,000
To	Office equipment A/c	2,500	By	Plant A/c	5,000
				Loss on Revaluation A/c	
				A's Capital -12/25	18,720
				B's Capital-8/25	12,480
				C's Capital-5/25	7,800
		47,500			47,500

Partners' Capital Accounts

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To A's Capital A/c			6,000	By Balance b/d	2,00,000	1,00,000	-
To B's Capital A/c			4,000				
To Loss on revaluation A/c	18,720	12,480	7,800	By Bank A/c			60,000
To Balance c/d	2,10,680	1,07,120	42,200	By C's Capital A/c	6,000	4,000	-
				By Profit on revaluation A/c	23,400	15,600	-
	2,29,400	1,19,600	60,000		2,29,400	1,19,600	60,000

Note: Amount brought in by new partner shall be distributed among the old partner's in their profit sacrificing ratio, which is same as old profit sharing ratio in this case.

Balance Sheet as at April 1,2022

Liabilities	₹	Assets	₹
Trade payables	50,000	Freehold premises	2,00,000
		Plant	40,000
Capital A/c:		Furniture	20,000
A	2,10,680	Office equipment	25,000
B	1,07,120	Inventories	30,000
C	42,200	Trade receivables	25,000
		Bank	70,000
	4,10,000		4,10,000

ILLUSTRATION 3

A and B are partners in a firm, sharing profits and losses in the ratio of 3:2. The Balance Sheet of A and B as on 1.1.2022 was as follows:

Liabilities	₹	*Amount* ₹	*Assets*	₹	*Amount* ₹
Trade payables		*17,000*	*Building*		*26,000*
			Furniture		*5,800*
Bank overdraft		*9,000*	*Inventories*		*21,400*

Capital accounts:			*Trade receivables*	*35,000*	
A	*44,000*		*Less: Provision*	*(200)*	*34,800*
B	*36,000*	*80,000*	*Investment*		*2,500*
			Cash		*15,500*
		1,06,000			*1,06,000*

'C' was admitted to the firm on the above date on the following terms:

(i) *C is admitted for 1/6 share in the future profits and to introduce a capital of ₹ 25,000.*

(ii) *The new profit sharing ratio of A, B and C will be 3:2:1 respectively.*

(iii) *'C' is unable to bring in cash for his share of goodwill, they decide to calculate goodwill on the basis of C's share in the profits and the capital contribution made by him to the firm.*

(iv) *Furniture is to be written down by ₹ 870 and Inventory to be depreciated by 5%. A provision is required for trade receivables @ 5% for bad debts. A provision would also be made for outstanding wages for ₹ 1,560. The value of buildings having appreciated be brought upto ₹ 29,200. The value of investments is increased by ₹ 450.*

(v) *It is found that the trade payables included a sum of ₹ 1,400, which is not to be paid off.*

Prepare the following:

(i) *Revaluation account.*

(ii) *Partners' capital accounts.*

SOLUTION

Revaluation Account

		₹			₹
To	Furniture	870	By	Building	3,200
To	Inventory	1,070	By	Trade payables	1,400
To	Provision for doubtful debts		By	Investment	450
	(₹ 1,750 – ₹ 200)	1,550			
To	Outstanding wages	1,560			
		5,050			5,050

Partners' Capital Accounts

	A	B	C		A	B	C
	₹	₹	₹		₹	₹	₹
To A			4,500	By Balance b/d	44,000	36,000	–
To B			3,000	By Cash A/c	–	–	25,000
To Balance c/d	48,500	39,000	17,500	By C (working note 2)	4,500	3,000	–
	48,500	39,000	25,000		48,500	39,000	25,000

Working Notes:

1. Calculation of goodwill:

   C's contribution of ₹ 25,000 consists of only 1/6th of capital.

   Therefore, total capital of firm should be ₹ 25,000 x 6 = ₹ 1,50,000

   But combined capital of A, B and C amounts ₹ 44,000 + 36,000 + 25,000 = ₹ 1,05,000

   Thus, the hidden goodwill of the firm is ₹ 45,000 (₹ 1,50,000- ₹ 1,05,000).

   C's share 1/6th = 7,500

   Goodwill will be shared by A & B in their sacrificing ratio.

2. Calculation of sacrificing ratio

Partners	New share	Old share	Sacrifice	Gain
A	$\frac{3}{6}$	$\frac{3}{5}$	$\frac{-3}{30}$	-
B	$\frac{2}{6}$	$\frac{2}{5}$	$\frac{-2}{30}$	-
C	$\frac{1}{6}$	-	-	$\frac{1}{6}$

Therefore, A will get = ₹ 45,000 × $\frac{3}{30}$ = ₹ 4,500;

B will get = ₹ 45,000 × $\frac{2}{30}$ = ₹ 3,000; and

C will be debited on account of goodwill = ₹ 45,000 × $\frac{1}{6}$ = ₹ 7,500

3.3 RESERVES IN THE BALANCE SHEET

Whenever a new partner is admitted, any reserve etc. appearing in the Balance Sheet should be transferred to the Capital Accounts of the old partners in the old profit sharing ratio.

The necessary journal entry would be:

Debit: Reserves or Profit and Loss Account

Credit: Old Partners' Capital Accounts (In the old profit sharing ratio)

ILLUSTRATION 4

Dalal, Banerji and Mallick are partners in a firm sharing profits and losses in the ratio 2:2:1. Their Balance Sheet as on 31st March, 2022 is as below:

Liabilities		₹	***Assets***	₹
Trade payables		*12,850*	*Land and Buildings*	*25,000*
Outstanding Liabilities		*1,500*	*Furniture*	*6,500*
General Reserve		*6,500*	*Inventory of goods*	*11,750*
Capital Account :			*Trade receivables*	*5,500*
Mr. Dalal	*12,000*		*Cash in hand*	*140*
Mr. Banerji	*12,000*		*Cash at Bank*	*960*
Mr. Mallick	*5,000*	*29,000*		
		49,850		*49,850*

The partners have agreed to take Mr. Mistri as a partner with effect from 1st April, 2022 on the following terms:

(1) Mr. Mistri shall bring ₹ 5,000 towards his capital.

(2) The value of Inventory should be increased by ₹ 2,500 and Furniture should be depreciated by 10%.

(3) Reserve for bad and doubtful debts should be provided at 10% of the Trade receivables.

(4) The value of land and buildings should be enhanced by 20%.

(5) The value of the goodwill be fixed at ₹ 15,000.

(6) General Reserve will be transferred to the Partners' Capital Accounts.

(7) The new profit sharing ratio shall be: Mr. Dalal 5/15, Mr. Banerji 5/15, Mr. Mallick 3/15 and Mr. Mistri 2/15.

The outstanding liabilities include ₹ 1,000 due to Mr. Sen which has been paid by Mr. Dalal. Necessary entries were not made in the books.

Prepare (i) Revaluation Account, (ii) The Capital Accounts of the partners, (iii) Balance Sheet of the firm after admission of Mr. Mistri.

SOLUTION

Revaluation Account

2022			₹	2022		₹
April 1	To Provision for bad and doubtful debts		550	April 1	By Inventory in trade	2,500
	To Furniture and fittings		650		By Land and Building	5,000
	To Capital A/cs: (Profit on revaluation transferred)					
	Dalal	2,520				
	Banerji	2,520				
	Mallick	1,260	6,300			
			7,500			7,500

Partners' Capital Accounts

Particulars	Dalal	Banerji	Mallick	Mistri	Particulars	Dalal	Benerji	Mallick	Mistri
	₹	₹	₹	₹		₹	₹	₹	₹
To Dalal				1,000	By Balance b/d	12,000	12,000	5,000	–
To Banerji				1,000	By General Reserve	2,600	2,600	1,300	
To Balance c/d	19,120	18,120	7,560	3,000	By Cash	–	–	–	5,000
					By Mistri	1,000	1,000	–	–
					By Outstanding Liabilities	1,000	–	–	
					By Revaluation A/c	2,520	2,520	1,260	–
	19,120	18,120	7,560	5,000		19,120	18,120	7,560	5,000

Working Note:

Calculation of sacrificing ratio

Partners	New share	Old share	Sacrifice	Gain
Dalal	$\frac{5}{15}$	$\frac{2}{5}$	$-\frac{1}{15}$	
Banerji	$\frac{5}{15}$	$\frac{2}{5}$	$-\frac{1}{15}$	
Mallick	$\frac{3}{15}$	$\frac{1}{5}$	No gain No loss	—
Mistri	$\frac{2}{15}$			$\frac{2}{15}$

Sacrifice by Mr. Dalal and Mr. Banerji= ₹ 15,000× $\frac{1}{15}$ = ₹ 1,000 each

Balance Sheet of M/s. Dalal, Banerji, Mallick and Mistri as on April 1, 2022

Liabilities		₹	Assets		₹
Trade payables		12,850	Land and Buildings		30,000
Outstanding Liabilities		500	Furniture		5,850
Capital Accounts of Partners :			Inventory of goods		14,250
Mr. Dalal	19,120		Trade receivables	5,500	
Mr. Banerji	18,120		*Less* : Provisions	(550)	4,950
Mr. Mallick	7,560		Cash in hand		140
Mr. Mistri	3,000	47,800	Cash at Bank		5,960
		61,150			61,150

3.4 COMPUTATION OF NEW PROFIT SHARING RATIO

When a new partner is admitted and there is no agreement to the contrary, it is supposed that old partners will continue to have inter se at the old profit sharing ratio.

For example, A and B are in partnership sharing profits and losses at the ratio of 3:2. They admitted C as 1/5 partner. For computation of new profit sharing ratio.

(i) Firstly, deduct the share offered to new partner from 1.

1 – 1/5 = 4/5

(ii) Divide the balance of share between A and B in the ratio of 3:2.

A = 4/5 x 3/5 = 12/25

B = 4/5 × 2/5 = 8/25

(iii) New profit sharing ratio is

	A	:	B	:	C
	12/25	:	8/25	:	1/5
or	12/25	:	8/25	:	5/25
	i.e. 12:8		: 5		

Computation of New profit sharing ratio- Cases

Case I: When new partner's share is given but the question is silent about the sacrifice made by the old partners: In this case it is assumed that the old partner will share the remaining share in their old profit sharing ratio.

Example: A and B are partners sharing profits in the ratio 3:2. They admit C for 1/3 share in future profits. Calculate the new ratio.

Solution

Share in Firm = 1

C's Share = 1/3

Remaining Profit = 1 - 1/3 = 2/3

This remaining share of 2/3 is divided between A and B in the ratio 3:2

So A's share = 2/3 × 3/5 = 6/15

B's share = 2/3 × 2/5 = 4/15

C's share = 1/3 × 5/5 = 5/15

New ratio = 6/15: 4/15: 5/15 = 6:4:5

Case II: When new partner purchases his share from old partner's in a particular ratio: In this case the new ratio of the old partners will be calculated by deducted the proportion given to the new partner from the shares of old partner.

Example: A and B are partners sharing in the ratio 3:2. They admit C as a new partner for 1/3rd share in future profits which he gets 1/9 from A and 2/9 from B. Calculate the new ratio.

Solution

A's old share = 3/5; A sacrifice in favour of C = 1/9

So A's new share = 3/5 – 1/9 = 22/45

B's old share = 2/5; B sacrifice in favour of C = 2/9

So B's new share = 2/5 – 2/9 = 8/45

C's new share = 3/9 x 5/15 = 15/45

New ratio = 22: 8: 15

Case III: When the old partners surrender a particular fraction of their share in favour of new partner: In this case following steps are followed:

1. Determine the share surrendered by the old partners.
2. Find the new share of the old partners by deducting share surrendered from their old share.
3. Calculate share of the new partner by taking the sum of surrendered share of old partners.
4. Calculate the new ratio.

Example

A and B are partners sharing in the ratio 3:2. They admit C as the new partner. A surrenders 1/3rd of his share and B surrenders 2/3rd of his share in favour of C. calculate the new ratio.

Solution

A's old share = 3/5; A surrender in favour of C = 3/5 x 1/3 = 3/15

A's new share = 3/5 - 3/15 = 6/15

B's old share = 2/5; B surrender in favour of C = 2/5 x 2/3 = 4/15

B's new share = 2/5 - 4/15 = 2/15

C's share = 3/15 + 4/15 = 7/15

New ratio = 6:2:7

Case IV: When the new partner acquires his share entirely from any one partner: In this case the sacrificing partner share is calculated by deducting his sacrifice from his old share.

Example: A and B are partners sharing in the ratio 3:2. They admit C for 1/5th share in profits which he acquires entirely from A. Calculate the new ratio.

Solution

A's old share = 3/5; Sacrifice in favour of C = 1/5

A's new share = 3/5 - 1/5 = 2/5

B's share = 2/5

C's share = 1/5

New ratio = 2:2:1

Case V: When the new partner acquires his share from the old partners in the certain ratio: In this the sacrifice of each partner is deducted from their old shares.

Example: A and B are partners sharing profits in the ratio 3:2. C is admitted for 1/5th share which he acquires from A and B in the ratio of 2:1. Calculate the new ratio.

Solution

A's old share = 3/5, A's sacrifice = 1/5 × 2/3 = 2/15

A's new share = 3/5 - 2/15 = 7/15

B's old share = 2/5, B's sacrifice = 1/5 × 1/3 = 1/15

B's new share = 2/5 - 1/15 = 5/15

C's share = 1/5 × 3/3 = 3/15

New ratio = 7:5:3

Sacrificing Partner:

The partners whose shares have decreased as a result of change are known as sacrificing partners.

Sacrificing Ratio:

Ratio in which the old partners sacrifice their share in favour of new partner is called sacrificing ratio. This ratio is calculated by taking out the difference between old profit shares and new profit shares

Sacrificing ratio = Old Profit sharing ratio – New Profit sharing ratio

Gaining Partners

The partners whose shares have increased as a result of change are known as gaining partners.

Gaining Ratio

The ratio in which the partners have agreed to gain their shares in profit from the other partner or partners, is known as gaining ratio. This ratio is calculated by taking out the difference between new profit shares and old profit shares

Example: X and Y are partners in a firm sharing profits and losses in the ratio 5:3. They admit Z into partnership. The new ratio 3:2:1. Calculate the Sacrificing Ratio.

Solution

X's sacrifice = X's old share - X's new ratio = 5/8 – 3/6 = 6/48

Y's sacrifice = Y's old share - Y's new ratio = 3/8 – 2/6 = 2/48

Thus, sacrificing ratio = 6:2 or 3:1

Example: A, B and C are sharing profits and losses in the ratio of 5:3:2. Calculate the new profit sharing ratio and the sacrificing ratio in each of the following alternative cases:

Case (a) If C acquires 1/10th share from B

Case (b) If C acquired 1/10th share equally from A and B

Case (c) If C's share is increased by 1/10th share by acquiring from A.

Case (d) If C's share is increased to 3/10th by acquiring from B.

Case (e) if A, B and C decide to share future profits and losses in the ratio of 5:2:3.

Case (f) if A, B and C decide to share future profits and losses in the ratio of 2:3:5.

Case (g) if A, B and C decide to share future profits and losses in the ratio of 2:1:2.

Case (h) if A, B and C decide to share future profits and losses equally.

Case(i) If A , B and C decide that the future profit sharing ratio between B and C shall be the same as existing between A and B

Solution

Case (a)	**A**	**B**	**C**
Their existing shares	5/10	3/10	2/10
Share acquired by C from B	-	-1/10	+1/10
Their new shares	5/10	2/10	3/10

New Profit sharing ratio of A, B and C = 5 : 2 : 3

Share sacrificed by B = 1/10

Case (b)	A	B	C
Their existing shares	5/10	3/10	2/10
Share acquired by C from A and B	-1/20	-1/20	+1/10
Their new shares	9/20	5/20	3/10

New Profit sharing ratio of A, B and C = 9 : 5 : 6

Sacrificing ratio of A and B = 1 : 1

Case (c)	A	B	C
Their existing shares	5/10	3/10	2/10
Share acquired by C from B	-1/10	-	+1/10
Their new shares	4/10	3/10	3/10

New Profit sharing ratio of A, B and C = 4 : 3 : 3

Share sacrificed by A = 1/10

Share acquired by C = New Share – Old share = 3/10 -2/10 = 1/10

Case (d)	A	B	C
Their existing shares	5/10	3/10	2/10
Share acquired by C from B	-	-1/10	+1/10
Their new shares	5/10	2/10	3/10

New Profit sharing ratio of A, B and C = 5 : 2 : 3

Share sacrificed by B = 1/10

Case (e)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	5/10	2/10	3/10
	-	1/10	-1/10

C gains by 1/10th share and B sacrifice 1/10th Share

Case (f)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	2/10	3/10	5/10
	3/10	-	-3/10

C gains by 3/10th share and A sacrifice 3/10th Share

Case (g)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	2/5	1/5	2/5
	1/10	1/10	-2/10

C gains by 2/10th share and A sacrifices 1/10th Share &B sacrifices 1/10th share.

Case (h)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	1/3	1/3	1/3
	5/30	-1/30	-4/30

B gains by 1/30th share, C gains by 4/30th share and A sacrifices by 5/30th Share

Case (i)

Ratio of A and B= 5 : 3

Ratio of B and C should be 5 : 3

Since B's share in relation to A is 3/5 or 60% of A's share, C's share should also be 60% of B's share

Thus C's share (60% of 3) = 1.8

New ratio of A, B and C = 5 : 3 : 1.8 or 25 : 15 : 9

	A	B	C
Their existing shares	5/10	3/10	2/10
Their new share	25/49	15/49	9/49
	-5/490	-3/490	8/490

C sacrifices by 8/490 and A gains by 5/490 and B gains by 3/490

ILLUSTRATION 5

A and B are in partnership sharing profits and losses at the ratio 3:2. They take C as a new partner. Calculate the new profit sharing ratio if -

(i) C purchases 1/10 share from A

(ii) A and B agree to sacrifice 1/10th share to C in the ratio of 2: 3

(iii) Simply gets 1/10th share of profit.

SOLUTION

(i) New profit sharing ratio:

A = 3/5 – 1/10 = 5/10

B = 2/5 i.e. 4/10

C = 1/10

i.e. 5:4: 1

(ii) A's sacrifice 1/10× 2/5 = 2/50

B's sacrifice 1/10 × 3/5 = 3/50

New profit sharing ratio

A = 3/5 – 2/50 = 28/50

B = 2/5 – 3/50 = 17/50

C = 1/10 i.e. 5/50

i.e. 28:17: 5

(iii) Let total share be 1

C's share=1/10

Remaining share=1-1/10=9/10

Distribution:

A = 9/10 × 3/5 = 27/50

B = 9/10 × 2/5 = 18/50

C = 1/10. i.e. = 5/50

i.e. 27:18: 5

ILLUSTRATION 6

A and B are in the partnership sharing profits and losses in the proportion of three-fourth and one-fourth respectively. Their balance sheet as on 31st March, 2022 was as follows:

Cash ₹ 1,000; trade receivables ₹ 25,000; Inventory ₹ 22,000; plant and machinery ₹ 4,000; trade payables ₹ 12,000; bank overdraft ₹ 15,000; A's capital ₹ 15,000; B's capital ₹ 10,000.

On 1st April, 2022, they admitted C into partnership on the following terms:

(i) C to purchase one–third of the goodwill for ₹ 2,000 and provide ₹ 10,000 as capital. Goodwill not to appear in books.

(ii) *Further profits and losses are to be shared by A, B and C equally.*

(iii) *Plant and machinery is to be reduced by 10% and ₹ 500 is to be provided for estimated bad debts. Inventory is to be taken at a valuation of ₹ 24,940.*

(iv) *By bringing in or withdrawing cash, the capitals of A and B are to be made proportionate to that of C on their profit-sharing basis.*

Set out entries to the above arrangement in the firm's journal and give the partners' capital accounts in tabular form.

SOLUTION

Journal Entries

as on 1st April, 2022

		Dr. (₹)	Cr. (₹)
Revaluation Account	Dr.	900	
To Plant and machinery Account			400
To Provision for bad debts Account			500
(Plant & machinery reduced by 10% and ₹ 500 provided for bad debts)			
Inventory Account	Dr.	2,940	
To Revaluation Account			2,940
(Value of inventory increased by ₹ 2,940)			
Revaluation Account	Dr.	2,040	
To A's capital Account			1,530
To B's capital Account			510
(Profit on revaluation transferred)			
Cash Account	Dr.	12,000	
To C's capital Account			12,000
(Cash brought in by C as his capital)			
C's Capital Account	Dr.	2,000	
B's capital Account	Dr.	500	
To A's capital Account			2,500
(Entry for goodwill purchased by B and C)			

A's capital Account	Dr.	9,030	
B's capital Account	Dr.	10	
To Cash Account			9,040
(Excess amount of capital withdrawn)			

Partners' Capital Accounts

	A	B	C		A	B	C
	₹	₹	₹		₹	₹	₹
To A's capital A/c	-	500	2,000	By Balance b/d	15,000	10,000	–
To Cash	9,030	10		By Revaluation A/c	1,530	510	–
To Balance c/d	10,000	10,000	10,000	By Cash		–	12,000
				By C's Capital A/c	2,000		
				By B's Capital A/c	500		
	19,030	10,510	12,000		19,030	10,510	12,000

Working Note:

Calculation of goodwill

C pays ₹ 2,000 on account of goodwill for 1/3rd share of profit/loss. Total goodwill is ₹ 2,000 x 3 = ₹ 6,000.

Gaining ratio:

B: 1/3-1/4 = 1/12

C: 1/3

Goodwill to be paid to A:

By B ₹	6,000 x 1/12 =	₹ 500
By C ₹	6,000 x 1/3 =	₹ 2,000
Total		₹ 2,500

ILLUSTRATION 7

A and B are partners of X llp. sharing profits and losses in 3:2 ratio between themselves. On 31st March, 2022, the balance sheet of the firm was as follows:

Balance Sheet of X llp as at 31.3.2022

Liabilities	₹	₹	***Assets***	₹
Capital accounts:			*Plant and machinery*	*20,000*
A	*37,000*		*Furniture and fittings*	*5,000*
B	*28,000*		*Inventories*	*15,000*
		65,000	*Trade receivables*	*20,000*
Trade payables		*5,000*	*Cash in hand*	*10,000*
		70,000		*70,000*

X agrees to join the business on the following conditions as and from 1.4.2022:

(a) He will introduce ₹ 25,000 as his capital and pay ₹ 15,000 to the partners as premium for goodwill for 1/3rd share of the future profits of the firm.

(b) A revaluation of assets of the firm will be made by reducing the value of plant and machinery to ₹ 15,000, Inventory by 10%, furniture and fitting by ₹ 1,000 and by making a provision of bad and doubtful debts at ₹ 750 on trade receivables.

Prepare profit and loss adjustment account, capital accounts of partners including the incoming partner X assuming that the relative ratios of the old partners will be in equal proportion after admission.

SOLUTION

Profit and Loss Adjustment Account

2022, April 1	₹	**2022, April 1**				₹
To Plant and machinery A/c	5,000	By Partners' capital accounts				
To Inventory A/c	1,500	- Loss on revaluation				
To Furniture and fitting A/c	1,000		(3/5)	A	4,950	
To Provision for bad and doubtful debts	750		(2/5)	B	3,300	8,250
	8,250					8,250

Partners' Capital Accounts

	A	B	X		A	B	X
	₹	₹	₹		₹	₹	₹
To Profit & loss adjustment A/c	4,950	3,300	–	By Balance b/d	37,000	28,000	–
				By Cash A/c	–	–	40,000
To A's & B's capital A/cs	–	–	15,000	By X's capital A/c [W. N. (ii)]	12,000	3,000	–
To Balance c/d	44,050	27,700	25,000				
	49,000	31,000	40,000		49,000	31,000	40,000

Working Notes:

(i) New profit sharing ratio:

On admission of X who will be entitled to 1/3rd share of the future profits of the firm. A and B would share the remaining 2/3rd share in equal proportion i.e. 1:1.

A: 2/3 x 1/2 = 1/3

B: 2/3 x 1/2 = 1/3

X:1/3

A, B and X would share profits and losses in equal ratio.

(ii) Adjustment of goodwill:

X pays ₹ 15,000 as premium for goodwill for 1/3rd share of the future profits.

Thus, total value of goodwill is ₹ 15,000 x 3 i.e. ₹ 45,000

Sacrificing ratio:

A: 3/5 - 1/3 = 4/15

A: 2/5 - 1/3 = 1/15

Hence, sacrificing ratio is 4:1

Adjustment of X's share of goodwill through existing partners' capital accounts in the profit sacrificing ratio:

	₹
A: 15,000 x 4/5 =	12,000
B: 15,000 x 1/5 =	3,000
	15,000

3.5 HIDDEN GOODWILL

When the value of the goodwill of the firm is not specifically given, the value of goodwill has to be inferred as follows:

Particulars	₹
Incoming partner's capital x Reciprocal of share of incoming partner	xxx
Less: Total capital of old partners+Net Accumulated Profits and Reserves (if any) + capital brought in by incoming partner	xxx
Value of Goodwill	xxx

ILLUSTRATION 8

A and B are partners with capitals of ₹ 7,000 each. They admit C as a partner with 1/4th share in the profits of the firm. C brings ₹ 8,000 as his share of capital. Give the necessary journal entry to record goodwill.

SOLUTION

Journal Entry

Particulars		Dr. (₹)	Cr. (₹)
C's Capital A/c [₹ 10,000 x 1/4]	Dr.	2,500	
To A's Capital A/c			1,250
To B's Capital A/c			1,250
(Being the share of C in the hidden goodwill adjusted through capital accounts by crediting sacrificing partners in their sacrificing ratio)			

Note: Hidden Goodwill= $8{,}000 \times \frac{4}{1}$ - (₹ 7,000 + ₹ 7,000+8,000) = ₹ 10,000

ILLUSTRATION 9

A and B are in partnership sharing profits and losses equally. The Balance Sheet M/s. A and B as on 31.12.2022, was as follows:

Liabilities	₹	*Assets*	₹
Capital A/cs		*Sundry Fixed Assets*	*60,000*
A	*45,000*	*Inventories*	*30,000*
B	*45,000*	*Bank*	*20,000*
Trade payables	*20,000*		
	1,10,000		*1,10,000*

On 1.1.2023 they agreed to take C as 1/3rd partner to increase the capital base to ₹ 1,35,000. C agrees to pay ₹ 60,000. Show the necessary journal entries and prepare partners' capital accounts.

SOLUTION

In the Books of M/s. A, B and C

Journal Entries

		₹	₹
Bank A/c	Dr.	60,000	
To C's Capital A/c			60,000
(Cash brought in by C for 1/3rd share)			
C's Capital A/c	Dr.	15,000	
To A's Capital A/c			7,500
To B's Capital A/c			7,500
A's Capital A/c	Dr.	7,500	
B's Capital A/c	Dr.	7,500	
To Bank A/c			15,000
(Amount of goodwill due to A and B withdrawn)			

Workings:

(1) Old Profit Sharing Ratio:1: 1

(2) New Profit Sharing Ratio: 1:1:1

(3) C's share of capital ₹ 1,35,000 × 1/3 = ₹ 45,000

(4) Goodwill ₹ 60,000 – ₹ 45,000 = ₹ 15,000 for 1/3rd share.

Total Goodwill:₹ 15,000 × 3 = ₹ 45,000

Partners' Capital A/cs

Particulars	A	B	C	Particulars	A	B	C
	₹	₹	₹		₹	₹	₹
To A			7,500	By Balance b/d	45,000	45,000	–
To B			7,500	By Bank	–	–	60,000
To Bank	7,500	7,500	–	By C	7,500	7,500	–
To Balance c/d	45,000	45,000	45,000				
	52,500	52,500	60,000		52,500	52,500	60,000

Note : In this problem it is mentioned that total capital should be at ₹ 1,35,000 hence excess capital is to be withdrawn by partners hence third entry is passed.

ILLUSTRATION 10

Leena and Meena were in business sharing profits and losses in the ratio of 2:3

Their Balance Sheet as on 31st March, 2022 was as follows:

Liabilities	**₹**	**Assets**	**₹**
Capital Accounts:		*Building*	*60,000*
Leena	*60,000*	*Plant*	*45,000*
Meena	*1,40,000*	*Furniture*	*23,500*
General Reserve	*40,000*	*Debtors*	*38,400*
Creditors	*42,600*	*Bills Receivable*	*12,500*
Bills Payable	*17,400*	*Stock*	*42,600*
		Bank	*78,000*
	3,00,000		*3,00,000*

On 1st April, 2022, they decided to admit Neena into the partnership giving her a 1/5th share in future profits. She brings in ₹ 80,000 as her share of capital. Goodwill was valued at ₹ 1,00,000 at the time of admission of Neena. The partners decided to revalue the Assets as follows:

Plant ₹ 40,000, Debtors ₹ 38,000, Stock ₹ 42,000, Building ₹ 90,000, Furniture ₹ 20,000, Bills Receivable ₹ 12,000.

You are required to show the following accounts in the books of the firm:-

(a) Profit & Loss Adjustment Account

(b) Partners' Capital Accounts

(c) The Balance Sheet of the new firm.

SOLUTION

In the books of Leena, Meena and Neena

(a) **Profit & Loss Adjustment Account**

Particulars	**₹**	**Particulars**	**₹**
To Plant	5,000	By Building	30,000
To Debtors	400		
To Stock	600		

To Furniture	3,500		
To Bills receivable	500		
To Profit on revaluation			
Leena	8,000		
Meena	12,000		
	30,000		30,000

Partners' Capital A/c

Particulars	Leena	Meena	Neena	Particulars	Leena	Meena	Neena
To Leena, Meena Goodwil adjustment entry			20,000	By Balance b/d	60,000	1,40,000	
To Balance c/d	92,000	1,88,000	60,000	By Bank			80,000
				By Neena	8,000	12,000	
				By General Reserve	16,000	24,000	
				By Revaluation	8,000	12,000	
	92,000	1,88,000	80,000		92,000	1,88,000	80,000

Balance Sheet as on 1st April, 2022 (after admission)

Liabilities	₹	Assets	₹
Capital Accounts:		Building	90,000
Leena	92,000	Plant	40,000
Meena	188,000	Furniture	20,000
Neena	60,000	Debtors	38,000
Creditors	42,600	Bills Receivable	12,000
Bills Payable	17,400	Stock	42,000
		Bank	1,58,000
	4,00,000		4,00,000

ILLUSTRATION 11

Alpha and Beeta were partners in a LLP namely Meta-Chem LLP sharing profits and losses equally.

Balance Sheet of Meta-Chem LLP as on 31st March, 2022

Liabilities		₹	Assets	₹
Capital :			*Factory Building*	*4,78,000*
Alpha	*3,00,000*		*Plant & Machinery*	*3,41,000*
Beeta	*2,00,000*	*5,00,000*	*Office Furniture*	*55,850*
General Reserve		*1,80,000*	*Inventory*	*77,740*
Workmen compensation fund		*60,000*	*Trade Receivables*	*1,43,210*
Term loan from IDFC bank		*2,78,000*	*Bank*	*44,200*
Trade payables		*1,22,000*		
		11,40,000		*11,40,000*

They agreed to admit Gyama as partner from 1st April 2022 on the following terms:

1. *He shall have one-sixth share in future profits.*
2. *New profit sharing ratio would be 3:2:1*
3. *He shall bring ₹ 2,50,000 as his capital.*
4. *Goodwill of the firm is valued at ₹ 3,00,000*
5. *Factory Building is to be appreciated by 20% and inventory is revalued at ₹ 70,000.*
6. *Machinery to be appreciated by 20%.and Office furniture to be revalued at ₹ 50,000*
7. *Of the trade receivables ₹ 3,210 are bad and 5% be provided for bad & doubtful debts.*
8. *There is no actual liability towards workman.*

You are required to prepare:

1. *Revaluation account*
2. *Partners' capital accounts.*
3. *Bank account.*
4. *Balance Sheet after admission.*

SOLUTION

In the books of Meta-Chem LLP

Revaluation A/c

Liabilities	₹	Assets	₹
To Bad debts	3,210	By Factory Building	95,600
To Provision for Doubtful Debts	7,000	By Plant and Machinery	68,200

To Office Furniture	5,850		
To Inventory	7,740		
To Profit on revaluation			
Alpha 70,000			
Beeta 70,000	1,40,000		
	1,63,800		1,63,800

Partners' Capital A/c

Particulars	Alpha	Beeta	Gyama	Particulars	Alpha	Beeta	Gyama
To Beeta			50,000	By balance b/d	3,00,000	2,00,000	
To Balance c/d	4,90,000	4,40,000	2,00,000	By Bank			2,50,000
				By Gyama		50,000	
				By General Reserve	90,000	90,000	
				By Workman comp. fund	30,000	30,000	
				By Revaluation A/c	70,000	70,000	
	4,90,000	4,40,000	2,50,000		4,90,000	4,40,000	2,50,000

Bank A/c

Particulars	₹	Particulars	₹
To balance b/d	44,200	By Balance c/d	2,94,200
To Gyama's capital	2,50,000		
	2,94,200		2,94,200

Balance Sheet of Meta-Chem LLP as on 1st April 2022 (after admission)

Liabilities	₹	Assets	₹
Capital Accounts:		Factory Building	5,73,600
Alpha 4,90,000		Plant & Machinery	4,09,200
Beeta 4,40,000		Office Furniture	50,000
Gyama 2,00,000	11,30,000	Inventory	70,000
Term Loan from IDFC bank	2,78,000	Trade Receivables 1,40,000	

Trade Payables	1,22,000	*Less*: Provision for Doubtful Debts 7,000	1,33,000
		Bank	2,94,200
	15,30,000		15,30,000

Working Note:

Partner	New Share		Old Share		Difference
Alpha	1/2	–	3/6	=	0
Beeta	1/2	–	2/6	=	1/6
Gyama		–	1/6 (gain)	=	1/6 (gain)

SUMMARY

- New partners are admitted for the benefit of the partnership firm. New partner is admitted either for increasing the partnership capital or for strengthening the management of the firm.
- When a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for the purpose. This account is debited with all reduction in the value of assets and increase in liabilities and credited with increase in the value of assets and decrease in the value of liabilities. The difference in two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit sharing ratio.
- Whenever a new partner is admitted, any reserve etc. appearing in the Balance Sheet should be transferred to the Capital Accounts of the old partners in the old profit sharing ratio.

TEST YOUR KNOWLEDGE

True or False

1. *A newly admitted partner does not have same rights as old partners.*
2. *When a new partner is admitted, old partners have to forego certain share in profits of the firm, this is called as sacrifice ratio.*
3. *Revaluation account is also called as Profit and Loss Adjustment Account.*

4. *Any appreciation in the value of an asset is credited to Revaluation account.*

5. *All the partners may decide not to change the values of assets and liabilities in the books of accounts.*

6. *New partner is entitled to have share in reserves appearing in the balance sheet prior to his admission.*

7. *If revaluation account shows credit balance then it represents profit and therefore it is credited to all partners equally.*

8. *New partner brings necessary amount as his capital.*

9. *New partner is entitled to share in revaluation profit.*

Multiple Choice Questions

1. *A and B are partners sharing profits and losses in the ratio 5:3. They admitted C and agreed to give him 3/10th of the profit. What is the new ratio after C's admission?*

   (a) 35:42:17.

   (b) 35:21:24.

   (c) 49:22:29.

2. *A and B are partners sharing profits in the ratio 5:3, they admitted C giving him 3/10th share of profit. If C acquires 1/5 from A and 1/10 from B, new profit sharing ratio will be:*

   (a) 5:6:3.

   (b) 2:4:6.

   (c) 17:11:12

3. *C was admitted in a firm with 1/4th share of the profits of the firm. C contributes ₹ 15,000 as his capital, A and B are other partners with the profit sharing ratio as 3:2. Find the required capital of A and B, if capital should be in profit sharing ratio taking C's as base capital:*

   (a) ₹ 27,000 and ₹ 16,000 for A and B respectively.

   (b) ₹ 27,000 and ₹ 18,000 for A and B respectively.

   (c) ₹ 32,000 and ₹ 21,000 for A and B respectively.

4. *A, B and C are partners sharing profits and losses in the ratio 6:3:3, they agreed to take D into partnership for 1/8th share of profits. Find the new profit sharing ratio.*

   (a) 12:27:36:42.

(b) 14:7:7:4.

(c) 1:2:3:4.

5. *A and B are partners sharing profits and losses in the ratio of 3:2 (A's Capital is ₹ 30,000 and B's Capital is ₹ 15,000). They admitted C and agreed to give 1/5th share of profits to him. How much C should bring in towards his capital?*

   (a) ₹ 9,000.

   (b) ₹ 12,000.

   (c) ₹ 11,250.

6. *A and B are partners sharing the profit in the ratio of 3:2. They take C as the new partner, who brings in ₹ 25,000 against capital and ₹ 10,000 against goodwill. New profit sharing ratio is 1:1:1. In what ratio will this amount will be shared among the old partners A & B.*

   (a) ₹ 8,000: ₹ 2,000.

   (b) ₹ 5,000: ₹ 5,000.

   (c) Old partners will not get any share in the goodwill brought in by C.

7. *A and B are partners sharing the profit in the ratio of 3:2. They take C as the new partner, who is supposed to bring ₹ 25,000 against capital and ₹ 10,000 against goodwill. New profit sharing ratio is 1:1:1. C brought cash for his share of Capital and agreed to compensate to A and B outside the firm. How this will be treated in the books of the firm.*

   (a) Cash brought in by C will only be credited to his capital account.

   (b) Goodwill will be raised to full value in old ratio.

   (c) Goodwill will be raised to full value in new ratio.

8. *X and Y are partners sharing profits in the ratio of 3: 1. They admit Z as a partner who pays ₹ 4,000 as Goodwill the new profit sharing ratio being 2:1: 1 among X, Y and Z respectively. The amount of goodwill will be credited to:*

   (a) X and Y as ₹ 3,000 and ₹ 1,000 respectively.

   (b) X only

   (c) Y only.

9. *P and Q are partners sharing Profits in the ratio of 2:1. R is admitted to the partnership with effect from 1st April on the term that he will bring ₹ 20,000 as his capital for 1/4th share and pays ₹ 9,000 for goodwill, half of which is to be withdrawn by P and Q. If profit*

on revaluation is ₹ 6,000 and opening capital of P is ₹ 40,000 and of Q is ₹ 30,000, find the closing balance of each capital.

(a) ₹ 47,000: ₹ 33,500: ₹ 20,000

(b) ₹ 50,000: ₹ 35,000: ₹ 20,000.

(c) ₹ 40,000: ₹ 30,000: ₹ 20,000

10. *Adam, Brain and Chris were equal partners of a firm with goodwill ₹ 1,20,000 shown in the balance sheet and they agreed to take Daniel as an equal partner on the term that he should bring ₹ 1,60,000 as his capital and goodwill, his share of goodwill was evaluated at ₹ 60,000 and the goodwill account is to be written off before admission. What will be the treatment for goodwill?*

(a) Write off the goodwill of ₹ 1,20,000 in old ratio.

(b) Cash brought in by Daniel for goodwill will be distributed among old partners in sacrificing ratio.

(c) Both (a) & (b)

Theory Questions

1. *Write short note on Revaluation account.*
2. *What is the difference between revaluation account and memorandum revaluation account?*

Practical Questions

1. *The following was the balance sheet of A, B and C who were equal partners on January 1, 2022*

Liabilities	**₹**	***Assets***	**₹**
Bills Payable	*3,000*	*Cash*	*1,000*
Creditors	*6,000*	*Debtors*	*10,000*
Capital Accounts :		*Stock*	*12,000*
A	*20,000*	*Furniture*	*5,000*
B	*15,000*	*Buildings*	*25,000*
C	*10,000*	*Bills Receivable*	*1,000*
	54,000		*54,000*

They agree to take D into partnership and give him a 1/4 share in the profits on the following terms:

(1) D should bring in ₹ 6,000 for goodwill and ₹ 10,000 as capital;

(2) one-half of the goodwill shall be withdrawn by old partners;

(3) stock and furniture be depreciated by 10%.

(4) a liability of ₹ 1,300 be created against bills discounted;

(5) the building be valued at ₹ 40,000;

(6) the values of liabilities and assets other than cash are not to be altered.

Give the necessary entries to give effect to the above arrangement; prepare revaluation account and opening balance sheet of the firm as newly constituted.

2. *Gopal and Govind are partners sharing profits and losses in the ratio 60:40. The firms' balance sheet as on 31.03.2022 was as follows:*

Liabilities	**₹**	***Assets***	**₹**
Capital accounts:		*Fixed assets*	*3,00,000*
Gopal	*1,20,000*	*Investments*	*50,000*
Govind	*80,000*	*Current assets*	*2,00,000*
Long term loan	*2,00,000*	*Loans and advances*	*1,00,000*
Current liabilities	*2,50,000*		
	6,50,000		*6,50,000*

Due to financial difficulties, they have decided to admit Guru as partner in the firm from 01.04.2022 on the following terms:

Guru will be paid 40% of the profits.

Guru will bring in cash ₹ 1,00,000 as capital. It is agreed that goodwill of the firm will be valued at 2 years' purchase of 3 years' normal average profits of the firm and Guru will bring in cash his share of goodwill. It was also decided that the partners will not withdraw their share of goodwill nor will the goodwill appear in the books of account.

The profits of the previous three years were as follows:

For the year ended 31.3.2020: profit ₹ 20,000 (includes insurance claim received of ₹ 40,000).

For the year ended 31.3.2021: loss ₹ 80,000 (includes voluntary retirement compensation paid ₹ 1,10,000).

For the year ended 31.3.2022: profit of ₹ 1,05,000 (includes a profit of ₹ 25,000 on the sale of assets).

It was decided to revalue the assets on 31.03.2022 as follows:

	₹
Fixed assets (net)	*4,00,000*
Investments	*Nil*
Current assets	*1,80,000*
Loans and advances	*1,00,000*

The new profit sharing ratio after the admission of Guru was 35:25:40.

Pass journal entries on admission, show goodwill calculation and prepare revaluation account, partners' capital accounts and balance sheet as on 01.04.2022 after the admission of Guru.

ANSWERS/HINTS

True or False

1. False: All the partners have same rights at all times, unless contrary is provided in the partnership deed/or agreed by the partners.

2. True: With every new partner, remaining old partners have to foregone a proportion in their share which is called as sacrificing ratio.

3. True: Revaluation is also called as profit and loss adjustment account.

4. True: Increase in asset is an income hence credited to revaluation account.

5. True: This can be done by opening Memorandum Revaluation Account.

6. False: New partner is not entitled to have any share in the reserves of the firm prior to his admission. Such reserves are distributed to old partners in their old profit sharing ratio.

7. False: If revaluation account shows credit balance then it represents profit and therefore it is credited to all partners in their profit sharing ratio and not equally.

8. True: Every incoming partner shall bring in some amount of capital for the firm.

9. False: New partner is not entitled to profit on revaluation, it belongs to old partners in their old profit sharing ratio.

Multiple Choice Questions

1.	(b)	**2.**	(c)	**3.**	(b)	**4.**	(b)	**5.**	(c)	**6.**	(a)
7.	(a)	**8.**	(b)	**9.**	(a)	**10.**	(c)				

Theoretical Questions

1. When a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for the purpose. This account is debited with all reduction in the value of assets and increase in liabilities and credited with increase in the value of assets and decrease in the value of liabilities. The difference in two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit sharing ratio.

2. Difference between revaluation account and memorandum revaluation account

(i) Revaluation account is prepared to find out the profit or loss on revaluation of assets and liabilities which appear in the new balance sheet at the new or revalued figures. Memorandum revaluation account is also prepared to record the effect of revaluation of assets and liabilities which of course are recorded at their old figures in the new balance sheet.

(ii) Revaluation account is not divided into two parts. But the memorandum revaluation account has two parts: first part for old partners and second part for all partners including the new partner.

Practical Problems

1.

		₹	₹
Cash Account	Dr.	16,000	
To D's Capital Account			16,000
(Amount of goodwill and capital brought in by D)			
D's Capital Account	Dr.	6,000	
To A's Capital Account			2,000
To B's Capital Account			2,000

To C's Capital Account			2,000
(Goodwill brought in by D credited to old partners in sacrifice ratio)			
A's Capital Account	Dr.	1,000	
B's Capital Account	Dr.	1,000	
C's Capital Account	Dr.	1,000	
To Cash Account			3,000
(Half the amount of goodwill withdrawn by existing partners)			
Memorandum Revaluation Account	Dr.	12,000	
To A's Capital Account			4,000
To B's Capital Account			4,000
To C's Capital Account			4,000
(Profit on revaluation credited to old partners)			
A's Capital Account	Dr.	3,000	
B's Capital Account	Dr.	3,000	
C's Capital Account	Dr.	3,000	
D's Capital Account	Dr.	3,000	
To Memorandum Revaluation Account			12,000
(The profit credited previously to old partners written off to all partners including D in the new profit-sharing ratio)			

Memorandum Revaluation Account

Stock	1,200	Buildings	15,000
Furniture	500		
Liability for bills discounted	1,300		
Profit transferred to capital accounts:			
A	4,000		

B	4,000		
C	4,000		
	15,000		15,000
Buildings	15,000	Stock	1,200
		Furniture	500
		Liability for bills discounted	1,300
		Loss transferred to capital accounts:	
		A	3,000
		B	3,000
		C	3,000
		D	3,000
	15,000		15,000

Balance Sheet of M/s. A, B, C and D

As on 1st January, 2022

Liabilities		₹	Assets	₹
Bills Payable		3,000	Cash	14,000
Creditors		6,000	Debtors	10,000
Capital Accounts:			Stock	12,000
A	22,000		Furniture	5,000
B	17,000		Buildings	25,000
C	12,000		Bills Receivable	1,000
D	7,000	58,000		
		67,000		67,000

2. (i) Calculation of Profit/ Loss for the year ended

	31.3.2020	31.3.2021	31.3.2022
Profit/(loss) for the year	20,000	(80,000)	1,05,000
Add/(*less*): Abnormal items	(40,000)	1,10,000	(25,000)
Net Profit/(loss)	(20,000)	30,000	80,000

Average profit = $\frac{(20,000)+30,000+80,000}{3}$ = ₹ 30,000

Two years' purchase of average profits= 30,000 x 2= ₹ 60,000

Goodwill to be brought in by Guru=₹ 60,000 x 40%=₹ 24,000

Goodwill brought in by Guru shared (at the profit sacrificing ratio) by:

	₹
Gopal (₹ 24,000 x 5/8)	15,000
Govind (₹ 24,000 x 3/8)	9,000
	24,000

(ii) Journal Entries

Date	Particulars		Dr. ₹	Cr. ₹
1.4.2022	Bank A/c	Dr.	1,24,000	
	To Guru's capital A/c			1,24,000
	(Amount of capital and goodwill brought in by Guru)			
1.4.2022	Guru's capital A/c	Dr.	24,000	
	To Gopal's capital A/c			15,000
	To Govind's capital A/c			9,000
	(Amount of goodwill brought in by Guru credited to capital accounts of the old partners in the profit sacrificing ratio 5:3)			
1.4.2022	Revaluation A/c	Dr.	70,000	
	To Investment A/c			50,000
	To Current assets A/c			20,000
	(Writing down the value of investments to nil and current assets from ₹ 2,00,000 to ₹ 1,80,000 on the occasion of admission of Guru)			
1.4.2022	Fixed assets A/c	Dr.	1,00,000	
	To Revaluation A/c			1,00,000
	(Writing up the value of fixed assets from ₹ 3,00,000 to ₹ 4,00,000 on the occasion of admission of Guru)			

1.4.2022	Revaluation A/c	Dr.	30,000	
	To Guru's capital A/c			18,000
	To Govind's capital A/c			12,000
	(Net revaluation profit credited to the capital accounts of the old partner in the old profit sharing ratio of 60:40)			

(iii) **Revaluation Account**

Particulars	₹	Particulars	₹
To Investments A/c	50,000	By Fixed assets A/c	1,00,000
To Current assets A/c	20,000		
To Partner's capital A/c:			
(Profit on revaluation)			
Gopal (60%)	18,000		
Govind (40%)	12,000		
	1,00,000		1,00,000

(iv) **Partner's Capital Accounts:**

Gopal's Capital Account

Particulars	₹	Particulars	₹
To Balance c/d	1,53,000	By Balance b/d	1,20,000
		By Bank A/c	15,000
		By Revaluation A/c	18,000
	1,53,000		1,53,000

Govind's Capital Account

Particulars	₹	Particulars	₹
To Balance c/d	1,01,000	By Balance b/d	80,000
		By Bank A/c	9,000
		By Revaluation A/c	12,000
	1,01,000		1,01,000

Guru's Capital Account

Particulars	₹	Particulars	₹
To Balance c/d	1,00,000	By Bank b/d	1,00,000
	1,00,000		1,00,000

Balance Sheet (after admission of Guru)
as on 1st April, 2022

Liabilities		₹	Assets	₹
Capital accounts:			Fixed assets	4,00,000
Gopal	1,53,000		Current assets	3,04,000
Govind	1,01,000		(including bank balance of ₹ 1,24,000)	
Guru	1,00,000	3,54,000		
Long term loan		2,00,000	Loans & advances	1,00,000
Current liabilities		2,50,000		
		8,04,000		8,04,000

Working Notes:

1. Calculation of profit sacrificing ratio

   Profit sacrificed by Gopal=60%-35%=25%

   Profit sacrificed by Govind =40%-25%=15%

   Sacrificing ratio =25%: 15% or 5:3

2. Bank balance after admission of Guru:

Bank Account

Particulars	₹	Particulars	₹
To Guru's capital A/c	1,24,000	By Balance c/d	1,24,000
	1,24,000		1,24,000

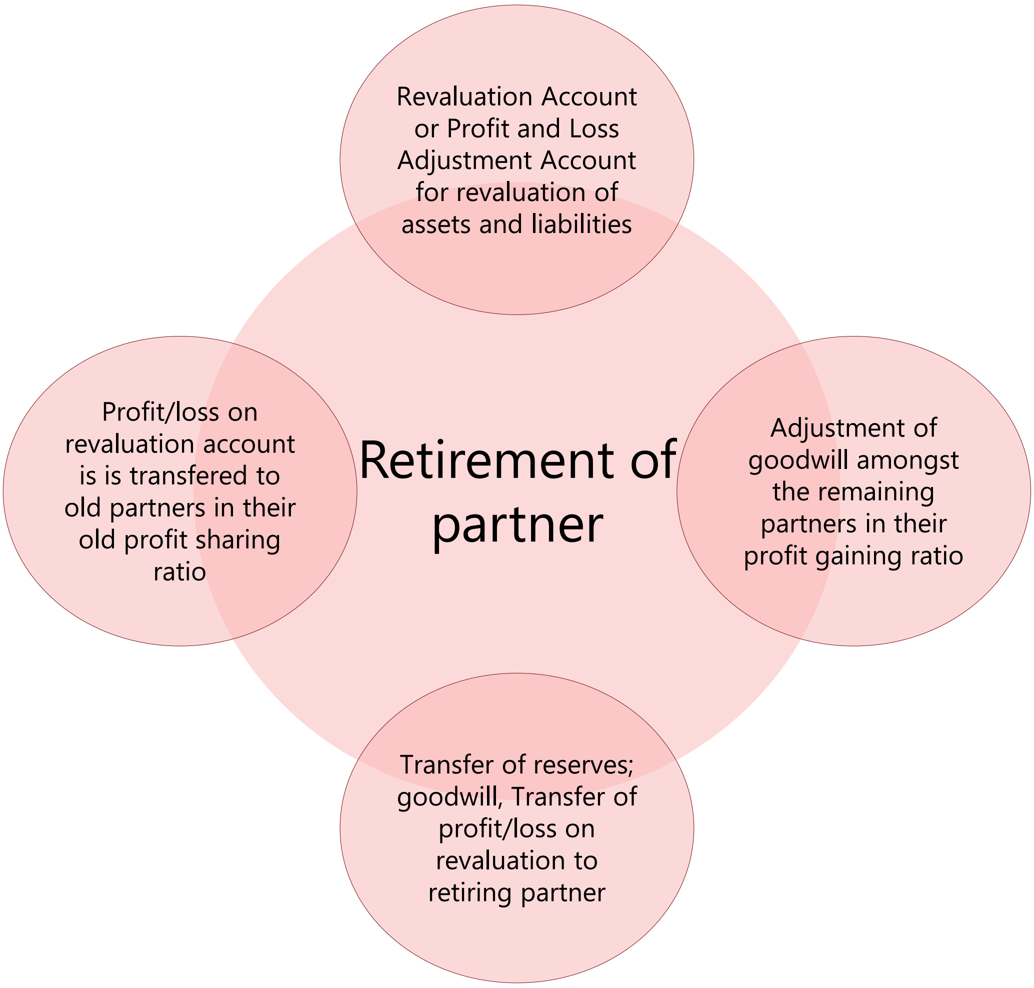
UNIT – 4: RETIREMENT OF A PARTNER

LEARNING OUTCOMES

After studying this unit, you would be able to:

- Learn how to compute the gaining ratio and observe the use of such gaining ratio.
- Be familiar with the accounting treatment in relation to revaluation of assets and liabilities.
- Learn the accounting entries to be passed for transfer of reserves standing in the balance sheet to partners' capital accounts in a manner already discussed for admission of a partner in unit 3 of the chapter.
- Learn the technique of keeping records if the balance due to the retiring partner is transferred to loan account.
- Familiarize with the term Joint Life Policy.
- Learn how to keep records for payment of premium in relation to Joint Life Policy. Also observe the accounting treatment in relation to such Joint Life Policy in case of retirement of a partner.

UNIT OVERVIEW



4.1 INTRODUCTION

A partner may retire from the partnership firm because of old age, illness, etc. Generally, the business of the partnership firm may not come to an end when one of the partners retires. Other partners may continue to run the business of the firm. Readjustment takes place in case of retirement of a partner likewise the case of admission of a partner. Whenever a partner retires, the continuing partners make gain in terms of profit sharing ratio. Therefore, the remaining partners arrange for the amount to be paid to discharge the claims of the retiring partners. Assets and liabilities are revalued, value of goodwill is raised and surrender value of joint life policy, if any, is taken into account. Revaluation profit and reserves are transferred to capital or current accounts of partners. Lastly, final amount due to the retiring partner is determined and discharged.

4.2 CALCULATION OF GAINING RATIO

On retirement of a partner, the continuing partners will gain in terms of profit sharing ratio. For example, if A, B and C were sharing profits and losses in the ratio of 5:3: 2 and B retires, then A and C have to decide at which ratio they will share profits and losses in future. If it is decided that the continuing partners will share profits and losses in future at the ratio of 3:2, then A gains 1/10th [(3/5)-(5/10)] and C gains 2/10 [(2/5)-(2/10)]. So the gaining ratio between A and C is 1:2. If A and C decide to continue at the ratio 5:2, this indicates that they are dividing the gained share in the previous profit sharing ratio.

Example: Amir, Jamir and Samir are in partnership sharing profits and losses at the ratio of 3:2:1. Now Amir wants to retire and Jamir and Samir want to continue at the ratio of 3:2. In this case, Jamir gains 8/30th of share of partnership (3/5 less 2/6) whereas Samir gains 7/30th (2/5 less 1/6) share of the partnership. So gaining ratio between Jamir and Samir is 8:7. On the other hand, if Jamir and Samir would decide to continue sharing profits and losses at the ratio of 2:1, then Jamir would gain 2/6th share of partnership i.e. [(2/3)–(2/6)], and Samir would gain 1/6th share of partnership i.e. [(1/3)–(1/6)]. So it appears that in such a case gaining ratio of Jamir and Samir would be 2:1. i.e., the existing profit sharing ratio between them.

Thus, on the retirement or death of a partner, his share in the profit would be taken by the remaining partners. In other words, they get additional share which is obviously a gain or benefit. The calculation of gaining ratio or benefit ratio is done as follows:

(i) When the new ratio is given, gaining ratio is calculated by deducting their new share of profits from the old share.

(ii) When the new profit sharing ratio is not given and the remaining partners share the future profits in the same ratio as before, the gaining ratio would be the old profit sharing ratio.

Observe the following table:

Ratio between Remaining Partners

		New Ratio	Gaining or Benefit Ratio
1.	When new ratio is given	As given in the examination problem	New Ratio minus Old ratio
2.	When the new Ratio is not given	The same old ratios between them	The same old ratios between them
3.	When gaining or benefit ratio is given	Old ratio + Gaining ratio	As given in the question

Calculation of New Profit Sharing Ratio

Case 1 When nothing is given about the new profit sharing ratio of the remaining partners: Under this situation the calculation of new ratio is done by striking out the share of the retiring partner.

Example : Alok, Bhaskar and Chetan are partners sharing in the ratio 3:2:1. Calculate new ratio if:

(a) If Alok retires.

(b) If Bhaskar retires.

(c) If Chetan retires.

Solution

Old Profit ratio = 3:2:1

(a) If Alok retires new profit ratio will be 2:1

(b) If Bhaskar retires new profit ratio will be 3:1

(c) If Chetan retires new profit ratio will be 3:2

Case 2: When gains of the continuing partners are specifically given in the question: In such a case, the new shares of the continuing partners are calculated by adding their respective gain to their old share.

New share = Old share + Gain

Example

Aarav, Banta and Chunmun are partners sharing in the ratio 3:2:1. Aarav retires and his share is taken over by the remaining partners as follow

Banta takes 2/6th from Aarav.

Chunmun takes 1/6th from Aarav.

Calculate new ratio.

Solution

Banta's New Share = Banta's old share + Banta's gain = 2/6 + 2/6 = 4/6

Chunmun's New Share = Chunmun's old share + Chunmun's gain = 1/6 + 1/6 = 2/6

So the new share = 4/6: 2/6 = 2:1

Case 3: When the ratio in which the remaining partners acquire the share of the outgoing partner is given:

Example

Deepu, Tasha and Honey are partners sharing profits in the ratio 3:2:1. Tasha retires and his share was acquired by deepu and honey in the ratio 2:1. Calculate new ratio.

Solution

Share acquired by Deepu = 2/6 × 2/3 = 4/18

Share acquired by Honey = 2/6 × 1/3 = 2/18

Deepu's new Share = Deepu 's old share + Deepu's gain = 3/6 + 4/18 = 13/18

Honey's new Share = Honey's old share + Honey's gain = 1/6+ 2/18 = 5/18

New Ratio = 13:5

Calculation of Gaining Ratio

Case – 1

A, B and C are partners sharing profits and losses in the ratio of 1/2, 3/10 and 1/5 respectively. B retires from the firm and A&C decide to share future profits and losses in the ratio of 3:2.

		A	C
Their new shares	(a)	3/5	2/5
Their old shares	(b)	1/2	1/5
Difference being gain	(a –b)	1/10	2/10

Gaining ratio of A and C = 1/10 : 2/10 = 1 : 2

Case – 2

W, A , B and C are partners sharing profits and losses in the ratio of 1/3, 1/6, 1/3 and 1/6 respectively. B retires and W, A and C decide to share future profits and losses equally.

		W	A	C
Their new shares	(a)	1/3	1/3	1/3
Their old shares	(b)	1/3	1/6	1/6
Difference being gain	(a –b)	-	1/6	1/6

Gaining ratio of A and C = 1/6 : 1/6 = 1 : 1

Case – 3

A, B and C are partners sharing profits and losses in the ratio of 25:15:9. B retires and it is decided that profit sharing ratio between A&C will be the same as existing between B and C.

Ratio of B and C = 15 : 9 = 5 : 3

Therefore new ratio of A and C should be 5 : 3

		A	C
Their new shares	(a)	5/8	3/8
Their old shares	(b)	25/49	9/49
Difference being gain	(a–b)	45/392	75/392

Gaining ratio of A and C = 45 : 75 = 3 : 5

Case – 4

A, B and C are partners sharing profits and losses in the ratio of 4/9, 1/3 and 2/9. B retires and surrenders 1/9th of his share in favour of A and remaining in favour of C.

		A	C
Their existing shares	(a)	4/9	2/9
Share surrendered by B	(b)	1/9 X 1/3 = 1/27	8/9 X 1/3 = 8/27
New share of remaining partner	(a + b)	13/27	14/27

New ratio of A and C = 13 : 14

Gaining ratio = 1/27 : 8/27 = 1 : 8

Case – 5

A, B & C are partners sharing profits and losses in the ratio of 1/2 , 3/10 and 1/5 respectively. B retires and his share is taken by A and C in the ratio of 2:1. Then immediately W is admitted for 1/4th share of profit, half of which was gifted by A and remaining share was taken by W equally from A and C.

		A	C
Their existing shares	(a)	1/2	1/5
Share acquired by remaining partners	(b)	2/3 x 3/10 = 2/10	1/3 x 3/10 = 1/10
New shares of remaining partners	(c= a + b)	7/10	3/10
Share gifted by A	(d)	1/2 x 1/4 = 1/8	-

Share acquired by W (other than gift) (e)		1/2 x 1/8 = 1/16	1/2 x 1/8 = 1/16
New Shares	(c – d - e)	41/80	19/80

New ratio of A , C and W = 41/80 : 19/80 : 20/80 = 41 : 19 : 20

4.3 REVALUATION OF ASSETS AND LIABILITIES ON RETIREMENT OF A PARTNER

On retirement of a partner, it is required to revalue assets and liabilities just as in the case of admission of a partner. If there is revaluation profit, then such profit should be distributed amongst the existing partners including the retiring partner at the existing profit sharing ratio. On the other hand, if there is loss on revaluation that is also to be distributed to all the partners including the retiring partner at the existing profit sharing ratio. To arrive at, profit or loss on revaluation of assets and liabilities, a Revaluation Account or Profit and Loss Adjustment Account is opened. Revaluation Account or Profit and Loss Adjustment Account is closed automatically by transfer of profit or loss balance to the Partners' Capital Accounts.

If it is decided that revalued figures of assets and liabilities will not appear in the balance sheet of the continuing partners, then a journal entry should be passed with the amount payable or chargeable to the retiring partner which the continuing partners will share at the ratio of gain. In the first instance, the journal entry for distribution of profit or loss on revaluation which will appear in the balance sheet also is as follows:

	Revaluation A/c	Dr.
	To Partners' Capital A/cs	
	(For profit on revaluation)	
Or	Partners' Capital A/c's	Dr.
	To Revaluation A/c	
	(For loss on revaluation)	

Now see how to deal with a situation where revalued figures will not appear in the Balance Sheet.

If A, B & C share profits and losses equally and there is a revaluation profit of ₹ 30,000 calculated on A's retirement, then ₹ 10,000 becomes due to A which is to be borne by B and C equally. So the journal entry will be as follows:

		₹	₹
B's Capital A/c	Dr.	5,000	
C's Capital A/c	Dr.	5,000	
To A's Capital A/c			10,000

Alternatively, it is possible to account for the increase in the value of assets or decrease in the value of liabilities by debiting the appropriate asset account or liability account and crediting partners' capital account at the existing profit sharing ratio. Simultaneously the partners capital accounts are to be debited for such gain at the new profit sharing ratio and the respective assets and liabilities account is to be credited again. So the following journal entries are necessary for ₹ 10,000 increase in sundry fixed assets and ₹ 2,000 decrease in trade payables:

			₹	₹
1)	Sundry Fixed Assets A/c	Dr.	10,000	
	Trade payables A/c	Dr.	2,000	
	To A's Capital A/c			4,000
	To B's Capital A/c			4,000
	To C's Capital A/c			4,000
	(Distribution of Revaluation Profit amongst the existing partners in the old profit sharing ratio)			
2)	B's Capital A/c	Dr.	6,000	
	C's Capital A/c	Dr.	6,000	
	To Sundry Fixed Assets A/c			10,000
	To Trade payables A/c			2,000
	(Being revalued assets and liabilities are not required to be shown in the Balance Sheet)			

In this case it is not necessary to open a separate Revaluation Account. However, the above effect can also be given through Memorandum Revaluation Account as discussed in the case of admission of a partner in unit 3.

4.4 RESERVE

On the retirement of a partner any undistributed profit or reserve standing at the Balance Sheet is to be credited to the Partners' Capital Accounts in the old profit sharing ratio. Alternatively, only the retiring partner's share may be transferred to his Capital Account if the others continue at the same profit sharing ratio.

For example, A, B and C were in partnership sharing profits and losses at the ratio 5:3: 2. A retired and B and C agreed to share profits and losses at the ratio of 3:2. Reserve balance was ₹ 10,000. In this case either of the following journal entries can be passed:

			₹	₹
1)	Reserve A/c	Dr.	10,000	
	To A's Capital A/c			5,000
	To B's Capital A/c			3,000
	To C's Capital A/c			2,000
	(Transfer of reserve to Partners' Capital A/cs in 5 : 3 : 2 on A's retirement)			
2)	Reserve A/c	Dr.	5,000	
	To A's Capital A/c			5,000
	(Transfer of A's share of Reserve to the Capital Account on his retirement)			

Note that alternative (2) has the same implications because B and C continued at the same ratio 3: 2 as they did before A's retirement.

Take another example: X, Y and Z were equal partners. Z decided to retire. X and Y decided to continue at the ratio of 3: 2. Reserve standing at the date of retirement of Z was ₹ 9,000. In this case adjustment of Z's share was not sufficient since the relationship between X and Y was also changed.

X's gain: $\frac{3}{5}-\frac{1}{3}=\frac{9-5}{15}=\frac{4}{15}$

Y's gain: $\frac{2}{5}-\frac{1}{3}=\frac{6-5}{15}=\frac{1}{15}$

Gaining Ratio: X: Y

4: 1

This is different from 1: 1. So alternative (1) is to be followed in this case.

		₹	₹
Reserve A/c	Dr.	9,000	
To X's Capital A/c			3,000
To Y's Capital A/c			3,000
To Z's Capital A/c			3,000
(Transfer of Reserve on Z's retirement)			

If the continuing partners want to show reserve in the Balance Sheet, the journal entry will be:

		₹	₹
X's Capital A/c	Dr.	2,400	
Y's Capital A/c	Dr.	600	
To Z's Capital A/c			3,000
(Adjustment entry for Z's share in reserve)			

4.5 FINAL PAYMENT TO A RETIRING PARTNER

The following adjustments are necessary in the Capital A/c:

(i) Transfer of reserve,

(ii) Transfer of goodwill,

(iii) Transfer of profit/loss on revaluation.

After adjustment of the above mentioned items, the Capital Account balance standing to the credit of the retiring partner represents amount to be paid to him.

The continuing partners may discharge the whole claim at the time of retirement. Then the journal entry will appear as follows:

Retiring Partner's Capital A/c Dr.

To Bank A/c

Sometimes the retiring partner agrees to retain some portion of his claim in the partnership as loan. The journal entry will be as follows:

Retiring partner's Capital A/c Dr.

To Retiring Partner's Loan A/c

To Bank A/c

As a rule, the payment is made according to terms of partnership agreement which might provide one of the following alternatives:

(a) Repayment may be made in instalments over a period of time and the interest is paid on outstanding balance which will be treated as a loan of the outgoing partner.

(b) The amount due may be treated as a loan to the firm and in return the firm will either pay interest at a fixed rate or share of the profit of the firm.

(c) An annuity may be paid to a retired partner for life or for an agreed number of years for the life of some dependent.

ILLUSTRATION 1

A and B are partners in a business sharing profit and losses as A-3/5th and B-2/5th. Their balance sheet as on 1st January, 2022 is given below:

Liabilities		₹	***Assets***	₹
Capital Accounts			*Plant and Machinery*	*20,000*
A	*20,000*		*Inventories*	*16,000*
B	*15,000*	*35,000*	*Trade receivables*	*15,000*
Reserve Account		*15,000*	*Balance at Bank*	*6,000*
Trade payables		*7,500*	*Cash in hand*	*500*
		57,500		*57,500*

B retires from the business owing to illness and A takes it over. The following revaluation was made:

(1) The goodwill of the firm is valued at ₹ 25,000.

(2) Depreciate Plant & Machinery by 7.5% and Inventories by 15%.

(3) Doubtful debts provision is raised against trade receivables at 5% and a discount reserve against trade payables at 2%.

Required:

Journalize the above transactions in the books of the firm and close the Partners' Accounts as on 1st January 2022. Give also the opening Balance Sheet of A.

SOLUTION

Journal Entries

2022			Dr. (₹)	Cr. (₹)
Jan 1.	A's Capital Account	Dr.	10,000	
	To B's Capital Account			10,000
	(The amount of share of goodwill adjusted on B's retirement)			
	Reserve Account	Dr.	15,000	
	To A's Capital Account			9,000
	To B's Capital Account			6,000
	(Transfer of reserve to A's Capital Account and B's Capital Account in the profit sharing ratio)			
	Profit and Loss Adjustment Account	Dr.	4,650	
	To Plant and Machinery Account			1,500
	To Inventory Account			2,400
	To Provision for Doubtful Debts Account			750
	(Reduction in the values, assets and creation of provision for doubtful debts as per agreement with B)			
	Reserve for Discount on Trade payables A/c	Dr.	150	
	To Profit and Loss Adjustment Account			150
	(Creation of reserve for discount on trade payables at 2%)			
	A's Capital Account	Dr.	2,700	
	B's Capital Account	Dr.	1,800	
	To Profit and Loss Adjustment Account			4,500
	(Transfer of loss on revaluation of assets and liabilities to Capital Accounts of A and B in the profit sharing ratio)			
	B's Capital Account	Dr.	29,200	
	To B's Loan Account			29,200
	(Transfer of B's Capital Account to his Loan A/c)			

Note: Here it is assumed that amount payable to B is transferred to his loan a/c.

Balance Sheet of A as on 1st January, 2022

Liabilities	₹	₹	Assets	₹	₹
A's Capital Account		16,300	Plant and Machinery		18,500
B's Loan Account		29,200	Inventories		13,600
Trade payables	7,500		Trade receivables	15,000	
Less: Reserve for Discount	(150)	7,350	*Less*: Prov. for Bad Debts	(750)	14,250
			Balance at Bank		6,000
			Cash		500
		52,850			52,850

ILLUSTRATION 2

F, G and K were partners in LLP sharing profits and losses at the 2:2: 1. K wants to retire on 31.12.2022. Given below is the Balance Sheet of the partnership as well as other information:

Balance Sheet as on 31.12.2022

Liabilities	₹	*Assets*	₹
Capital A/cs		*Sundry Fixed Assets*	*1,50,000*
F	*1,20,000*	*Inventories*	*50,000*
G	*80,000*	*Trade receivables*	*70,000*
K	*60,000*	*(Including Bills Receivable 20,000)*	
Reserve	*10,000*	*Bank*	*50,000*
Trade payables	*50,000*		
	3,20,000		*3,20,000*

F and G agree to share profits and losses at the ratio of 3: 2 in future. Value of Goodwill is taken to be ₹ 50,000. Sundry Fixed Assets are revalued upward by ₹ 30,000 and Inventories by ₹ 10,000. Bills Receivable dishonoured ₹ 5,000 on 31.12.2022 but not recorded in the books. Dishonour of bill was due to insolvency of the customer. F and G agree to bring sufficient cash to discharge claim of K and to make their capital proportionate. Also they wanted to maintain ₹ 75,000 bank balance for working capital.

Required:

Pass necessary journal entries and draft the Balance Sheet of M/s F & G LLP. Also prepare capital accounts of partners and draft the Balance Sheet of Ms/ F & G after K's retirement.

SOLUTION

Journal Entries

		₹	₹
(1)	F's Capital A/c Dr.	10,000	
	To K's Capital A/c		10,000
	(Being the adjustment for goodwill on K's retirement) - Refer W.N.		
(2)	Reserve A/c Dr.	10,000	
	To F's Capital A/c		4,000
	To G's Capital A/c		4,000
	To K's Capital A/c		2,000
	(Transfer of Reserve to Partners' Capital A/cs on K's retirement)		
(3)	Sundry Fixed Assets A/c Dr.	30,000	
	Inventory A/c Dr.	10,000	
	To Profit and Loss Adjustment A/c		40,000
	(Increase in the value of Sundry Fixed Assets and inventory recorded)		
(4)	Profit and Loss Adjustment A/c Dr.	5,000	
	To Trade Receivable A/c		5,000
	(Loss arising out of dishonoured bill recorded)		
(5)	Profit and Loss Adjustment A/c Dr.	35,000	
	To F's Capital A/c		14,000
	To G's Capital A/c		14,000
	To K's Capital A/c		7,000
	(Profit on revaluation transferred to Partners' Capital A/cs on K's retirement)		
(6)	Bank A/c Dr.	1,04,000	
	To F's Capital A/c		70,000
	To G's Capital A/c		34,000
	(Cash brought in by F and G as per agreement)		
(7)	K's Capital A/c Dr.	79,000	
	To Bank A/c		79,000
	(Payment made to K on retirement)		

Working Note:

Adjusting entry for goodwill

Partner	Old Share	New Share	Gain	Sacrifice
F	$\frac{2}{5}$	$\frac{3}{5}$	$\frac{1}{5}$	–
G	$\frac{2}{5}$	$\frac{2}{5}$	–	–
K	$\frac{1}{5}$	–	–	$\frac{1}{5}$

Adjusting entry:

	₹	₹
F's Capital A/c (50,000 x 1/5) Dr.	10,000	
To K's Capital A/c		10,000

Balance Sheet (after K's retirement)

Liabilities	₹	Assets	₹
Capital A/cs:		Sundry Fixed Assets	1,80,000
F	1,98,000	Inventories	60,000
G	1,32,000	Trade receivables	65,000
Trade payables	50,000	Bank	75,000
	3,80,000		3,80,000

Partners' Capital Accounts

	F	G	K		F	G	K
	₹	₹	₹		₹	₹	₹
To K's Capital A/c	10,000	–	–	By Balance b/d	1,20,000	80,000	60,000
To Balance c/d	1,28,000	98,000	79,000	By F's Capital A/c			10,000
				By P & L Adj. A/c	14,000	14,000	7,000
				By Reserve	4,000	4,000	2,000
	1,38,000	98,000	79,000		1,38,000	98,000	79,000
To Bank	–	–	79,000	By Balance b/d	1,28,000	98,000	79,000
To Balance c/d	1,98,000	1,32,000	–	By Bank	70,000	34,000	–
	1,98,000	1,32,000	79,000		1,98,000	1,32,000	79,000

Working Notes:

1.	**Total Capital**	₹
	Sundry Fixed Assets (₹ 1,50,000 + ₹ 30,000)	1,80,000
	Inventory (₹ 50,000 + ₹ 10,000)	60,000
	Trade receivables	65,000
	(Including Bill Receivable of ₹ 15,000)	
	Bank	75,000
		3,80,000
	Less: Sundry Creditors	(50,000)
		3,30,000
	F's share (3,30,000 × 3/5)	1,98,000
	G's share (3,30,000 × 2/5)	1,32,000

2. **Bank Account**

	₹		₹
To Balance b/d	50,000	By K's Capital A/c	79,000
To F's Capital A/c	70,000	By Balance c/d	75,000
To G's Capital A/c	34,000		
	1,54,000		1,54,000

ILLUSTRATION 3

A, B & C were in partnership sharing profits in the proportions of 5:4:3. The balance sheet of the firm as on 31st March, 2022 was as under:

Liabilities	₹	***Assets***	₹
Capital accounts:		*Fixtures*	*8,200*
A	*1,35,930*	*Inventories*	*1,57,300*
B	*95,120*	*Trade receivables*	*93,500*
C	*61,170*	*Cash*	*74,910*
Trade payables	*41,690*		
	3,33,910		*3,33,910*

A had been suffering from ill-health and gave notice that he wished to retire. An agreement was, therefore, entered into as on 31st March, 2022, the terms of which were as follows:

(i) *The profit and loss account for the year ended 31st March, 2022 which showed a net profit of ₹ 48,000 was to be re-opened. B was to be credited with ₹ 4,000 as bonus, in consideration of the extra work which had devolved upon him during the year. The profit sharing was to be revised from 1st April, 2021, as 3:4:4.*

(ii) *Goodwill was to be valued at two years' purchase of the average profits of the preceding five years. The fixtures were to be valued by an independent valuer. The valuations arising out of the above agreement were goodwill ₹ 56,800 and fixtures ₹ 10,980. A provision of 2% was to be made for doubtful debts and the remaining assets were to be taken at their book values.*

B and C agreed, as between themselves, to continue the business, sharing profits in the ratio of 3:2 and decided to retain the fixtures on the books at the revised value, and to increase the provision for doubtful debts to 6%.

Required:

Submit the journal entries necessary to give effect to the above arrangements and to draw up the capital account of the partners after carrying out all adjusting entries as stated above.

SOLUTION

Journal Entries

Particulars		Dr. (₹)	Cr. (₹)
A's Capital Account	Dr.	20,000	
B's Capital Account	Dr.	16,000	
C's Capital Account	Dr.	12,000	
To Profit and Loss Adjustment Account			48,000
(Profit written back for making adjustments)			
Profit and Loss Adjustment Account	Dr.	4,000	
To B's Capital account			4,000
(Bonus Credited to B's Capital Account)			
Profit and Loss Adjustment Account	Dr.	44,000	
To A's Capital Account			12,000
To B's Capital Account			16,000
To C's Capital Account			16,000
(Distribution of profits in the new ratio)			
Fixtures Account	Dr.	2,780	
To Provision for Doubtful debts Account @ 2%			1,870

To A's Capital Account			248
To B's Capital Account			331
To C's Capital Account			331
(Revaluation of assets on A's retirement)			
A's Capital Account	Dr.	1,43,669	
To A's Loan Account			1,43,669
(Transfer of A's Capital Account to his Loan Account)			
B's Capital Account	Dr.	2,244	
C's Capital Account	Dr.	1,496	
To Provision for Doubtful Debts Account			3,740
(Raising provision for bad debts)			
B's Capital Account	Dr.	13,425	
C's Capital Account	Dr.	2,066	
To A's Capital Account			15,491
(Adjusting entry of goodwill passed through partners' capital accounts in gaining/sacrificing ratio)			

Partners' Capital Accounts

	A	B	C		A	B	C
	₹	₹	₹		₹	₹	₹
To Profit and Loss Adjustment A/c	20,000	16,000	12,000	By Balance b/d	1,35,930	95,120	61,170
				By Profit and Loss Adjustment A/c	–	4,000	–
To A's Loan A/c	1,43,669	–	–				
To Provision for Doubtful Debts A/c	–	2,244	1,496	By Profit and loss Adjustment A/c	12,000	16,000	16,000
To A	–	13,425	2,066	By Fixtures Less provision for Doubtful Debts A/c	248	331	331
To Balance c/d	–	83,782	61,939	By B	13,425		
				By C	2,066		
	1,63,669	1,15,451	77,501		1,63,669	1,15,451	77,501

Note: The balance of A's Capital Account has been transferred to A's Loan Account.

Working Note:

Calculation for adjustment of Amount of Goodwill

Partner	Old Share	New Share	Gain	Sacrifice
A	$\frac{3}{11}$	–	–	$\frac{3}{11}$
B	$\frac{4}{11}$	$\frac{3}{5}$	$\frac{13}{55}$	–
C	$\frac{4}{11}$	$\frac{2}{5}$	$\frac{2}{55}$	–

ILLUSTRATION 4

K, L & M are partners sharing profits and losses in the ratio 5:3:2. Due to illness, L wanted to retire from the firm on 31.3.2022 and admit his son N in his place.

Balance Sheet of K, L and M as on 31.3.2022

Liabilities	₹	₹	*Assets*	₹
Capital:			*Furniture*	*20,000*
K	*40,000*		*Trade receivables*	*50,000*
L	*60,000*		*Inventory in Trade*	*50,000*
M	*30,000*	*1,30,000*	*Cash and Bank balances*	*80,000*
Reserve		*50,000*		
Trade payables		*20,000*		
		2,00,000		*2,00,000*

On retirement of L assets were revalued: Furniture ₹ 10,000 and Inventory in trade ₹ 30,000. 50% of the amount due to L was paid off in cash and the balance was retained in the firm as capital of N. On admission of the new partner, goodwill was valued at ₹ 50,000. Partners are being paid off their extra balances to make capital proportionate by keeping N's capital as base.

You are required to give:

(i) Necessary journal entries; (ii) balance sheet of M/s K, M and N as on 1.4.2022; (iii) capital accounts of partners.

SOLUTION

Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
31.3.2022	Profit and Loss Adjustment A/c	Dr.	30,000	
	To Furniture A/c			10,000
	To Inventory in Trade A/c			20,000
	(Being revaluation of Furniture and inventory in trade recorded)			
	K's Capital A/c	Dr.	15,000	
	L's Capital A/c	Dr.	9,000	
	M's Capital A/c	Dr.	6,000	
	To Profit and Loss Adjustment A/c			30,000
	(Being net revaluation loss debited to capital accounts of K, L and M in the ratio 5 : 3 : 2)			
	Reserve A/c	Dr.	50,000	
	To K's Capital A/c			25,000
	To L's Capital A/c			15,000
	To M's Capital A/c			10,000
	(Being reserve transferred to capital accounts, K, L and M)			
	N's Capital A/c	Dr.	15,000	
	To L's Capital A/c			15,000
	(Being adjusting entry for goodwill passed in gaining/ sacrificing ratio)			
	L's Capital A/c	Dr.	81,000	
	To Cash and Bank A/c			40,500
	To N's Capital A/c			40,500
	(Being 50% of the amount due to L was paid off in cash and balance was retained in the firm as capital of N)			

	K's Capital A/c	Dr.	7,500	
	M's Capital A/c	Dr.	17,000	
	To Cash and Bank A/c			24,500
	(Being amount paid to K and M to make their capital proportionate)			

Working Note:

1. Calculation for adjustment of Amount of Goodwill

Partner	Old Share	New Share	Gain	Sacrifice
K	$\frac{5}{10}$	$\frac{5}{10}$	–	–
L	$\frac{3}{10}$	–	–	$\frac{3}{10}$
M	$\frac{2}{10}$	$\frac{2}{10}$	–	–
N	–	$\frac{3}{10}$	$\frac{3}{10}$	–

2. Calculation of excess capital paid off to M to make capital proportionate.

Partner	Capital Balance	P/L Ratio	Excess Capital Paid Off
K	50,000	5	7,500
N	25,500	3	–
M	34,000	2	17,000

Partners' Capital Accounts

	K ₹	L ₹	M ₹	N ₹		K ₹	L ₹	M ₹	N ₹
To Profit and Loss Adjustment A/c	15,000	9,000	6,000		By Balance b/d By Reserve	40,000 25,000	60,000 15,000	30,000 10,000	
To Cash & Bank A/c	-	40,500	-	-	By L's Capital A/c	-	-	-	40,500
To N's Capital A/c	-	40,500	-	-	By N's Capital A/c	-	15,000	-	-
To L's Capital A/c	-	-	-	15,000					
To Cash & Bank A/c									

(Balancing figure)	7,500	-	17,000	-					
To Balance c/d	42,500	-	17,000	25,500					
	65,000	90,000	40,000	40,500		65,000	90,000	40,000	40,500
					By Balance b/d	35,000	–	14,000	25,500

Balance Sheet of M/s K, M & N

as on 1st April, 2022

Liabilities	₹	₹	**Assets**	₹
Capital Accounts:			Furniture	10,000
K	42,500		Trade receivables	50,000
M	17,000		Inventory in Trade	30,000
N	25,500	85,000	Cash and Bank balance	15,000
Trade payables		20,000		
		1,05,000		1,05,000

ILLUSTRATION 5

Dowell llp. with partners Mr. A, Mr. B and Mr., C, are sharing profits and losses in the ratio of 10:6:4. The balance sheet of the firm as at 31st March, 2022 is as under:

Liabilities		₹	**Assets**	₹
Capitals :			*Land*	*10,000*
Mr. A	*80,000*		*Buildings*	*2,00,000*
Mr. B	*20,000*		*Plant and Machinery*	*1,30,000*
Mr. C	*30,000*	*1,30,000*	*Furniture*	*43,000*
Reserves			*Investments*	*12,000*
(un-appropriated profit)		*20,000*	*Inventories*	*1,30,000*
Long Term Debt		*3,00,000*	*Trade receivables*	*1,39,000*
Bank Overdraft		*44,000*		
Trade payables		*1,70,000*		
		6,64,000		*6,64,000*

It was mutually agreed that Mr. B will retire from partnership and in his place Mr. D will be admitted as a partner with effect from 1st April, 2022. For this purpose, the following adjustments are to be made:

(a) *Goodwill is to be valued at ₹ 1 lakh but the same will not appear as an asset in the books of the reconstituted firm.*

(b) *Buildings and plant and machinery are to be depreciated by 5% and 20% respectively. Investments are to be taken over by the retiring partner at ₹ 15,000. Provision of 20% is to be made on Trade receivables to cover doubtful debts.*

(c) *In the reconstituted firm, the total capital will be ₹ 2 lakhs which will be contributed by Mr. A, Mr. C and Mr. D in their new profit sharing ratio, which is 2:2:1.*

(i) *The surplus funds, if any, will be used for repaying bank overdraft.*

(ii) *The amount due to retiring partner shall be transferred to his loan account.*

Required:

Prepare

(a) *Revaluation account;*

(b) *Partners' capital accounts;*

(c) *Bank account; and*

(d) *Balance sheet of the reconstituted firm as on 1st April, 2022.*

SOLUTION

Revaluation Account

	₹				₹
To Buildings A/c	10,000	By Investments A/c			3,000
To Plant and Machinery A/c	26,000	By Loss to Partners:			
To Provision for Doubtful Debts A/c	27,800		A	30,400	
			B	18,240	
			C	12,160	60,800
	63,800				63,800

A's Capital Account

	₹		₹
To Revaluation A/c	30,400	By Balance b/d	80,000
To Balance c/d	80,000	By Reserves A/c	10,000
		By C and D's Capital A/c	10,000
		By Bank A/c (balancing figure)	10,400
	1,10,400		1,10,400

B's Capital Account

	₹		₹
To Revaluation A/c	18,240	By Balance b/d	20,000
To Investments A/c	15,000	By Reserves A/c	6,000
To B's Loan A/c	22,760	By C and D's Capital A/c	30,000
	56,000		56,000

C's Capital Account

	₹		₹
To Revaluation A/c	12,160	By Balance b/d	30,000
To A and B's Capital A/c	20,000	By Reserves A/c	4,000
To Balance c/d	80,000	By Bank A/c (balancing figure)	78,160
	1,12,160		1,12,160

D's Capital Account

	₹		₹
To A and B's Capital A/cs	20,000	By Bank A/c	60,000
To Balance c/d	40,000		
	60,000		60,000

Bank Account

	₹		₹
To A's Capital A/c	10,400	By Bank Overdraft A/c	44,000
To C's Capital A/c	78,160	By Balance c/d	1,04,560
To D's Capital A/c	60,000		
	1,48,560		1,48,560

Balance Sheet of Dowell llp.

as at 1st April, 2022

Liabilities		₹	**Assets**		₹
Capital Accounts:			Land		10,000
A	80,000		Buildings		1,90,000
C	80,000		Plant and Machinery		1,04,000
D	40,000	2,00,000	Furniture		43,000
Long Term Debts		3,00,000	Inventories		1,30,000
Trade payables		1,70,000	Trade receivables	1,39,000	

B's Loan Account		22,760	*Less*: Provision for Doubtful Debts)	(27,800)	1,11,200
			Balance at Bank		1,04,560
		6,92,760			6,92,760

Note: Even though the problem says goodwill ₹ 1,00,000 to appear in new Balance Sheet, it is written off so as to company with Accounting Standard. Net entry for goodwill is:

C's capital	Dr.	20,000	
D's capital	Dr.	20,000	
To A's capital			10,000
To B's capital			30,000

4.6 PAYING A PARTNER'S LOAN IN INSTALMENT

Strictly speaking, paying a partner's loan is only a matter of arranging finance. However, sometimes it is stated that the loan is to be paid off in so many equal instalments and that the balance is to carry interest. In such case, what should be done is that the loan should be divided into equal parts. The interest for the period should be calculated and the payment should consist of the instalment on account of the loan plus interest for the period. Suppose a partner's loan stands at ₹ 30,000 and that it has to be paid in four annual equal instalments and that the loan is to carry interest at 6% per annum. The annual instalment on account of loan comes to ₹ 7,500. For the first year the first interest is ₹ 1,800 i.e. 6% on ₹ 30,000. In the first year the amount to be paid will be ₹ 9,300. Balance of ₹ 22,500 will now be left. Next year the interest will be ₹ 1,350. The amount to be paid therefore will be ₹ 7,500 plust interest viz., ₹ 8,850. The loan account will appear in the books as under.

Retiring Partner's Loan Account

		₹			₹
I Year	To Cash (7,500 + 1,800)	9,300	I Year	By Capital A/c	30,000
	To Balance c/d	22,500		By Interest A/c	1,800
		31,800			31,800
II Year	To Cash (7,500 + 1,350)	8,850	II Year	By Balance b/d	22,500
	To Balance c/d	15,000		By Interest A/c	1,350

				(6% on ₹ 22,500)	
		23,850			23,850
III Year	To Cash	8,400	III Year	By Balance b/d	15,000
	To Balance c/d	7,500		By Interest Account	900
		15,900			15,900
IV Year	To Cash	7,950	IV Year	By Balance b/d	7,500
				By Interest A/c	450
		7,950			7,950

ILLUSTRATION 6

M/s X is a partnership firm with the partners A, B and C sharing profits and losses in the ratio of 3:2:5. The balance sheet of the firm as on 30th June 2022, was as under:

Balance Sheet of M/s. X as on 30.06.2022

Liabilities	₹	*Assets*	₹
A's Capital A/c	*1,04,000*	*Land*	*1,00,000*
B's Capital A/c	*76,000*	*Building*	*2,00,000*
C's Capital A/c	*1,40,000*	*Plant and Machinery*	*3,80,000*
Long Term Loan	*4,00,000*	*Investments*	*22,000*
Bank Overdraft	*44,000*	*Inventories*	*1,16,000*
Trade payables	*1,93,000*	*Trade receivables*	*1,39,000*
	9,57,000		*9,57,000*

It was mutually agreed that B will retire from partnership and in his place D will be admitted as a partner with effect from 1st July, 2022. For this purpose, the following adjustments are to be made:

(a) *Goodwill of the firm is to be valued at ₹ 2 lakhs due to the firm's locational advantage but the same will not appear as an asset in the books of the reconstituted firm.*

(b) *Buildings and plant and machinery are to be valued at 90% and 85% of the respective balance sheet values. Investments are to be taken over by the retiring partner at ₹ 25,000. Trade receivables are considered good only upto 90% of balance sheet figure. Balance be considered bad.*

(c) *In the reconstituted firm, the total capital will be ₹ 3 lakhs, which will be contributed by A, C and D in their new profit sharing ratio, which is 3:4:3.*

(d) *The amount due to retiring partner shall be transferred to his loan account.*

Required:

Prepare Revaluation Account and Partners' Capital Accounts.

SOLUTION

Revaluation Account

2022		₹	2022			₹
July 1	To Building	20,000	July 1	By Investments		3,000
				(25,000 - 22,000)		
	To Plant and Machinery	57,000				
	To Bad Debts	13,900		By Partners' Capital A/cs		
				(Loss on revaluation)		
				A (3/10)	26,370	
				B (2/10)	17,580	
				C (5/10)	43,950	87,900
		90,900				90,900

Partners' Capital Accounts

	A	B	C	D		A	B	C	D
	₹	₹	₹	₹		₹	₹	₹	₹
To Revaluation A/c	26,370	17,580	43,950	–	By Balance b/d	1,04,000	76,000	1,40,000	-
To B's and C's Capital A/cs	–	–	–	60,000	By D's Capital A/c (W.N.1)	–	40,000	20,000	–
To Investments A/c	–	25,000	–	–	By Bank A/c	12,370	–	3,950	1,50,000
To B's Loan A/c	–	73,420	–	–					
To Balance c/d (W.N. 2)	90,000	-	1,20,000	90,000					
	1,16,370	1,16,000	1,63,950	1,50,000		1,16,370	1,16,000	1,63,950	1,50,000

Working Notes:

1. Adjustment of goodwill

Goodwill of the firm is valued at ₹ 2 lakhs

Sacrificing ratio:

A	3/10-3/10	= 0
B	2/10-0	= 2/10
C	5/10-4/10	= 1/10

Hence, sacrificing ratio of B and C is 2:1. A has not sacrificed any share in profits after retirement of B and admission of D in his place.

Adjustment of D's share of goodwill through existing partners' capital accounts in the profit sacrificing ratio:

				₹
B :	₹ 60,000 x 2/3	=	40,000	
C :	₹ 60,000 x 1/3	=	20,000	60,000

2. Capital of partners in the reconstituted firm :

	₹
Total capital of the reconstituted firm (given)	3,00,000
A (3/10)	90,000
B (4/10)	1,20,000
C (3/10)	90,000

4.7 JOINT LIFE POLICY

A partnership firm may decide to take a Joint Life Insurance Policy on the lives of all partners. The firm pays the premium and the amount of policy is payable to the firm on the death of any partner or on the maturity of policy whichever is earlier. The objective of taking such a policy is to minimize the financial hardships to the event of payment of a large sum to the legal representatives of a deceased partner or to the retiring partner.

The accounting treatment for the premium paid and the Joint Life Policy may be on any of the following ways:

1. **When premium paid is treated as an expense:** When premium is treated as an expense then it is closed every year by transferring to profit and loss account. In this case complete amount received from the insurance company either on a surrender of policy or on the death of the partner becomes a gain.

   Accounting entries are:

   (a) On payment of premium

   Joint Life Policy Insurance Premium A/c Dr.

To Bank A/c

(b) On charging to Profit and Loss Account

Profit and Loss Account Dr.

To Joint Life Policy Insurance Premium A/c

(c) On maturity of the Policy

Insurance Company/ Bank Account Dr.

To Partners' Capital A/cs (individually)

(Including the account of the representative of a deceased partner)

2. **When premium paid is treated as an asset:** In this case insurance premium paid is first debited to life policy account and credited to bank account. At the end of the year the amount in excess of surrender value is treated as a loss and is transferred to Profit and Loss Account. In this case the amount received from the insurance company in excess of the surrender value results in a gain at the time of receipt of such amount which is transferred to Capital Accounts of the partners in the profit sharing ratio.

3. **Creation of Joint Policy Reserve Account:** Under this method, premium paid is debited to policy account and credited to bank account. At the end of the year, amount equal to premium is transferred from Profit and Loss Appropriation Account to Policy Reserve Account. After this, policy account is brought down to its surrender value by debiting the life policy reserve account with amount which exceeds the surrender value of the policy. Thus, in this method, policy account appears on the assets side and policy reserve account appears on the liabilities side of the Balance Sheet until it is realized. Both these accounts appear in the Balance Sheet at the surrender value of the policy. This method is different from the method discussed in (2) above only in respect of reserve account.

   On the death of a partner Joint Life Policy Reserve Account is transferred to Joint Life Policy Account and then the balance is transferred to Partners' Capital Accounts.

ILLUSTRATION 7

Red, White and Black shared profits and losses in the ratio of 5:3:2. They took out a joint life Policy in 2018 for ₹ 50,000, a premium of ₹ 3,000 being paid annually on 10th June. The surrender value of the policy on 31st December of various years was as follows: 2018 nil; 2019 ₹ 900; 2020 ₹ 2,000; 2021 ₹ 3,600. Black retires on 15th April, 2022.

Required

Prepare ledger accounts assuming no Joint Life Policy Account is maintained.

SOLUTION

Joint Life Policy Premium Account

		₹			₹
10th June, 2018	To Bank A/c	3,000	31st Dec., 2018	By Profit and Loss A/c	3,000
10th June, 2019	To Bank A/c	3,000	31st Dec., 2019	By Profit and Loss A/c	3,000
10th June, 2020	To Bank A/c	3,000	31st Dec., 2020	By Profit and Loss A/c	3,000
10th June, 2021	To Bank A/c	3,000	31st Dec., 2021	By Profit and Loss A/c	3,000

Profit and Loss Account

		₹		₹
31st Dec., 2018	To Joint Life Policy Premium A/c	3,000		
31st Dec., 2019	To Joint Life Policy Premium A/c	3,000		
31st Dec., 2020	To Joint Life Policy Premium A/c	3,000		
31st Dec., 2021	To Joint Life Policy Premium A/c	3,000		

Joint Life Policy Account

		₹			₹
15th April, 2022	To Capital A/cs:		15th April, 2022	By Bank A/c	3,600
	(Transfer)				
	Red 5/10	1,800			
	White 3/10	1,080			
	Black 2/10	720			
		3,600			3,600

ILLUSTRATION 8

Red, White and Black shared profits and losses in the ratio of 5: 3: 2. They took out a Joint Life Policy in 2018 for ₹ 50,000, a premium of ₹ 3,000 being paid annually on 10th June. The surrender value of the policy on 31st December of various years was as follows: 2018 nil; 2019 ₹ 900: 2020 ₹ 2,000; 2021 ₹ 3,600.

Black retires on 15th April, 2022.

Required:

Prepare ledger accounts assuming Joint Life Policy Account is maintained on surrender value basis.

SOLUTION

Joint Life Policy Account

		₹			₹
10th June, 2018	To Bank A/c	3,000	31st Dec., 2018	By Profit and Loss A/c	3,000
10th June, 2019	To Bank A/c	3,000	31st Dec., 2019	By Profit and Loss A/c	2,100
				By Balance c/d	900
		3,000			3,000
1st January, 2020	To Balance b/d	900	31st Dec., 2020	By Profit and Loss A/c	1,900
10th June, 2020	To Bank A/c	3,000		By Balance c/d	2,000
		3,900			3,900
1st January, 2021	To Balance b/d	2,000	31st Dec., 2021	By Profit and Loss A/c	1,400
10th June, 2021	To Bank A/c	3,000		By Balance c/d	3,600
		5,000			5,000
1st January, 2022	To Balance b/d	3,600	15th April, 2022	By Bank	3,600
		3,600			3,600

Profit and Loss Account

		₹			₹
31st Dec., 2018	To Joint Life Policy A/c	3,000			
31st Dec., 2019	To Joint Life Policy A/c	2,100			
31st Dec., 2020	To Joint Life Policy A/c	1,900			
31st Dec., 2021	To Joint Life Policy A/c	1,400			

ILLUSTRATION 9

A, B and C are in partnership sharing profits and losses at the ratio of 5:3: 2. The balance sheet of the firm on 31.12.2021 was as follows:

Balance Sheet

Liabilities	₹	***Assets***	₹
Capital A/cs:		*Sundry Fixed Assets*	*80,000*
A	*50,000*	*Inventories*	*50,000*
B	*40,000*	*Trade receivables*	*30,000*
C	*30,000*	*Joint Life Policy*	*20,000*
Bank Loan	*40,000*	*Bank*	*10,000*
Trade payables	*30,000*		
	1,90,000		*1,90,000*

On 1.1.2022, A wants to retire, B and C agreed to continue at 2:1. Joint Life Policy was taken on 1.1.2017 for ₹ 1,00,000 and its surrender value as on 31.12.2021 was ₹ 25,000. For the purpose of A's retirement goodwill was raised for ₹ 1,00,000. Sundry Fixed Assets was revalued for ₹ 1,10,000. Also they agreed to bring necessary cash to discharge 50% of the A's claim, to make the bank balance ₹ 25,000 and to make their capital proportionate.

Required:

Prepare necessary journal entries to give the effect in capital accounts of partners.

SOLUTION

Journal Entries

			₹	₹
1.	B's Capital A/c	Dr.	49,500	
	C's Capital A/c	Dr.	18,000	
	To A's Capital A/c			67,500
	(Share of revaluation profit ₹ 67,500 including good will due to A borne by B and C at the gaining ratio 11 : 4)			
2.	A's Capital A/c	Dr.	1,17,500	
	To A's Loan A/c			58,750
	To Bank A/c			58,750
	(Settlement of A's claim on his retirement by payment of 50% in case and transferring the balance to his Loan A/c).			

3.	Bank A/c	Dr.	73,750	
	To B's Capital A/c			60,333
	To C's Capital A/c			13,417
	(Cash brought in by the continuing partners).			

Working Notes:

1. Revaluation Profit

	₹
Goodwill	1,00,000
Sundry Fixed Assets	30,000
Joint Life Policy	5,000
	1,35,000

A's Share ₹ 1,35,000 × 5/10 = ₹ 67,500.

2. Gaining Ratio

B : 2/3 – 3/10 = 11/30

C : 1/3 – 2/10 = 4/30

Gaining Ratio :	B	:	C
	11	:	4

3. Total Capital

		₹
Assets as per Balance Sheet		1,90,000
Additional Bank Balance		15,000
		2,05,000
Less : Bank Loan	40,000	
Sundry Creditors	30,000	
A's Loan	58,750	(1,28,750)
		76,250
B's Share		50,833
C's Share		25,417

4.8 SEPARATE LIFE POLICY

Instead of life policy taken jointly on the name of all the partners, all the partners may take individual life policies for each of them by paying the premium from the firm. In the event of retirement, the retired partner is entitled for the proportionate amount of the life policies of all the partners.

Example: Sona, Gabbu and Amit are partners Profit sharing ratio is 3:1:1

	SONA	GABBU	AMIT
Policy	1,00,000	2,00,000	3,00,000
Surrender Value	10,000	20,000	30,000

If Amit retires, then, Amit will get ₹ 60,000 × 1/5 = 12,000

ILLUSTRATION 10

Aarav, Nirav and Purav are partners in LLP sharing profits and losses in the ratio of 3:2:1. Their Balance Sheet as on 31st March, 2022 was as follows:

Balance Sheet as on 31st March, 2022

Liabilities	₹	*Assets*	₹
Capital : Aarav	*80,000*	*Building*	*50,000*
Nirav	*50,000*	*Machinery*	*67,500*
Purav	*35,000*	*Debtors*	*65,000*
General Reserve	*60,000*	*Stock*	*80,000*
Trade Creditors	*50,000*	*Bank*	*12,500*
	2,75,000		*2,75,000*

Purav retired from the business on 1st April 2022 on the following terms:

1. *Goodwill was to be valued at 2 years purchase of average profit of past 3 years.*

   31st March, 2020 ₹ 41,000

   31st March, 2021 ₹ 50,000

   31st March, 2022 ₹ 55,000

2. *Goodwill was not to be raised in the books of accounts.*
3. *Provision for Doubtful Debts was to be created on debtors at 5%. Machinery is to be depreciated by 10% and stock is revalued at ₹ 71,000.*

5. *Building to be appreciated by 20%.*

6. *Aarav and Nirav to bring in additional capital of ₹ 35,000 and ₹ 25,000 respectively.*

7. *Balance payable to Purav must be paid immediately.*

You are required to prepare:

1. *Revaluation account*

2. *Partners capital accounts.*

3. *Bank account.*

4. *Balance Sheet after retirement.*

SOLUTION

In The Books of Aarav Nirav and Purav

Revaluation A/c

Particulars	₹	Particulars		₹
To Provision for Doubtful Debts	3,250	By Building		10,000
To Machinery	6,750	By Loss on revaluation		
To Stock	9,000	Aarav	4,500	
		Nirav	3,000	
		Purav	1,500	9,000
	19,000			19,000

Partners Capital A/c

Particulars	Aarav	Nirav	Purav	Particulars	Aarav	Nirav	Purav
To Loss on Revaluation	4,500	3,000	1,500	By Balance b/d	80,000	50,000	35,000
To Bank			60,500	By General Reserve	30,000	20,000	10,000
To Purav capital	10,200	6,800		By Aarav, Nirav capital			17,000
To Balance c/d	1,30,300	85,200		By Bank	35,000	25,000	
	1,45,000	95,000	62,000		1,45,000	95,000	62,000

Bank A/c

Particulars	₹	Particulars	₹
To Balance b/d	12,500	By Purav's Capital	60,500
To Aarav's Capital	35,000	By Balance c/d	12,000

To Nirav's Capital	25,000		
	72,500		72,500

Balance Sheet as on April 1st, 2022

Liabilities			₹	Assets		₹
Capital :	Aarav	1,30,300		Building		60,000
	Nirav	85,200	2,15,500	Machinery		60,750
Trade Creditors			50,000	Debtors	65,000	
				Less: Provision for doubtful Debts	3,250	61,750
				Stock		71,000
				Bank		12,000
			2,65,500			2,65,500

Working note :

Valuation of Goodwill (as per weight average method)

31st March 2020	₹ 41,000 X 1= 41,000
31st March 2021	₹ 50,000 X 2 = 1,00,000
31st March 2022	₹ 55,000 X 3 = 1,65,000
Total	₹ 3,06,000

Weighted average profit (3,06,000/6) = 51,000

Goodwill (2 years purchase) = 2 x 51,000 = ₹ 1,02,000

Purav's share = 1/6th = 1,02,000/6 = 17,000

Journal entry for adjustment of goodwill

Aarav capital A/c	Dr.	10,200	
Nirav capital	Dr.	6,800	
To Purav capital			17,000

ILLUSTRATION 11

Satyam, Shivam & Sundaram are partners of M/s. Great Stationers sharing profits and losses in the ratio of 1:1:2.

On 31st March, 2022 their Balance Sheet was as under :

Liabilities		*₹*	*Assets*	*₹*
Capitals :			*Building*	*2,50,000*
Satyam	*1,95,000*		*Plant*	*1,60,000*
Shivam	*1,48,000*		*Investments*	*85,000*
Sunderam	*1,12,000*	*4,55,000*	*Stock*	*45,280*
General Reserve		*80,000*	*Trade Receivable*	*68,000*
Loan from Satyam		*94,000*	*Bank*	*95,720*
Sundry Creditors		*75,000*		
		7,04,000		*7,04,000*

On 1st April 2022 Shivam retired on the following terms:

1. *Goodwill is to be valued at ₹ 1,20,000 but the same will not appear as an asset in the books of the reconstituted firm.*
2. *Buildings is to be appreciated by 20% and Plant is to be depreciated by 10 %.*
3. *Investments are to be taken over by the Satyam in full settlement of his loan.*
4. *Provision of 5% is to be made on trade receivables to cover doubtful debts.*
5. *In the reconstituted firm, the total capital will be ₹ 3,00,000/- which will be contributed by Satyam and Sunderam in their new profit sharing ratio, which is 2:3.*
6. *The amount due to retiring partner shall be transferred to his loan account.*

You are required to give journal entries to record above adjustments and also prepare Balance Sheet thereafter.

SOLUTION

In the books of Satyam Shivam & Sundaram

Journal entries

Sr No	Particulars		Dr. ₹	Cr. ₹
1	General Reserve A/c	Dr.	80,000	
	To Satyam Capital A/c			20,000
	To Shivam Capital A/c			20,000
	To Sunderam Capital A/c			40,000
	(Being General reserve distributed among old partners)			
2.	Satyam Capital A/c	Dr.	18,000	

	Sunderam Capital A/c Dr. To Shivam Capital A/c (Being adjustment entry for goodwill passed)	12,000	30,000
3.	Building A/c Dr. To Revaluation A/c (Being Building appreciated)	50,000	50,000
4.	Satyam loan A/c Dr. To Revaluation A/c To Investments A/c (Being investments taken over by Satyam)	94,000	9,000 85,000
5.	Revaluation A/c Dr. To Plant To Provision for Doubtful Debts (Being Assets revalued)	19,400	16,000 3,400
6.	Revaluation A/c Dr. To Satyam Capital A/c To Shivam capital A/c To Sundaram Capital A/c (Being profit on Revaluation distributed)	39,600	9,900 9,900 19,800
7	Shivam Capital A/c Dr. To Shivam loan a/c (Being amount payable to Shivam transferred to his Loan A/c)	2,07,900	2,07,900
8.	Satyam Capital A/c Dr. To Bank A/c (Being Capital accounts adjusted in Profit sharing ratio)	86,900	86,900
9.	Bank A/c To Sunderam Capital A/c (Being Capital accounts adjusted in Profit sharing ratio)	20,200	20,200

Balance Sheet as on April 1st, 2022

Liabilities		₹	Assets		₹
Capitals :			Building		3,00,000
Satyam	1,20,000		Plant		1,44,000
Sunderam	1,80,000	3,00,000	Stock		45,280
Shivam loan A/c		2,07,900	Trade Receivable	68,000	
Sundry Creditors		75,000	*Less*: Provision for Doubtful Debts	3,400	64,600
			Bank		29,020
		5,82,900			5,82,900

Working Note:

Revaluation A/c

Particulars		₹	Particulars	₹
To Provision for Doubtful Debts		3,400	By building	50,000
To Plant		16,000	By Investments	9,000
To Revaluation profit				
Satyam	9,900			
Shivam	9,900			
Sunderam	19,800	39,600		
		59,000		59,000

Bank A/c

Particulars	₹	Particulars	₹
To Balance b/d	95,720	By Satyam Capital	86,900
To Sundaram Capital	20,200	By Balance c/d	29,020
	1,15,920		1,15,920

Partners Capital A/c

Particulars	Satyam	Shivam	Sundaram	Particulars	Satyam	Shivam	Sundaram
				By Balance b/d	1,95,000	1,48,000	1,12,000
To Shivam	18,000		12,000	By Satyam and Sunderam		30,000	
To Shivam loan A/c		2,07,900		By General Reserve	20,000	20,000	40,000

				By Revaluation	9,900	9,900	19,800
To bank	86,900			By bank			20,200
To balance c/d	1,20,000		1,80,000				
	2,24,900	2,07,900	1,92,000		2,24,900	2,07,900	1,92,000

Partner	Old Share		New share		Gain Share
Satyam	1/4	-	2/5	=	3/20
Shivam	1/4	-	-	=	(5/20)
Sunderam	2/4	-	3/5	=	2/20

SUMMARY

- Re-adjustment takes place in case of retirement of a partner likewise the case of admission of a partner. Whenever a partner retires, the continuing partners make gain in terms of profit sharing ratio. So they arrange for the amount to be paid to discharge the claims of the retiring partners.
- On retirement of a partner, it is required to revalue assets and liabilities just as in the case of admission of a partner. If there is revaluation profit/loss, then such profit/loss should be distributed amongst the existing partners including the retiring partner at the existing profit sharing ratio.
- On the retirement of a partner any undistributed profit or reserve standing at the Balance Sheet is to be credited to the Partners' Capital Accounts in the old profit sharing ratio.
- Following adjustments are necessary in the Capital A/c of a retiring partner at the time of final payment:

  (i) Transfer of reserve,

  (ii) Transfer of goodwill,

  (iii) Transfer of profit/loss on revaluation.
- There are three methods for treating premium paid on Joint Life Policy: firstly, it can be shown as an expense; alternatively it can be shown as an asset to the extent of surrender value and the balance as an expense; Thirdly, a joint Life Policy reserve can be created; On retirement of a partner, the surrender value of the Joint Life Policy is to be raised in the books of accounts if it is not shown already as an asset. If the surrender value is more than the value of joint Life Policy shown in the Balance Sheet, only the excess amount should be transferred to revaluation account.

TEST YOUR KNOWLEDGE

True and False

1. *Business of a partnership has to be closed if any one of the partners retires.*

2. *At the time of retirement of a partner no special treatment is required for any reserves appearing in the Balance Sheet.*

3. *After retirement of a partner, profit sharing ratio of continuing partners remains the same.*

4. *If any partner wants to retire from the business, he must retire on 1st day of the accounting year.*

5. *Retiring partner has to forego his share of goodwill in the firm.*

6. *If a partner retires in between the accounting year then he is not entitled to any profit from the date of beginning of the year till his date of retirement.*

7. *If the firm has taken any joint life policy then it is to be surrendered at the time of retirement of a partner.*

8. *Any joint life policy reserve appearing in the Balance Sheet is credited to all the partners in their old profit sharing ratio.*

9. *No revaluation account is necessary on retirement of a partner.*

10. *Profit on revaluation is credited to continuing partners, retiring partner is not entitled to any profit on revaluation.*

Multiple Choice Questions

1. *C, D and E are partners sharing profits and losses in the proportion of 1/2, 1/3 and 1/6. D retired and the new profit sharing ratio between C and E is 3:2 and the Reserve of ₹ 12,000 is divided among the partners in the ratio:*

   (a) ₹ 2,000: ₹ 4,000: ₹ 6,000.

   (b) ₹ 5,000: ₹ 5,000: ₹ 2,000.

   (c) ₹ 6,000: ₹ 4,000: ₹ 2,000.

2. *A, B and C takes a Joint Life Policy, after five years B retires from the firm. Old profit sharing ratio is 2:2:1. After retirement, A and C decides to share profits equally. They had taken a Joint Life Policy of ₹ 2,50,000 with the surrender value ₹ 50,000. What will be the treatment in the partner's capital account on receiving the JLP amount if joint life policy premium is fully charged to revenue as and when paid?*

(a) ₹ 50,000 credited to all the partners in old ratio.

(b) ₹ 2,50,000 credited to all the partners in old ratio.

(c) ₹ 2,00,000 credited to all the partners in old ratio.

3. *A, B and C take a Joint Life Policy, after five years, B retires from the firm. Old profit sharing ratio is 2:2:1. After retirement A and C decides to share profits equally. They had taken a Joint Life Policy of ₹ 2,50,000 with the surrender value ₹ 50,000. What will be the treatment in the partner's capital account on receiving the JLP amount if joint life policy is maintained at the surrender value?*

(a) ₹ 50,000 credited to all the partners in old ratio.

(b) ₹ 2,50,000 credited to all the partners in old ratio.

(c) No treatment is required.

4. *A, B and C are partners sharing profits in the ratio 2:2:1. On retirement of B, goodwill was valued as ₹ 30,000. Find the contribution of A and C to compensate B.*

(a) ₹ 20,000 and ₹ 10,000.

(b) ₹ 8,000 and ₹ 4,000.

(c) They will not contribute anything.

5. *A, B and C were partners in a firm sharing profits and losses in the ratio of 2:2:1 respectively with the capital balance of ₹ 50,000 for A and B, for C ₹ 25,000. B declared to retire from the firm and balance in reserve on the date was ₹ 15,000. If goodwill of the firm was valued as ₹ 30,000 and profit on revaluation was ₹ 7,050 then what amount will be transferred to the loan account of B.*

(a) ₹ 70,820.

(b) ₹ 50,820.

(c) ₹ 25,820.

6. *A, B and C are partners sharing profits and losses in the ratio of 3:2:1. C retires on a decided date and Goodwill of the firm is to be valued at ₹ 60,000. Find the amount payable to retiring partner on account of goodwill.*

(a) ₹ 30,000.

(b) ₹ 20,000.

(c) ₹ 10,000.

7. *A, B and C were partners sharing profits and losses in the ratio of 3:2:1. A retired and Goodwill of the firm is to be valued at ₹ 24,000. What will be the treatment for goodwill?*

   (a) *Credited to Revaluation Account at ₹ 24,000.*

   (b) *Adjusted through partners' capital accounts in gaining/sacrificing ratio.*

   (c) *Only A's capital account credited with ₹ 12,000.*

8. *Balances of A, B and C sharing profits and losses in proportionate to their capitals, stood as A - ₹ 2,00,000; B - ₹ 3,00,000 and C - ₹ 2,00,000. A desired to retire from the firm, B and C share the future profits equally, Goodwill of the entire firm be valued at ₹ 1,40,000 and no Goodwill account being raised.*

   (a) *Credit Partner's Capital Account with old profit sharing ratio for ₹ 1,40,000.*

   (b) *Credit Partner's Capital Account with new profit sharing ratio for ₹ 1,40,000.*

   (c) *Credit A's Account with ₹ 40,000 and debit B's Capital Account with ₹ 10,000 and C's Capital Account with ₹ 30,000.*

Theoretical questions

1. *Write short notes on:*

   (i) *Calculation of gaining ratio.*

   (ii) *Final payment of a retiring partner.*

2. *What is joint life policy? What is the objective of taking such a policy?*

Practical questions

1. *On 31st March, 2022, the balance sheet of M/s Ram, Rahul and Rohit sharing profits and losses in proportion to their capital, stood as follows:*

Liabilities	₹	₹	**Asset**	₹
Capital accounts:			Land & building	2,00,000
Ram	3,00,000		Machinery	2,00,000
Rahul	2,00,000		Closing stock	1,00,000
Rohit	1,00,000	6,00,000	Sundry debtors	2,00,000
Sundry creditors		2,00,000	Cash and bank balances	1,00,000
		8,00,000		8,00,000

On 31st March, 2022, Ram desired to retire from the firm and the remaining partners decided to carry on. It was agreed to revalue the assets and liabilities on that date on the following basis:-

1. *Land and buildings be appreciated by 30%.*
2. *Machinery be depreciated by 20%.*
3. *Closing stock to be valued at ₹ 80,000.*
4. *Provision for bad debts be made at 5%.*
5. *Old credit balances of sundry creditors ₹ 10,000 be written off.*
6. *Joint life policy of the partners surrendered and cash obtained ₹ 60,000.*
7. *Goodwill of the entire firm be valued at ₹ 1,80,000 and Ram's share of the goodwill be adjusted in the accounts of Rahul and Rohit who share the future profits equally. No goodwill account being raised.*
8. *The total capital of the firm is to be the same as before retirement. Individual capital be in their profit sharing ratio.*
9. *Amount due to Ram is to be settled as 50% on retirement and the balance 50% within one year.*

Prepare revaluation account, capital account of partners: Rahul & Rohit, loan account of Ram, cash account and balance sheet as on 1.4.2022 of M/s Rahul and Rohit.

2. *A, B, C were in partnership sharing profits and losses in the ratio of 3:2:1. The balance sheet of the firm as on 31.2.2022 was as under:*

Liabilities		**₹**	***Assets***	**₹**
Capital accounts:				
A	*1,50,000*		*Fixtures*	*30,000*
B	*1,00,000*		*Stock*	*1,70,000*
C	*50,000*	*3,00,000*	*Sundry debtors*	*90,000*
Sundry creditors		*40,000*	*Cash*	*50,000*
		3,40,000		*3,40,000*

A, on account of ill-health, gave notice that he wished to retire from the firm. A retirement agreement was, therefore, entered as on 31.3.2022, the terms of which were as follows:

(a) *The profit and loss account for the year ended 31.3.2022, which showed a net profit of ₹ 42,000 was to be re-opened. B was to be credited with ₹ 6,000 as bonus, in consideration of the extra work, which had devolved upon him during the year. The profit sharing basis was to be revised and the revised ratio is to be 2:3:1 as and from 1st April 2021.*

(b) *Goodwill was to be valued at two years' purchase of the simple average profits of five years. Profits for these five years ending on 31st March were as under:*

	₹
31.3.2018	*15,000*
31.3.2019	*23,000*
31.3.2020	*25,000*
31.3.2021	*35,000*
31.3.2022	*42,000*

(c) *Fixtures are to be valued at ₹ 39,800 and a provision of 2% was to be made for doubtful debts and the remaining assets were to be taken at their book value.*

(d) *That the amount payable to A shall be paid by B.*

B and C agreed, as between themselves, to continue the business, sharing profits and losses in the ratio of 3:1 and decided to retain fixtures in the books at the revised value and increase the provision for doubtful debts to 6 %. Total capital of the firm will be ₹ 3 lakhs as before to be maintained in the new ratio as between B and C.

You are required to give the necessary entries to give effect to the above arrangements. Prepare capital accounts of partners, cash account and balance sheet of B and C after giving effect to the above arrangements on the retirement of A.

ANSWERS/HINTS

True and False

1. False: Business of a partnership is not closed if any one of the partners retires, remaining partners continue to carry on the business.

2. False: At the time of retirement of a partner all the reserves appearing in the balance sheet are transferred to all the partners in their old profit sharing ratio.

3. False: After retirement of a partner, profit sharing ratio of continuing partners does not remain the same.

4. False: A partner can retire on any day as per his own wish.

5. False: Retiring partner is entitled to his share of goodwill in the firm.

6. False: If a partner retires in between the accounting year then he is certainly entitled to the profit from the date of beginning of the year till his date of retirement.

7. True: The firm is eligible for the surrender value on the Joint Life Policy taken on the partners at the time of their retirement.

8. True: As per the surrender policy method, the JLP reserve is distributed to the partners in their profit sharing ratio through capital account.

9. False: Revaluation account is necessary on retirement of a partner.

10. False: Profit on revaluation is credited to all the partners in their profit sharing ratio.

Multiple Choice Questions

1.	(c)	**2.**	(a)	**3.**	(c)	**4.**	(b)	**5.**	(a)	**6.**	(c)
7.	(b)	**8.**	(c)								

Theoretical Questions

1. **(a)** On retirement of a partner, the continuing partners will gain in terms of profit sharing ratio. For example, if A, B and C were sharing profits and losses in the ratio of 5:3: 2 and B retires, then A and C have to decide at which ratio they will share profits and losses in future. If it is decided that the continuing partners will share profits and losses in future at the ratio of 3:2, then A gains 1/10th [(3/5)-(5/10)] and C gains 2/10 [(2/5)-(2/10)]. So the gaining ratio between A and C is 1:2. If A and C decide to continue at the ratio 5:2, this indicates that they are dividing the gained share in the previous profit sharing ratio.

   (b) The following adjustments are necessary in the Capital A/c: (i) Transfer of reserve, (ii) Transfer of goodwill, (iii)Transfer of profit/loss on revaluation. After adjustment of these items, the Capital Account balance standing to the credit of the retiring partner represents amount to be paid to him. The continuing partners may discharge the whole claim at the time of retirement.

2. A partnership firm may decide to take a Joint Life Insurance Policy on the lives of all partners. The firm pays the premium and the amount of policy is payable to the firm on the death of any partner or on the maturity of policy whichever is earlier. The objective of taking such a policy is to minimize the financial hardships to the event of payment of a large sum to the legal representatives of a deceased partner or to the retiring partner.

Practical Questions

1. **Revaluation Account**

		₹		₹
To Machinery A/c		40,000	By Land and Buildings A/c	60,000
To Closing Stock A/c		20,000	By Sundry Creditors A/c	10,000
To Provision for Bad Debts A/c		10,000	By Cash and Bank A/c– Joint Life policy surrendered	60,000
To Partners' Capital A/cs:				
Ram	30,000			
Rahul	20,000			
Rohit	10,000	60,000		
		1,30,000		1,30,000

Partners' Capital Accounts

			Rahul	Rohit				Rahul	Rohit
			₹	₹				₹	₹
31.3.2022	To	Ram's Capital A/c	30,000	60,000	31-3-2022	By	Balance b/d	2,00,000	1,00,000
	To	Balance c/d	3,00,000	3,00,000		By	Revaluation A/c	20,000	10,000
						By	Cash & bank A/c – cash brought in by Rahul and Rohit	1,10,000	2,50,000
			3,30,000	3,60,000				3,30,000	3,60,000
					1-4-2022	By	Balance b/d	3,00,000	3,00,000

Ram's Loan Account

		₹			₹
31-3-2022	To Balance c/d	2,10,000	31-3-2022	By Ram's Capital A/c	2,10,000
		2,10,000			2,10,000
			1-4-2022	By Balance b/d	2,10,000

Cash and Bank Account

		₹			₹
31-3 2022	To Balance b/d	1,00,000	31-3-2022	By Ram's capital A/c	2,10,000
	To Revaluation A/c- joint life policy surrendered	60,000		By Balance c/d	3,10,000
	To Rahul's Capital A/c	1,10,000			
	To Rohit's Capital A/c	2,50,000			
		5,20,000			5,20,000
1-4-2022	To Balance b/d	3,10,000			

M/s Rahul & Rohit
Balance Sheet as on 1st April, 2022

Liabilities	₹	₹	**Assets**	₹	₹
Capital accounts:			Land and buildings		2,60,000
Rahul	3,00,000		Machinery		1,60,000
Rohit	3,00,000	6,00,000	Closing stock		80,000
Ram's loan account		2,10,000	Sundry debtors	2,00,000	
Sundry creditors		1,90,000	*Less:* Provision for bad debts	(10,000)	1,90,000
			Cash and bank balances		3,10,000
		10,00,000			10,00,000

Working Notes:

1. Gaining ratio of existing partners:

Rahul 1/2-1/3=1/6

Rohit 1/2-1/6=2/6

2. Total goodwill of firm is ₹ 1,80,000

Ram's share (1/2 x ₹ 1,80,000)=₹ 90,000

Ram's share of goodwill is to be borne by Rahul and Rohit in their gaining ratios i.e.

Rahul=1/3 x ₹ 90,000= ₹ 30,000

Rohit = 2/3 x ₹ 90,000=₹ 60,000

3. Ram's Capital Account

		₹			₹
31-3-2022	To Cash and Bank A/c	2,10,000	31-3-2022	By Balance b/d	3,00,000
	To Ram's Loan A/c -Transfer	2,10,000		By Revaluation A/c	30,000
				By Rahul's Capital A/c - Goodwill	30,000
				By Rohit's Capital A/c-Goodwill	60,000
		4,20,000			4,20,000

2. Journal Entries

		₹	₹
1.	A's Capital account Dr.	21,000	
	B's Capital account Dr.	14,000	
	C's Capital account Dr.	7,000	
	To Profit and loss adjustment account		42,000
	(Profit written back for making adjustments)		
2.	Profit and loss adjustment account Dr.	6,000	
	To B's Capital account		6,000
	(Bonus credited to B's capital account)		
3.	Profit and loss adjustment account Dr.	36,000	
	To A's Capital account		12,000
	To B's Capital account		18,000
	To C's Capital account		6,000
	(Distribution of profits in the new ratio)		
4.	Fixtures account Dr.	9,800	
	To Provision for bad debts account		1,800
	To A's Capital account		2,667
	To B's Capital account		4,000
	To C's Capital account		1,333
	(Revaluation of assets on A's retirement)		
5.	B's capital account Dr.	2,700	
	C's capital account Dr.	900	
	To Provision for bad debts account		3,600
	(Raising provision for bad debts)		

6.	A's capital account Dr.		1,62,334	
	To B's Capital account			1,62,334
	(Amount payable to A paid by B)			
7.	B's Capital account	Dr.	14,000	
	C's Capital account	Dr.	4,667	
	To A's Capital account			18,667
	(Adjusting entry of goodwill passed through partners' capital accounts in gaining/sacrificing ratio)			

Partners' Capital Accounts

	A ₹	B ₹	C ₹		A ₹	B ₹	C ₹
To P & L adjustment A/c	21,000	14,000	7,000	By Balance b/d	1,50,000	1,00,000	50,000
To Provision for bad debts A/c	-	2,700	900	By P & L adjustment account	-	6,000	-
To B's Capital A/c	1,62,334	-	-	By P & L adjustment account	12,000	18,000	6,000
To Cash A/c	-	34,634	-	By Fixtures A/c	2,667	4,000	1,333
To A's Capital A/c		14,000	4,667	By A's capital A/c	-	1,62,334	-
				By B and C's capital A/c	18,667		
To Balance c/d	-	2,25,000	75,000	By Cash A/c			30,234
	1,83,334	2,90,334	87,567		1,83,334	2,90,334	87,567

Cash Account

	₹		₹
To Balance b/d	50,000	By B's capital A/c	34,634
To C's capital A/c	30,234	By Balance b/d	45,600
	80,234		80,234

Balance Sheet of B and C

as on 31st March, 2022 (after retirement of A)

Liabilities		₹	Assets	₹	₹
Capital accounts:			Fixtures		39,800
B	2,25,000		Stock		1,70,000

C	75,000	3,00,000	Sundry debtors	90,000	
Sundry creditors		40,000	*Less*: Provision for bad debts	(5,400)	84,600
			Cash		45,600
		3,40,000			3,40,000

Working Notes:

Calculation of goodwill:

1. Average of last five year's profit

Year ended on	**Profit** ₹
31.3.2018	15,000
31.3.2019	23,000
31.3.2020	25,000
31.3.2021	35,000
31.3.2022	42,000
	1,40,000

2. Goodwill at two years' purchase

₹ 28,000 x 2=₹ 56,000

3. Calculation for adjustment of Amount of Goodwill

Partner	Old Share	New Share	Gain	Sacrifice
A	$\frac{2}{6}$	–	–	$\frac{2}{6}$
B	$\frac{3}{6}$	$\frac{3}{4}$	$\frac{3}{12}$	–
C	$\frac{1}{6}$	$\frac{1}{4}$	$\frac{1}{12}$	–

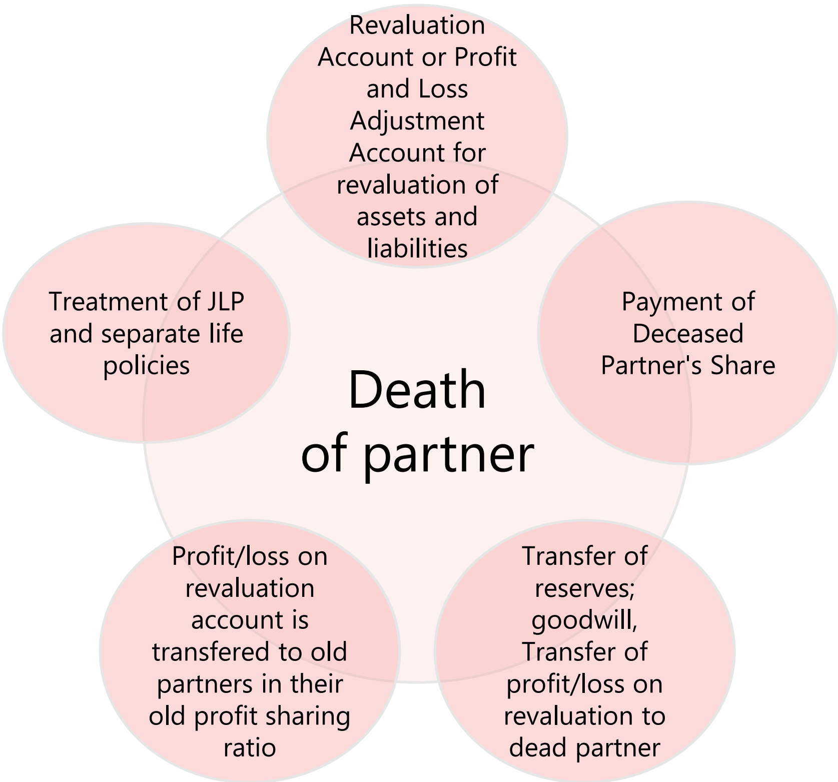
UNIT – 5 DEATH OF A PARTNER

LEARNING OUTCOMES

After studying this unit, you would be able to:

- Understand the implication of the excess money received on death of a partner from a joint life policy from the insurance company in the accounts of the partnership. Learn the journal entries required to record this transaction.
- Understand the accounting implications if death of a partner takes place at any date during the accounting period. Learn to record this transaction and how to record payment of profit to the Executor of the deceased partner for part of the accounting year.
- Be familiar with other accounting treatments in case of death of partner which are similar to the explained in case of retirement of a partner.

UNIT OVERVIEW



5.1 INTRODUCTION

Business of a partnership firm may not come to an end due to death of a partner as it is known as Reconstitution of Partnership. Other partners shall continue to run the business of the firm. The problems arising on the death of a partner are similar to those arising on retirement. Assets and liabilities have to be revalued and the resultant profit or loss has to be transferred to the capital accounts of all partners including the deceased partner. Goodwill is dealt with exactly in the way already discussed in the case of retirement in the earlier unit. Treatment of joint life policy will also be same as in the case of retirement. However, in case of death of a partner, the firm would get the joint policy value.

5.2 RIGHT OF OUTGOING PARTNER IN CERTAIN CASES TO SHARE SUBSEQUENT PROFITS

As per provisions of Section 37 of the Indian Partnership Act., "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 and the outgoing partner or his estate, then, in the absence of a contract to the contrary, 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.

Provided that whereby contract between the partners an option is given to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and that option is duly exercised, the estate of the deceased partner, or the outgoing partner or his estate, as the case may be, is not entitled to any further or other share of profits; but if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account under the foregoing provisions of this section. This way, the outgoing partner has the option to receive, interest at the rate of 6% p.a. or the share of profit earned on the unsettled amounts for the period till his dues are settled by the firm in the absence of any contract made to the contrary".

It may be noted that the outgoing partner is not bound to make election until the share of the profit that would be payable to him has been ascertained.

For example, A, B and C are in a partnership business-sharing profits and losses equally. C died on 31st October, 2021. The capitals of the partners, after all necessary adjustments stood at ₹ 50,000, ₹75,000 and ₹ 1,20,000 respectively. A and B continued to carry on the business further without settling the accounts of C. Final payment to C is made on February 1, 2022. The profit made during the period of three months amounts to ₹ 28,000.

Under Section 37 of the Partnership Act, C can exercise any of the following two options.

(i) Share in subsequent profits of firm:

Profit made—₹ 28,000

C's share – $28{,}000 \times \dfrac{1{,}20{,}000}{2{,}45{,}000}$ = ₹ 13,714

(ii) Interest at 6% p.a.

$$1,20,000 \times \frac{6}{100} \times \frac{3}{12} = ₹\ 1,800$$

Since, (i) option is beneficial for C, he will necessarily go for his proportionate share in profits.

5.3 AMOUNT PAYABLE TO LEGAL REPRESENTATIVES OF DEAD PARTNER

When the partner dies the amount payable to him/her is paid to his/her legal representatives. The representatives are entitled to the followings:

(a) The amount standing to the credit to the capital account of the deceased partner

(b) Interest on capital, if provided in the partnership deed upto the date of death:

(c) Share of goodwill of the firm;

(d) Share of undistributed profit or reserves;

(e) Share of profit on the revaluation of assets and liabilities;

(f) Share of profit upto the date of death;

(g) Share of Joint Life Policy.

Legal representatives are liable for:

(i) Drawings

(ii) Interest on drawings

(iii) Share of loss on the revaluation of assets and liabilities;

(iv) Share of loss that have occurred till the date of his/her death.

Calculation of profit upto the date of death of a partner.

Such Profit is calculated through P&L Suspense account. After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account.

If the death of a partner occurs during the year, the representatives of the deceased partner are entitled to his/her share of profits earned till the date of his/her death. Such profit is ascertained by any of the following methods:

(i) Time Basis

(ii) Turnover or Sales Basis

(i) Time Basis

In this case, it is assumed that profit has been earned uniformly throughout the year. For example:

The total profit of previous year is ₹ 2,25,000 and a partner dies three months after the close of previous year, the profit of three months is ₹ 31,250 i.e. 1,25,000 × 3/12, if the deceased partner took 2/10 share of profit, his/her share of profit till the date of death is ₹ 6,250 i.e. ₹ 31,250 × 2/10

(ii) Turnover or Sales Basis

In this method, we have to take into consideration the profit and the total sales of the last year. Thereafter the profit up to the date of death is estimated on the basis of the sale of the last year. Profit is assumed to be earned uniformly at the same rate.

Example

Arun, Tarun and Neha are partners sharing profits in the ratio of 3:2:1. Neha dies on 31st May 2022. Sales for the year 2021-2022 amounted to ₹ 4,00,000 and the profit on sales is ₹ 60,000. Accounts are closed on 31 March every year. Sales from 1st April 2022 to 31st May 2022 is ₹ 1,00,000. The deceased partner's share in the profit upto the date of death will be as follows.

Profit from 1st April 2022 to 31st May 2022 on the basis of sales:

If sales are ₹ 4,00,000, profit is ₹ 60,000

If the sales are ₹ 1,00,000 profit is: 60,000/4,00,000 × 1,00,000 = ₹ 15,000

Neha's share = 15,000 × 1/6 = ₹ 2,500

Alternatively profit is calculated as

Rate of profit = $\frac{60,000}{4,00,000}$ x 100 = 15%

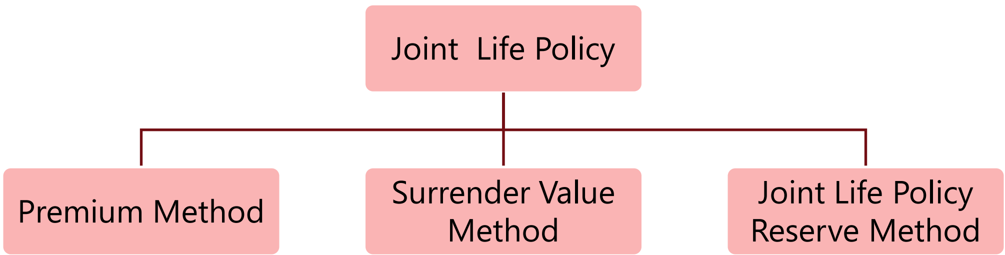
Sale upto date of death = 1,00,000

Profit = 1,00,000 x 15/100 = ₹ 15,000

The above adjustments are made in the capital account of the deceased partner and then the balance in the capital account is transferred to an account opened in the name of his/her executor. The payment of the amount of the deceased partner depends on the agreement. In the absence of an agreement, the legal representative of a deceased partner is entitled to interest @ 6% p.a. on the amount due from the date of death till the date of final payment

5.4 SPECIAL TRANSACTIONS IN CASE OF DEATH: JOINT LIFE POLICY

In case of Partnership, Partners generally get Joint Life Policy(JLP) in name of all partners. If partner expires, then partners are entitled for share in JLP.



Method 1: If Joint Life Policy does not appear in the Balance Sheet, then the firm will gain on the death of a partner. For example, A, B and C are in partnership sharing profits and losses at the ratio of 5:3:2. They took a Joint Life Policy of ₹ 1,00,000. Now, if A dies, the firm will receive ₹ 1,00,000 from the insurance company.

The journal entries will appear as follows:

			₹	₹
(i)	Bank A/c	Dr.	1,00,000	
	To Joint Life Policy A/c			1,00,000
	(Policy value received from the insurance company on A's death)			
(ii)	Joint Life Policy A/c	Dr.	1,00,000	
	To A's Capital A/c			50,000
	To B's Capital A/c			30,000
	To C's Capital A/c			20,000
	(Joint Life Policy written off and credited to old partners in Profit Sharing Ratio)			

Method 2: If Joint Life Policy appears in the Balance Sheet at surrender value, then the firm will gain on the death of a partner. For example, A, B and C are in partnership sharing profits and losses at the ratio of 5:3:2. They took a Joint Life Policy of ₹ 1,00,000 which is appearing in the Balance Sheet at the surrender value of ₹ 10,000. Now, if A dies, the firm will receive ₹ 1,00,000 from the insurance company.

The journal entries will appear as follows:

		₹	₹
(i)	Bank A/c Dr.	1,00,000	
	To Joint Life Policy A/c		1,00,000
	(Policy value received from the insurance company on A's death)		
(ii)	Joint Life Policy A/c Dr.	90,000	
	To A's Capital A/c		45,000
	To B's Capital A/c		27,000
	To C's Capital A/c		18,000
	(Joint Life Policy written off and credited to old partners in Profit Sharing Ratio)		

Method 3:

If Joint Life Policy appears in the Balance Sheet at surrender value along with Joint Life Policy Reserve, then the firm will gain on the death of a partner and reserve will be distributed among partners. For example, A, B and C are in partnership sharing profits and losses at the ratio of 5:3:2. They took a Joint Life Policy of ₹ 1,00,000 which is appearing in the Balance Sheet at the surrender value of ₹ 10,000,along with JLP reserve. Now, if A dies, the firm will receive ₹ 1,00,000 from the insurance company.

The journal entries will appear as follows:

		₹	₹
(i)	Bank A/c Dr.	1,00,000	
	To Joint Life Policy A/c		1,00,000
	(Policy value received from the insurance company on A's death)		
(ii)	Joint Life Policy A/c Dr.	90,000	
	To A's Capital A/c		45,000
	To B's Capital A/c		27,000
	To C's Capital A/c		18,000
	(Joint Life Policy written off and credited to old partners in Profit Sharing Ratio)		
(iii)	Joint Life Policy Reserve A/c Dr.	10,000	
	To A's Capital A/c		5,000

To B's Capital A/c		3,000
To C's Capital A/c		2,000
(Joint Life Policy reserved written off and credited to old partners in Profit Sharing Ratio)		

5.5 SPECIAL TRANSACTIONS IN CASE OF DEATH: SEPARATE LIFE POLICY

Instead of taking one joint life policy in the names of all the partners, the partners may take individual policies on the lives of respective partners. The premium paid is charged to profit and loss account. On the death of a partner then only the amount for which the deceased partner was insured would be recovered from the insurance company. The policies of the surviving partners will continue to survive but the surrender value of the policies of the surviving partners would also be taken into account for the purpose of calculating the amount payable to the legal representatives of the deceased partner. In other words the legal representatives would be entitled to receive share in surrender value equivalent to the profit sharing ratio of the deceased.

Bank A/c	Dr.	(Assured value)
To Separate Life Policy of Deceased partner A/c		
(Policy value received on death of a partner)		
Separate Life Policy of Deceased Partner A/c	Dr.	(Assured value)
Separate Life Policy of Remaining Partners A/c	Dr	(Surrender value)
To Executor's A/c	(Total value distributed in profit sharing ratio)	
To Remaining partners A/c	(Total value distributed in profit sharing ratio)	
(Being the total of assured value of deceased partner's life policy and surrender value of other partners' life policy(s) distributed in the profit and loss sharing ratio)		

Example: Sona, Gabbu and Amit are partners sharing profits in the ratio of 3:1:1.

	SONA	GABBU	AMIT
Policy	1,00,000	2,00,000	3,00,000
Surrender Value	10,000	20,000	30,000

If Amit dies, then, Amit's executives will get 3,00,000 x 1/5 and 1/5(10,000+20,000) = 60,000+6,000 = 66,000

5.6 SPECIAL TRANSACTIONS IN CASE OF DEATH: PAYMENT OF DECEASED PARTNER'S SHARE

The basic distinction between retirement and death of a partner relates to finalisation of amount payable to the Executor of the deceased partner. Although, revaluation of goodwill is done in the same way as it has been done in case of retirement, in addition, the executor of the deceased partner is entitled to share of profit upto the date of death.

For example, A, B and C are in partnership sharing profits and losses at the ratio of 2:2:1. A died on 15th April, 2022. The firm closes its books of account as on 31st December every year. So the executor of A is entitled for 3½ months profit. If A's share is immediately paid off then profit for 2022 can be taken as base for calculating 3½ months profits in the year, 2022. If M/s. A, B & C earned ₹ 96,000 in year 2021, then 3½ months profit is ₹ 28,000. A's share comes to ₹ 28,000 × 2/5 i.e. ₹ 11,200.

Journal entry is:

Profit and Loss Suspense A/c *	Dr.	₹ 11,200	
To A's Capital A/c			₹ 11,200
(Share of A 3½ months profit in 2022 is transferred to his Capital Account on death)			

*At the end of the year 2022, the Profit & Loss Suspense A/c will be transferred to Profit and Loss A/c.

ILLUSTRATION 1

The following was the Balance Sheet of Om & Co. in which X, Y, Z were partners sharing profits and losses in the ratio of 1:2:2 as on 31.3.2022. Mr. Z died on 31st December, 2022. His account has to be settled under the following terms.

Balance Sheet of Om & Co. as on 31.3.2022

Liabilities	₹	₹	Assets	₹
Trade payables		20,000	Building	1,20,000
Bank loan		50,000	Computers	80,000
General reserve		30,000	Inventories	20,000
Capital accounts:			Trade receivables	20,000
X	40,000		Cash at bank	50,000
Y	80,000		Investments	10,000
Z	80,000	2,00,000		
		3,00,000		3,00,000

Goodwill is to be calculated at the rate of two years purchase on the basis of average of three years' profits and losses. The profits and losses for the three years were detailed as below:

Year ending on	***profit/loss***
31.3.2022	*30,000*
31.3.2021	*20,000*
31.3.2020	*(10,000) Loss*

Profit for the period from 1.4.2022 to 31.12.2022 shall be ascertained proportionately on the basis of average profits and losses of the preceding three years.

During the year ending on 31.3.2022 a car costing ₹ 40,000 was purchased on 1.4.2021 and debited to traveling expenses account on which depreciation is to be calculated at 20% p.a. at written down value method. This asset is to be brought into account at the depreciated value.

Other values of assets were agreed as follows:

Inventory at ₹ 16,000, building at ₹ 1,40,000, computers at ₹ 50,000; investments at ₹ 6,000. Trade receivables were considered good.

Required:

(i) Calculate goodwill and Z's share in the profits of the firm for the period 1.4.2022 to 31.12.2022.

(ii) Prepare revaluation account assuming that other items of assets and liabilities remained the same.

(iii) Prepare partners' capital accounts and balance sheet of the firm Om & Co. as on 31.12.2022.

SOLUTION

(i) Calculation of goodwill and Z's share of profit

(a)	Adjusted profit for the year ended 31.3.2022:	₹	₹
	Profit (Given)		30,000
	Add: Cost of car wrongly written off	40,000	
	Less: Depreciation for the year 2021-22 (20% on 40,000)	(8,000)	32,000
			62,000
(b)	Average of last three year's profits and losses	Profit/ (loss)	
	Year ended on	₹	
	31.3.2020	(10,000)	

	31.3.2021	20,000	
	31.3.2022	62,000	
		72,000	
	Average profit (72,000/3)	24,000	
(c)	Goodwill at 2 years' purchase		
	₹ 24,000 x 2 = ₹ 48,000		
(d)	Z's share of profits from the period 1.4.2022 to 31.12.2022		
	₹ 24,000 x 9/12 x 2/5 = ₹ 7,200		

(ii) **Revaluation Account**

	₹			₹
To Inventory account	4,000	By Building account		20,000
To Computers account	30,000	By Loss transferred to		
To Investments account	4,000	X	4,560	
To depreciation on car	4,800	Y	9,120	
		Z	9,120	22,800
	42,800			42,800

Partners' Capital Accounts

	X ₹	Y ₹	Z ₹		X ₹	Y ₹	Z ₹
To Revaluation A/c	4,560	9,120	9,120	By Balance b/d	40,000	80,000	80,000
To Z's Executor's A/c			1,22,080	By General reserve	6,000	12,000	12,000
To Z	6,400	12,800	–	By X and Y	–	–	19,200
To Balance c/d	41,440	82,880		By Car A/c	6,400	12,800	12,800
				By Profit and Loss suspense A/c	–	–	7,200
	52,400	1,04,800	1,31,200		52,400	1,04,800	1,31,200

Balance Sheet of Om & Co. as on 31st December,2022

Liabilities	₹	Assets	₹
Trade payables	20,000	Building	1,40,000
Bank loan	50,000	Car	27,200
Capital accounts:		Inventories	16,000
X	41,440	Computers	50,000

Y	82,880	Investments	6,000
Z's Executor's account	1,22,080	Trade receivables	20,000
		Cash at bank	50,000
		Profit and Loss suspense Account	7,200
	3,16,400		3,16,400

Working Note:

Goodwill calculated at the time of death of partner Z ₹ 48,000

Partner	Old Share	New Share	Gain	Sacrifice
X	$\frac{1}{5}$	$\frac{1}{3}$	$\frac{2}{15}$	–
Y	$\frac{2}{5}$	$\frac{2}{3}$	$\frac{4}{15}$	–
Z	$\frac{2}{5}$	–	–	$\frac{2}{5}$

Adjusting entry:

X's Capital Account	Dr.	6,400	
Y's Capital Account	Dr.	12,800	
To Z's Capital Account			19,200
(Adjustment for goodwill on the death of Z on the basis of gaining ratio)			

ILLUSTRATION 2

The partnership agreement of a firm consisting of three partners - A, B and C (who share profits in proportion of ½, ¼ and ¼ and whose fixed capitals are ₹ 10,000; ₹ 6,000 and ₹ 4,000 respectively) provides as follows:

(a) *That partners be allowed interest at 10 per cent per annum on their fixed capitals, but no interest be allowed on undrawn profits or charged on drawings.*

(b) *That upon the death of a partner, the goodwill of the firm be valued at two years' purchase of the average net profits (after charging interest on capital) for the three years to 31st December preceding the death of a partner.*

(c) *That an insurance policy of ₹ 10,000 each to be taken in individual names of each partner, the premium is to be charged against the profit of the firm.*

(d) *Upon the death of a partner, he is to be credited with his share of the profits, interest on capitals etc. calculated upon 31st December following his death.*

(e) *That the share of the partnership policy and goodwill be credited to the deceased partner as on 31st December following his death.*

(f) *That the partnership books be closed annually on 31st December.*

A died on 30th September 2022, the amount standing to the credit of his current account on 31st December, 2021 was ₹ 450 and from that date to the date of death he had withdrawn ₹ 3,000 from the business.

An unrecorded liability of ₹ 2,000 was discovered on 30th September, 2022. It was decided to record it and be immediately paid off.

The trading result of the firm (before charging interest on capital) had been as follows: 2019 Profit ₹ 9,640; 2020 Profit ₹ 6,720; 2021 Profit ₹ 7,640; 2022 Profit ₹ 3,670.

Assuming the surrender value of the policy to be 20 percent of the sum assured.

Required

Prepare an account showing the amount due to A's legal representative as on 31st December, 2022.

SOLUTION

A's Capital Account

2022		₹	2022		₹
Sep. 30	To Current A/c	2,550	Jan. 1	By Balance b/d	10,000
	(3,000 - 450)		Dec. 31	By Profit and Loss A/c :	
Dec. 31	To Profit and Loss Adjt.	1,000		Interest on Capital	1,000
	(Unrecorded Liability)			Share of Profit	835
	To Balance Transferred to			B & C (Goodwill)	6,000
	A's Executor's A/c	21,285		Insurance Policies A/c	7,000
		24,835			24,835

Working Notes:

(i) Valuation of Goodwill

Year	Profit before Interest on fixed capital	Interest	Profit after interest
	₹	₹	₹
2019	9,640	2,000	7,640
2020	6,720	2,000	4,720

2021	7,640	2,000	5,640
	21,000	6,000	18,000

	₹
Average	6,000
Goodwill at two years purchase of average net profits	12,000
Share of A in the goodwill	6,000

(ii) Profit on Separate Life Policy

A's policy	10,000
B and C's policy @ 20%	4,000
	14,000
Share of A (1/2)	7,000

(iii) Share in profit for 2022

Profit for the year	3,670
Less : Interest on capitals	(2,000)
	1,670
A's share in profit (1/2)	835

(iv) As unrecorded liability of ₹ 2,000 has been charged to Capital Accounts through Profit and Loss Adjustment Account, no further adjustment in current year's profit is required.

(v) Profits for 2019, 2020 and 2021 have not been adjusted (for valuing goodwill) for unrecorded liability for want of precise information.

ILLUSTRATION 3

The following is the Balance Sheet of M/s. ABC LLP as at 31st December, 2021.

Balance Sheet as at 31st December, 2021

Liabilities	₹	***Assets***		₹
Capital		*Machinery*		*5,000*
A	*4,100*	*Furniture*		*2,800*
B	*4,100*	*Fixture*		*2,100*
C	*4,500*	*Cash*		*1,500*
General Reserve	*1,500*	*Inventories*		*950*
Trade payables	*2,350*	*Trade receivables*	*4,500*	
		Less: Provision for Doubtful debts	*300*	*4,200*
	16,550			*16,550*

C died on 3rd January, 2022 and the following agreement was to be put into effect.

(a) Assets were to be revalued: Machinery to ₹ 5,850; Furniture to ₹ 2,300; Inventory to ₹ 750.

(b) Goodwill was valued at ₹ 3,000 and was to be credited with his share, without using a Goodwill Account

(c) ₹ 1,000 was to be paid away to the executors of the dead partner on 5th January, 2022.

Required

(i) The Journal Entry for Goodwill adjustment.

(ii) The Revaluation Account and Capital Accounts of the partners.

(iii) Which account would be debited and which account credited if the provision for doubtful debts in the Balance Sheet was to be found unnecessary to maintain at the death of C.

SOLUTION

(i) Journal Entry in the books of the firm

Date	Particulars		₹	₹
Jan 3, 2022	A's Capital A/c	Dr.	500	
	B's Capital A/c	Dr.	500	
	To C's Capital A/c			1,000
	(Being the required adjustment for goodwill through the partner's capital accounts)			

(ii) Revaluation Account

Particulars	₹	Particulars	₹
To Furniture A/c (₹ 2,800 – 2,300)	500	By Machinery A/c (₹ 5,850 – 5,000)	850
To Inventory A/c (₹ 950 – 750)	200		
To Partners' Capital A/cs	150		
(A – ₹ 50, B – ₹ 50, C – ₹ 50)			
	850		850

Partners' Capital Accounts

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To C (Goodwill)	500	500	–	By Balance b/d	4,100	4,100	4,500
To Cash A/c	–	–	1,000	By General Reserve A/c	500	500	500

To Executors A/c	–	–	5,050	By Revaluation A/c (Profit)	50	50	50
To Balance C/d	4,150	4,150	–	By A (Goodwill)	–	–	500
				By B (Goodwill)	–	–	500
	4,650	4,650	6,050		4,650	4,650	6,050

(iii) Provision for Doubtful Debts Account is a credit balance. To close, this account is to be debited. It becomes a gain for the partners. Therefore, either Partners' Capital Accounts (including C) or Revaluation Account is to be credited.

Working Note:

Statement showing the Required Adjustment for Goodwill

Particulars	A	B	C
Right of goodwill before death	1/3	1/3	1/3
Right of goodwill after death	1/2	1/2	–
Gain/(Sacrifice)	(+) 1/6	(+) 1/6	(-) 1/3

Profit sharing ratio is equal before or after the death of C because nothing has been mentioned in respect of profit-sharing ratio.

ILLUSTRATION 4

B and N were partners. The partnership deed provides inter alia:

(i) That the accounts be balanced on 31st December each year.

(ii) That the profits be divided as follows:

B: One-half; N: One-third; and carried to Reserve Account: One-sixth

(iii) That in the event of death of a partner, his executor will be entitled to the following:

(a) the capital to his credit at the date of death; (b) his proportion of profit to date of death based on the average profits of the last three completed years; (c) his share of goodwill based on three years' purchases of the average profits for the three preceding completed years.

Trial Balance on 31st December, 2021

Particulars	*Dr. (₹)*	*Cr. (₹)*
B's Capital		*90,000*
N's Capital		*60,000*
Reserve		*30,000*
Bills receivable	*50,000*	

Investments	*40,000*	
Cash	*1,10,000*	
Trade payables		*20,000*
Total	*2,00,000*	*2,00,000*

The profits for the three years were 2019: ₹ 42,000; 2020: ₹ 39,000 and 2021: ₹ 45,000. N died on 1st May, 2022. Show the calculation of N (i) Share of Profits; (ii) Share of Goodwill; (iii) Draw up N's Executors Account as would appear in the firms' ledger transferring the amount to the Loan Account.

SOLUTION

(i)	Ascertainment of N's Share of Profit		(ii)	Ascertainment of Value of Goodwill	
	2019	42,000		2019	42,000
	2020	39,000		2020	39,000
	2021	45,000		2021	45,000
	Total Profit	1,26,000		Total Profit for 3 years	1,26,000
	Average Profit	42,000		Average Profit	42,000
	4 months' Profit	14,000		Goodwill - 3 years	
				Purchase of Average Profit	1,26,000
	N's Share in Profit				
	(2/5th* of ₹ 14,000)	5,600		N's Share of goodwill	
				(2/5 of ₹ 1,26,000)	50,400

* Profit sharing ratio between B and N = 1/2; 1/3; = 3: 2, Therefore N's share of Profit = 2/5

N's Executors Account

Date	Particulars	₹	Date	Particulars	₹
2022			2022		
May 1,	To N's Loan A/c	1,28,000	Jan. 1	By Capital A/c	60,000
			May 1	By Reserves	
				(2/5th of ₹ 30,000)	12,000
			May 1	By B's Capital A/c	
				(Share of goodwill)	50,400
			May 1	By P/L Suspense A/c	
				(Share of Profit)	5,600
		1,28,000			1,28,000

ILLUSTRATION 5

Diya, Riya & Kiya are partners of M/s. DRK Fabrics sharing profits and losses in the ratio of 2:1:2. On 31st March 2022 their Balance Sheet was as under:

Liabilities	₹	Assets	₹
Capitals :		Land & Building	1,65,000
Diya	1,50,000	Furniture	75,000
Riya	1,80,000	Joint life Policy	60,000
Kiya	70,000	Inventory	88,740
General Reserve	1,40,000	Trade Receivable	96,750
Trade payables	60,000	Bank	1,14,510
	6,00,000		6,00,000

Kiya died on 30th September, 2022.

The partnership deed provides as follows:

(a) *That partners be allowed interest at 12% p.a. on their capitals, but no interest be charged on drawings.*

(b) *Upon the death of a partner, the goodwill of the firm be valued at one years' purchase of the average net profits (after charging interest on capital) for the four years to 31st March preceding the death of a partner. The profits of the firm before charging interest on capitals were*

2018-19	1,62,000
2019-20	1,99,000
2020-21	1,87,000
2021-22	1,96,000

Average capital during preceding four years may be assumed as ₹ 3,00,000

(c) *Profits till the date of death to be ascertained on the basis of average profit of previous four years*

(d) *Upon the death of a partner, she is to be credited with her share of the profits, interest on capitals etc. calculated till the date of death*

After the death of Kiya

1. *₹ 2,00,000 was received from insurance company against Joint life Policy.*

2. *Land & Building was appreciated by 20%, Furniture to be depreciated by 10%, inventory to be revalued at ₹ 80,000. Bad debts amounted ₹ 1760.*

3. *Amount payable to Kiya was paid in cash.*

You are required to prepare

1. *Revaluation A/c*
2. *Partners' Capital A/c*
3. *Balance Sheet as on 30th September 2022, assuming other Assets and liabilities remaining the same.*

SOLUTION

Revaluation A/c

Particulars		₹	Particulars	₹
To Furniture		7,500	By Land & Building	33,000
To Inventory		8,740		
To Bad Debts		1,760		
To Profit on Revaluation				
Diya	6,000			
Riya	3,000			
Kiya	<u>6,000</u>	15,000		
		33,000		33,000

Partners Capital A/c

Particulars	Diya ₹	Riya ₹	Kiya ₹	Particulars	Diya ₹	Riya ₹	Kiya ₹
To Kiya capital	40,000	20,000		By Balance b/d	1,50,000	1,80,000	70,000
To Bank			2,79,800	By General Reserve	56,000	28,000	56,000
To Balance c/d	2,28,000	2,19,000		By Joint life Policy	56,000	28,000	56,000
				By Interest on Capital			4,200
				By revaluation	6,000	3,000	6,000
				By Diya & Riya capital			60,000
				By Profit & loss suspense A/c			27,600
	2,68,000	2,39,000	2,79,800		2,68,000	2,39,000	2,79,800

Bank A/c

Particulars	₹	Particulars	₹
To Balance B/d	1,14,510	By Kiya's Capital	2,79,800
To Bank	2,00,000	By Balance c/d	34,710
	3,14,510		3,14,510

Balance Sheet as on 30th September, 2022

Liabilities	₹	Assets	₹
Capitals :		Land & Building	1,98,000
Diya	2,28,000	Furniture	67,500
Riya	2,19,000	Inventory	80,000
		Trade Receivable	94,990
Trade payables	60,000	Bank	34,710
		Profit and loss Suspense (27,600+4,200)	31,800
	5,07,000		5,07,000

Working Notes:

1. Goodwill valuation

2018-19	1,62,000		
2019-20	1,99,000		
2020-21	1,87,000		
2021-22	1,96,000		
Total	7,44,000		
Average		= 7,44,000/4	= 1,86,000
Less: Interest on Capital		3,00,000 X 12%	= 36,000
Adjusted Average Profit			=1,50,000
Goodwill (1 year's purchase)			= 1,50,000
Kiya's share (2/5)			= 60,000

2. Journal entry for adjustment of goodwill

Particulars		₹	₹
Diya's Capital A/c	Dr.	40,000	
Riya's Capital A/c	Dr.	20,000	
To Kiya's Capital A/c			60,000
(Share of goodwill adjusted)			

3. Kiya's share of profit till the date of death

Average profit for full year before interest on capital	=	1,86,000
6 month's profit	=	93,000
Less: interest on capital 4,00,000 X 12% X 6/12	=	24,000
Adjusted profit till the date of death	=	69,000
Kiya's share 2/5th	=	27,600

4. The Joint life policy in this question is based on the surrender value method- where in the amount shown in the balance sheet shall be deducted from the JLP proceeds received from insurance co, on the death of a partner.

₹ 2,00,000- 60,000 (Balance Sheet value) = ₹ 1,40,000 (divided in profit sharing ratio between the partners.)

NOTE: The ICAI through technical guide (issued in June, 2022) has recommended the formats of financial statements for Limited Liability Partnerships (LLPs). This would enable these entities to communicate their financial performance and financial position in standardised formats thereby enhancing their consistency and comparability. The said format of financial statements is being given as Annexure – II at the end of the chapter for awareness of students. It may be noted that this format does not form part of syllabus and has been given here for the knowledge of students only.

SUMMARY

- The problems arising on the death of a partner are similar to those arising on retirement. Assets and liabilities have to be revalued and the resultant profit or loss has to be transferred to the Capital Accounts of all partners including the deceased partner. Goodwill is dealt with exactly in the way already discussed in the case of retirement.
- Treatment of joint life policy will also be same as in the case of retirement. However, in case of death of a partner, the firm would get the joint policy value. The only additional point is that as death may occur on any day, the representatives of the deceased partner will be entitled to the partner's share of profit from the beginning of

the year to the date of death. After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account.

- If the death takes place during the accounting period, the Executor of the deceased partner is entitled to have a share of profit upto the date of death based on the profit earned in the immediately preceding year or some other agreed basis. For this purpose, the deceased partners' Capital Accounts is credited and Profit & Loss Suspense Account is debited.

TEST YOUR KNOWLEDGE

True and False

1. *Business of partnership comes to an end on death of a partner.*
2. *Legal heir of a deceased partner automatically becomes partner in the firm.*
3. *A revaluation account is opened in the books of accounts on death of a partner.*
4. *Any reserve appearing in the balance sheet on the date of death of a partner is transferred to all partners capital account in their profit sharing ratio.*
5. *Legal heirs of a deceased partner are entitled to his capital account balance only.*
6. *It is not necessary to adjust goodwill on death of a partner.*
7. *On death of a partner continuing partners can agree to change their capital contribution and profit sharing ratio.*
8. *On death of a partner, the firm gets surrender value of the joint life policy.*
9. *Only legal heirs of deceased partner are entitled to amount received from joint life policy.*

Multiple Choice Questions

1. *In the absence of proper agreement, representative of the deceased partner is entitled to the Dead partner's share in*

   (a) Profits till date, goodwill, joint life policy, share in revalued assets and liabilities.

   (b) Capital, goodwill, joint life policy, interest on capital, share in revalued assets and liabilities.

   (c) Capital, profits till date, goodwill, joint life policy, share in revalued assets and liabilities.

2. *A, B and C are the partners sharing profits and losses in the ratio 2:1:1. Firm has a joint life policy of ₹ 1,20,000 and in the balance sheet it is appearing at the surrender value i.e. ₹ 20,000. On the death of A, how this JLP will be shared among the partners.*

   (a) ₹ 50,000: ₹ 25,000: ₹ 25,000.

   (b) ₹ 60,000: ₹ 30,000: ₹ 30,000.

   (c) ₹ 40,000: ₹ 35,000: ₹ 25,000.

3. *R, J and D are the partners sharing profits in the ratio 7:5:4. D died on 30th June 2022. It was decided to value the goodwill on the basis of three year's purchase of last five years average profits. If the profits are ₹ 29,600; ₹ 28,700; ₹ 28,900; ₹ 24,000 and ₹ 26,800. What will be D's share of goodwill?*

   (a) ₹ 20,700.

   (b) ₹ 27,600.

   (c) ₹ 82,800.

4. *R, J and D are the partners sharing profits in the ratio 7:5:4. D died on 30th June 2022 and profits for the accounting year 2021-2022 were ₹ 24,000. How much share in profits for the period 1st April 2022 to 30th June 2022 will be credited to D's Account.*

   (a) ₹ 6,000.

   (b) ₹ 1,500.

   (c) ₹ 2,000.

5. *Revaluation account is prepared at the time of*

   (a) Admission and retirement of a partner

   (b) Death of a partner

   (c) All of the above

6. *If three partners A, B & C are sharing profits as 5:3:2, then on the death of a partner A, how much B & C will pay to A's executer on account of goodwill. Goodwill is to be calculated on the basis of 2 years purchase of last 3 years average profits. Profits for last three years are: ₹ 3,29,000; ₹ 3,46,000 and ₹ 4,05,000.*

   (a) ₹ 2,16,000 & ₹ 1,42,000.

   (b) ₹ 2,44,000 & ₹ 2,16,000.

   (c) ₹ 2,16,000 & ₹ 1,44,000.

Theory Questions

1. *Explain distinction between retirement and death of a partner as relating to finalisation of amount payable.*
2. *What amount is payable to legal representatives of dead partner?*

Practical Questions

1. *The Balance Sheet of Seed, Plant and Flower as at 31st December, 2021 was as under :*

Liabilities		₹	**Assets**	₹
Trade payables		20,000	Fixed Assets	40,000
General Reserve		5,000	Debtors	10,000
Capital:			Bills Receivable	4,000
Seed	25,000		Inventories	16,000
Plant	15,000		Cash at Bank	10,000
Flower	15,000	55,000		
		80,000		80,000

The profit sharing ratio was: Seed 5/10, Plant 3/10 and Flower 2/10. On 1st May, 2022 Plant died. It was agreed that:

(a) *Goodwill should be valued at 3 years purchase of the average profits for 4 years. The profits were:*

2018	₹ 10,000	2020	₹ 12,000
2019	₹ 13,000	2021	₹ 15,000

(b) *The deceased partner to be given share of profits upto the date of death on the basis of the previous year.*

(c) *Fixed Assets were to be depreciated by 10%. A bill for ₹ 1,000 was found to be worthless. These are not to affect goodwill.*

(d) *A sum of ₹ 7,750 was to be paid immediately, the balance was to remain as a loan with the firm at 9% p.a. as interest.*

Seed and Flower agreed to share profits and losses in future in the ratio of 3: 2.

Give necessary journal entries.

2. *Peter, Paul and Prince were partners sharing profits and losses in the ratio 2:1:1. It was provided in the partnership deed that in the event of retirement /death of a partner he/his legal representatives would be paid:*

(i) *The balance in the capital Account* *(ii)* *His share of goodwill of the firm valued at two years purchase of normal average profits (after charging interest on fixed capital) for the last three years to 31st December preceding the retirement or death.*

(iii) *His share of profits from the beginning of the accounting year to the date of retirement or death, which shall be taken on proportionate basis of profits of the previous year as increased by 25%*

(iv) *Interest on fixed capital at 10% p.a. though payable to the partners will not be payable in the year of death or retirement.*

(v) *All the asset are to be revalued on the date of retirement or death and the profit and loss be debited/credited to the Capital Accounts in the profit sharing ratio.*

Peter died on 30th September, 2022. The books of Account are closed on calendar year basis from 1st January to 31st December.

The balance in the Fixed Capital Accounts as on 1st January, 2022 were Peter ₹ 10,000, Paul ₹ 5,000 and Prince ₹ 5,000. The balance in the Current Account as on 1st January, 2022 were Peter ₹ 20,000, Paul ₹ 10,000 and Prince ₹ 7,000. Drawings of Peter till 30th September, 2022 were ₹ 10,000. The profits of the firm before charging interest on capital for the calendar years 2019, 2020 and 2021 were ₹ 1,00,000, ₹ 1,20,000 and ₹ 1,50,000 respectively. The profits include the following abnormal items of credit:

	2019	**2020**	**2021**
	₹	**₹**	**₹**
Profit on sale of assets	*5,000*	*7,000*	*10,000*
Insurance claim received	*3,000*	*-*	*12,000*

The firm has taken out a Joint Life Policy for ₹ 1,00,000. Besides the partners had severally insured their lives for ₹ 50,000 each, the premium in respect thereof being charged to the Profit and Loss account. The surrender value of the Policies were 30% of the face value. On 30th June, 2022 the firm received notice from the insurance company that the insurance premium in respect of fire policy had been undercharged to the extent of ₹ 6,000 in the year 2021 and the firm has to pay immediately. The revaluation of the assets indicates an upward revision in value of assets to the extent of ₹ 20,000. Prepare an account showing the amount due to Peter's Legal representatives as on 30th September, 2022 along with necessary workings.

ANSWERS/HINTS

True and False

1. False: Surviving partners continue to carry on the business.

2. False: Legal heirs of deceased partners are entitled to dues of the deceased partner.

3. True: To find out the actual values of the assets and liabilities, revaluation account is prepared.

4. True: reserves belong to the partners in the same manner the capital contributed by them. Hence it is distributed to them through the capital account.

5. False: Legal heirs of a deceased partner are entitled to all the dues of deceased partner.

6. False: It is very much necessary to adjust goodwill on death of a partner.

7. True: Yes, it can be continued in the earlier share or in new share- in either case it leads to computing a new profit sharing ratio

8. False: On death of a partner the firm gets full value of sum assured of the joint life policy.

9. False**:** All the partners are entitled to amount received from joint life policy.

Multiple Choice Questions

1.	**(c)**	2.	**(a)**	3.	**(a)**	4.	**(b)**	5.	**(c)**	6.	**(c)**

Theoretical Questions

1. The basic distinction between retirement and death of a partner relates to finalisation of amount payable to the Executor of the deceased partner. Although, revaluation of goodwill is done in the same way as it has been done in case of retirement, in addition, the executor of the deceased partner is entitled to share of profit upto the date of death

2. When the partner dies the amount payable to him/her is paid to his/her legal representatives. The representatives are entitled to the followings :

(a) The amount standing to the credit to the capital account of the deceased partner;

(b) Interest on capital, if provided in the partnership deed upto the date of death;

(c) Share of goodwill of the firm;

(d) Share of undistributed profit or reserves;

(e) Share of profit on the revaluation of assets and liabilities;

(f) Share of profit upto the date of death;

(g) Share of Joint Life Policy.

Practical Questions

1. **Journal Entries**

2022			₹	₹
May 1	General Reserve Account	Dr.	5,000	
	To Seed's Capital Account			2,500
	To Plant's Capital Account			1,500
	To Flower's Capital Account			1,000
	(General Reserve transferred to Capital Account on the death of Plant)			
	Seed's Capital Account	Dr.	3,750	
	Flower's Capital Account	Dr.	7,500	
	To Plant's Capital Account			11,250
	(Adjustment for goodwill on the death of Plant on the basis of gaining ratio) (Value = 3 × (10,000 + 13,000 + 12,000 + 15,000)/4)			
	Revaluation Account	Dr.	5,000	
	To Fixed Assets Account			4,000
	To Bills Receivable Account			1,000
	(Depreciation of fixed assets @ 10% and writing off of one bill for ₹1,000 on Plant's death)			
	Seed's Capital Account	Dr.	2,500	
	Plant's Capital Account	Dr.	1,500	
	Flower's Capital Account	Dr.	1,000	
	To Revaluation Account			5,000
	(Loss on Revaluation transferred to capital accounts)			
	Profit and Loss Suspense Account	Dr.	1,500	

	To Plant's Capital Account (Plant's share of four month's profit based on the previous year)			1,500
	Plant's Capital Account To Plant's Executor's Account (Amount standing to the credit of Plant's Capital Account transferred to the credit of his Executor's Account)	Dr.	27,750	27,750
	Plant's Executor's Account To Bank Account (Amount paid to Plant's Executors)	Dr.	7,750	7,750

2. **In the books of M/s Paul and Prince**

Executors of Peter Account

	₹		₹
To Balance c/d	2,91,125	By Peter's capital A/c (W.N.6)	20,000
		By Peter's Current A/c (W.N.7)	2,71,125
	2,91,125		2,91,125

Working Notes:

		2019	2020	2021
		₹	₹	₹
1.	**Valuation of Goodwill:**			
	Profit as per Profit and loss A/c	1,00,000	1,20,000	1,50,000
	Less: Interest on capital @ 10%	2,000	2,000	2,000
	Abnormal Items:			
	Profit on sale of asset	5,000	7,000	10,000
	Insurance claim received	3,000	-	12,000
	Insurance premium undercharged	-	-	6,000
		90,000	1,11,000	1,20,000
	Total profit of three years		3,21,000	

	Average profit		1,07,000	
	Goodwill (2 x Average profit)		2,14,000	
	Peter's share of goodwill (2/4)		1,07,000	

2.	**Peter's share of profit:**	**₹**
	Profit for the year 2021	1,50,000
	Less: Insurance premium undercharged	6,000
		1,44,000
	Add: 25% increase thereof	36,000
	Estimated profit for 2022	1,80,000
	Less: Interest on capital *	1,000
	Estimated profit for 2022	1,79,000
	Estimated profit upto 30.9.22	1,34,250
	Peter's Share (2/4)	67,125

*Since Peter was not entitled to interest on capital in the year of death, interest is payable only to the remaining two partners.

3. Profit on revaluation of assets:

	₹
Upward revision in the value of assets	20,000
Peter's share (2/4)	10,000

4. Peter's share in insurance premium undercharged:

Insurance premium undercharged in 2021	6,000
Peter's share	3,000

5. Share of life policy:

Joint life policy	1,00,000
Maturity value of Peter's individual life policy	50,000
Surrender value of individual life policies of Paul & Prince	
(30 % of face value)	30,000
	1,80,000
Peter's share (2/4)	90,000

6. **Peter's Capital Account**

		₹			₹
30.9.22	To Executors of Peter A/c (Transfer)	20,000	1.1.22	By Balance b/d	10,000
			30.9.22	By Profit on revaluation of assets	10,000*
		20,000			20,000

* This is generally transferred to Peter's current account. But as per the requirement of adjustment No. (v) of question, it is transferred to capital account.

7. **Peter's Current Account**

		₹			₹
30.9.22	To Drawings	10,000	1.1.22	By Balance b/d	20,000
	To Insurance premium undercharged	3,000	30.9.22	By Share of goodwill	1,07,000
				By share of profit	67,125
	To Executor's of Peter's Account (balance transferred)	2,71,125		By Share of life policy	75,000
				By Paul & Prince	15,000
		2,84,125			2,84,125

Note: The share of goodwill given to peter would be borne by remaining partners in their gaining ratio, so that goodwill account does not appear in the balance sheet.

UNIT - 6: DISSOLUTION OF PARTNERSHIP FIRMS AND LLP

LEARNING OUTCOMES

After studying this unit, you would be able to:

- Go through the circumstances in which a partnership is dissolved.
- Understand that on the dissolution of a partnership all assets are sold out and all liabilities are discharged. Learn the accounting technique relating to the disposal of assets and payment of liabilities.
- Learn how to settle the partner's claims in case of surplus and how to raise money from partners in case of a deficit.
- Deal with piecemeal distribution to partners of the amount realized from assets net of liabilities.
- Winding up of a Limited Liability Partnership (LLP)

UNIT OVERVIEW

Circumstances leading to Dissolution of Partnership

- where the firm is constituted for a fixed term, on the expiry of that term
- where the firm is constituted to carry out one or more adventures or undertaking, then by completion thereof
- by the death of a partner, and
- by the adjudication of a partner as an insolvent.

Methods of piecemeal distribution

Piecemeal distribution involves either of two methods

- Maximum loss method
- Highest relative capital method

6.1 INTRODUCTION

Apart from the readjustment of rights of partners in the share of profit by way of change in the profit-sharing ratio and admission of a new partner or for retirement/death of a partner, another important aspect of partnership accounts is how to close books of accounts in case of dissolution. In this Unit, we will discuss the circumstances leading to the dissolution of a partnership firm and accounting treatment necessary to close its books of accounts. Also, we will discuss the special problems relating to the insolvency of partners and the settlement of the partnership's liabilities.

6.2 CIRCUMSTANCES LEADING TO DISSOLUTION OF PARTNERSHIP

A partnership is dissolved or comes to an end on:

(a) the expiry of the term for which it was formed;

(b) completion of the venture for which it was entered into;

(c) death of a partner;

(d) insolvency of a partner.

However, the partners or remaining partners (in case of death or insolvency) may continue to do the business. In such a case there will be a new partnership but the firm will continue. When the business comes to an end then only it will be said that the firm has been dissolved.

A firm stands dissolved in the following cases:

A firm stands dissolved in the following cases:				
(i) The partners agree that the firm should be dissolved;	(ii) All partners except one become insolvent;	(iii) The business becomes illegal;	(iv) In case of partnership at will, a partner gives notice of dissolution; and	(v) The court orders dissolution.

The court has the option to order dissolution of a firm in the following circumstances :	(a)	Where a partner has become of unsound mind;
	(b)	Where a partner suffers from permanent incapacity;
	(c)	Where a partner is guilty of misconduct of the business;
	(d)	Where a partner persistently disregards the partnership agreement;
	(e)	Where a partner transfers his interest or share to a third party;
	(f)	Where the business cannot be carried on except at a loss; and
	(g)	Where it appears to be just and equitable.

6.3 CONSEQUENCES OF DISSOLUTION

On the dissolution of a partnership, firstly, the assets of the firm, including goodwill, are realized. Then the amount realized, is applied first towards repayment of liabilities to outsiders and loans taken from partners; afterwards, the capital contributed by partners is repaid and, if there is still a surplus, it is distributed among the partners in their profit-sharing ratio.

Conversely, after payment of liabilities of the firm and repayment of loans from partners, if the assets of the firm leftover are insufficient to repay in full the capital contributed by each partner, the deficiency is borne by the partners in their profit-sharing ratio.

According to the provisions contained in section 48 of the Partnership Act, upon dissolution of the partnership, the mutual rights of the partners, unless otherwise agreed upon, are settled in the following manner:

(a) Losses including deficiencies of capital are paid, first out of profits, next out of capital, and, lastly, if necessary, by the partners individually in the proportion in which they are entitled to share profits.

(b) The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital have to be applied in the following manner and order:

(i) in paying the debts of the firm to third parties;

(ii) in paying to each partner rateably what is due to him from the firm in respect of advances as distinguished from capital;

(iii) in paying to each partner what is due to him on account of capital; and

(iv) the residue, if any, to be divided among the partners in the proportion in which they are entitled to share profits.

Distinction between Dissolution of Partnership and Dissolution of Partnership Firm

Dissolution of Partnership	Dissolution of Partnership Firm
Dissolution of a partnership refers to the discontinuance of the relation between the partners of the firm.	Dissolution of the firm implies that the entire firm ceases to exist, including the relation among all the partners.
There can be change in profit sharing ratio or admission/death/retirement of a partner.	Dissolution of partnership firm occurs.
In event of dissolution of the partnership, the business continues as usual, but the partnership is reconstituted.	In event of the dissolution of the firm, the business ceases to end.
There is no intervention by the court.	Court has the inherent power to intervene. By its order, a firm can be dissolved.
Economic relationships among partners may remain same or change.	Economic relationship among partners comes to an end.
Assets and liabilities are revalued. New balance sheet is prepared.	Assets are sold and realized. Liabilities are paid off.
Revaluation account is prepared.	Realization account is prepared.
Assets and liabilities are revalued after winding up of the existing partnership.	Assets and liabilities are settled on winding up of a firm.
Books of accounts are not closed.	Books of accounts are closed.

6.3.1 Dissolution before the expiry of a fixed term

A partner who, on admission, pays a premium to the other partners with a stipulation that the firm will not be dissolved before the expiry of a certain term, will be entitled to a suitable refund of premium or of such part as may be reasonable, if the firm is dissolved before the term has expired.

No claim in this respect will arise if:	(1)	the firm is dissolved due to the death of a partner;
	(2)	the dissolution is mainly due to the partner's (claiming refund) own misconduct; and
	(3)	the dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it.

The amount to be repaid will be such as is reasonable having regard to the terms upon which the admission was made and to the length of the period agreed upon and that already expired. Any amount that becomes due will be borne by other partners in their profit- sharing ratio.

6.4 CLOSING OF PARTNERSHIP BOOKS ON DISSOLUTION

To close books of accounts of Partnership Firm. We need to transfer all the assets and liabilities to Realization Account. Given below is the specimen of the Realization Account.

Specimen of Realization Account

Particulars	₹	Particulars	₹
To Sundry Assets (Excluding Cash/Bank, Debit Balance of P&L A/c, Partners' Current, Capital, and Loan A/cs)		By Sundry Liabilities (Excluding Credit Balance of P&L A/c, Partners' Current, Capital, and Loan A/c)	
To Bank/Cash (expenses for realization)		By Provision on Assets	
To Bank/Cash A/c (Amount paid for liabilities and unrecorded liabilities)		By Bank/Cash A/c (Amount realized from assets and unrecorded assets)	
To Partners' Capital A/cs (Expenses or Liabilities paid by partners)		By Partners' Capital A/cs (Assets taken over by partners)	
To Partners' Capital A/cs (Profit on realization distributed among partners in profit sharing ratio)		By Partners' Capital A/cs (Loss on realization distributed among partners in profit sharing ratio)	

6.4.1 Treatment of Goodwill at the time of dissolution of Firm

Treatment of Goodwill

- If Goodwill appears in the Balance Sheet, it is considered as purchased Goodwill and is treated like any other asset and is transferred to realization account.
- If Goodwill does not appear in the balance sheet, no entry is required for this.
- If something is realized or Goodwill is purchased by any one of the partners, then either Cash Account is debited or Partner's Capital A/c is debited and Realization Account is credited.

We will understand how to close the books of accounts through illustration the required journal entries to be made for closing the books of a firm with the example given below:

Balance Sheet of Fast and Quick as at Dec. 31, 2021

Liabilities		₹	***Assets***		₹
Sundry Creditors		20,000	Plant and Machinery		40,000
Fast's Loan		10,000	Patents		6,000
General Reserve		10,000	Stock		25,000
Capitals:			Sundry Debtors	19,000	
Fast	30,000		*Less:* Prov. for doubtful debts	(1,000)	18,000
Quick	25,000	55,000	Cash		6,000
		95,000			95,000

Fast and Quick share profits in the ratio of 3:2. On 1st January, 2022 the firm was dissolved. Fast took over the patents at a valuation of ₹ 5,000. The other assets realized as under:

Particulars	₹
Plant and Machinery	45,000
Stock	22,000
Sundry Debtors	18,500
Total	85,500

The Sundry Creditors were paid off at a discount of 5%. The expense amounted to ₹ 3,500. The steps to close the books are given below:

I. Open a **Realization Account** and **transfer all assets** except cash in hand or at a bank at book values. Realization Account is debited and the various assets are credited and thus closed. It should be remembered that Sundry Debtors and Provisions for Bad Debts Accounts are two separate accounts and the gross amount of debtors should be transferred. In the above example the entry will be:

Particulars		₹	₹
Realization Account	Dr.	90,000	
To Plant and Machinery Account			40,000
To Patents Account			6,000
To Stock Account			25,000
To Sundry Debtors			19,000
(Transfer of various assets to the debit side of Realization Account)			

II. **Transfer of liabilities** to outsiders and provisions and reserves against assets (e.g., Provision for Doubtful Debts) to the credit side of Realization account. The accounts of the liabilities and provisions will be debited and thus closed. The entry should be at book figures. The entry will be:

Particulars		₹	₹
Sundry Creditors Account	Dr.	20,000	
Provision for Doubtful Debts Account	Dr.	1,000	
To Realization Account			21,000
(Transfer of liabilities to outsiders and provision against debtors to Realization Account)			

Note: Accounts denoting accumulated losses or profits should not be transferred to the Realization Account.

III. (i) The Realization Account should be **credited with the actual amount realized by the sale of assets**. This should take no note of the book figures. of course, Cash (or Bank) Account will be debited. Thus:

Particulars		₹	₹
Cash Account	Dr.	85,500	
To Realization Account			85,500
(Amount realized by the sale of various assets)			

(ii) If a **partner takes over an asset**, his Capital Account should be debited and Realization Account credited with the value agreed upon, Thus:

Particulars		₹	₹
Fast's Capital Account	Dr.	5,000	
To Realization Account			5,000
(Patents taken over by Fast at ₹ 5,000)			

IV. **Expenses of dissolution** or realization of assets are debited to the Realization Account and credited to Cash Account. Thus

Particulars		₹	₹
Realization Account	Dr.	3,500	
To Cash Account			3,500
(Payment of Expenses)			

V. (i) The actual amount **paid to creditors** should be debited to the Realization Account and Cash Account is credited:

Particulars		₹	₹
Realization Account	Dr.	19,000	
To Cash Account			19,000
(Payment of Sundry Creditors ₹ 20,000 less 5%)			

(ii) If any **liability is taken over by a partner**, his Capital Account should be credited and Realization Account debited with the amount agreed upon.

VI. At this stage, the Realization Account will show **profit or loss**. If the debit side is bigger, there is a loss; if the credit side is bigger, there is a profit. Profit or loss is transferred to the Capital Accounts of partners in the profit-sharing ratio. In the case of profit, Realization Account is debited and Capital Accounts are credited. The entry for loss is, naturally, reverse of this entry. The Realization Account in the example given above shows a loss of ₹ 1,000 (see account below).

Particulars		₹	₹
Fast's Capital Account	Dr.	600	
Quick's Capital Account	Dr.	400	
To Realization Account			1,000
(Transfer of loss to Capital Account in the ratio of 3:2)			

VII. **Partner's Loans** if any, should now be paid. The entry is to debit the Loan Account and credit Cash Account. Thus:

Particulars		₹	₹
Fast's Loan Account	Dr.	10,000	
To Cash Account			10,000
(Repayment of Fast's Loan)			

VIII. Any reserve of accumulated profit or loss lying in the books (as shown by the Balance Sheet) should be transferred to the Capital Account in the profit-sharing ratio. Thus:

Particulars		₹	₹
General Reserve	Dr.	10,000	
To Fast's Capital Account			6,000
To Quick's Capital Account			4,000
(General Reserve transferred to Capital Account in the ratio of 3:2)			

IX. At this stage the Capital Accounts of partners will show how much amount is due to them or from them. The partner owing money to the firm will pay; Cash Account will be debited and his Capital Account credited and thus closed. Money owing to a partner will be paid to him; his Capital Account will be debited and the Cash Account credited. This will close the Capital Accounts' as well as the Cash Account. The entry in the above example is seen in the Capital Accounts below:

Particulars		₹	₹
Fast's Capital Account	Dr.	30,400	
Quick's Capital Account	Dr.	28,600	
To Cash Account			59,000
(Amount paid to partners on Capital Account)			

Ledger Accounts

Plant and Machinery Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	40,000	Jan. 1	By Realization A/c – Transfer	40,000

Patents Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	6,000	Jan. 1	By Realization A/c – Transfer	6,000

Stock Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	25,000	Jan. 1	By Realization A/c – Transfer	25,000

Sundry Debtors Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	19,000	Jan. 1	By Realization A/c – Transfer	19,000

Provision for Doubtful Debts Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c		Jan. 1	By Balance b/d	1,000
	Transfer	1,000			

Sundry Creditors Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c -Transfer	20,000	Jan. 1	By Balance b/d	20,000

Fast's Loan Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Cash Account	10,000	Jan. 1	By Balance b/d	10,000

General Reserve Account

2022	Particulars		₹	2022	Particulars	₹
Jan. 1	To Capital Accounts			Jan. 1	By Balance b/d	10,000
	Fast	6,000				
	Quick	4,000	10,000			
			10,000			10,000

Realization Account

2022	Particulars	₹	2022	Particulars		₹
Jan. 1	To Sundry Assets		Jan. 1	By Sundry Creditors		20,000
	Plant and Machinery	40,000		By Provision for Doubtful Debts		1,000
	Patents	6,000		By Cash Account-		85,500
	Stock	25,000		assets realized		

	Sundry Debtors	19,000		By Fast's Capital Account-patents taken over		5,000
	To Cash Account-Exp.	3,500		By Loss to:		
	To Cash Account-Creditors paid	19,000		Fast	600	
				Quick	400	1,000
		1,12,500				1,12,500

Cash Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	6,000	Jan. 1	By Realization A/c-Expenses	3,500
	To Realization b/d	85,500	Jan. 1	By Realization A/c-Creditors	19,000
			Jan. 1	By Fast's Loan Account	10,000
			Jan. 1	By Fast's Capital A/c	30,400
			Jan. 1	By Quick's Capital A/c	28,600
		91,500			91,500

Fast's Capital Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c-Patents	5,000	Jan. 1	By Balance b/d	30,000
	To Realization A/c-Loss	600	Jan. 1	By General Reserve	6,000
	To Cash Account	30,400			
		36,000			36,000

Quick's Capital Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c-loss	400	Jan. 1	By Balance b/d	25,000
	To Cash Account	28,600		By General Reserve	4,000
		29,000			29,000

Note:

(1) If any of the assets are taken over by a partner at a value mutually agreed to by the partners, debit the Partner's Capital Account and credit Realization Account with the price of asset taken over.

(2) Pay off the liabilities, crediting cash, and debiting the liability accounts, the difference between the book figure and the amount paid being transferred to the Realization Account.

(3) Liabilities to outsiders may also be transferred to the Realization Account. In that case, the amount paid in respect of the liabilities in cash should be debited to the Realization Account, Cash Account being credited. If liability is taken over by a partner, Realization Account should be debited and the Partners' Capital A/cs credited at the figure agreed upon.

(4) The balance of the Realization Account will represent either the profit or loss on realization. Divide it between the partners in the proportion in which they shared profits and losses. In the case of a loss, credit Realization Account and debit various partners' Capital Accounts; follow the opposite course in the case of a profit.

(5) Pay off the partners' loans or advances which are separate from the capital (if any) contributed by them, after setting off against them any debit balance in the capital account of the concerned partner.

(6) The balance of the cash account at the end will be exactly equal to the balance of capital account, provided they are in credit; credit cash, and debit the partners' capital account with the amount payable to them to close their accounts.

ILLUSTRATION 1

X, Y, and Z are partners of the firm XYZ and Co., sharing Profits and Losses in the ratio of 4: 3: 2. Following is the Balance Sheet of the firm as on 31st March, 2022:

Balance Sheet as on 31st March, 2022

Liabilities	₹	***Assets***	₹
Partners' Capitals:		Fixed Assets	5,00,000
X	4,00,000	Stock in trade	3,00,000
Y	3,00,000	Sundry debtors	5,00,000
Z	2,00,000	Cash in hand	10,000
General Reserve	90,000		
Sundry Creditors	3,20,000		
	13,10,000		13,10,000

Partners of the firm decided to dissolve the firm on the above-said date.

Fixed assets realized ₹5,20,000 and book debts ₹4,40,000.

Stocks were valued at ₹2,50,000 and it was taken over by partner Y.

Creditors allowed discount of 5% and the expenses of realization amounted to ₹6,000.

You are required to prepare:

(i) Realization account;

(ii) Partners capital account; and

(iii) Cash account.

SOLUTION

(i) **Realization Account**

Particulars	₹	Particulars	₹
To Fixed assets	5,00,000	By Creditors	3,20,000
To Stock in trade	3,00,000	By Cash (5,20,000+4,40,000)	9,60,000
To Debtors	5,00,000	By Y (Stock taken over)	2,50,000
To Cash – Expenses	6,000	By Loss transferred to partners' capital accounts	
To Cash -Creditors		X	35,555
(3,20,000 x 95%)	3,04,000	Y	26,667
		Z	17,778
	16,10,000		16,10,000

(ii) **Partners' Capital Accounts**

Particulars	X	Y	Z	Particulars	X	Y	Z
	₹	₹	₹		₹	₹	₹
To Realization Account	35,555	26,667	17,778	By Balance b/d	4,00,000	3,00,000	2,00,000
To Realization Account	-	2,50,000	-	By General reserve	40,000	30,000	20,000
To Cash	4,04,445	53,333	2,02,222				
	4,40,000	3,30,000	2,20,000		4,40,000	3,30,000	2,20,000

(iii) **Cash Account**

Particulars	₹	Particulars	₹
To Balance b/d	10,000	By Realization A/c (Expenses)	6,000
To Realization A/c (Fixed assets and book debts realized)	9,60,000	By Realization A/c (Creditors)	3,04,000
		By X	4,04,445

		By Y	53,333
		By Z	2,02,222
	9,70,000		9,70,000

6.5 CONSEQUENCES OF INSOLVENCY OF A PARTNER

If the capital account of a partner is in debit, after his share of loss or profit has been adjusted therein, the firm will not have sufficient cash or assets to pay off the amounts due to the other partners, until the amount is repaid by the partner whose account is in debit. If however, the partner is insolvent, the amount will not be realized. In such a case, the deficiency may be borne by the solvent partners in their profit-sharing ratio or according to the principle settled in the well-known case of *Garner* vs. *Murray*. In the latter case, the deficiency would be borne by the solvent partners in proportion to their capitals and not in the proportion in which they share profits and losses.

If a partner goes insolvent then the following are the consequences:			
1. The partner adjudicated as insolvent ceases to be a partner on the date on which the order of adjudication is made.	2. The firm is dissolved on the date of the order of adjudication unless there is a contract to the contrary.	3. The estate of the insolvent partner is not liable for any act of the firm after the date of the order of adjudication, and	4. The firm cannot be held liable for any acts of the insolvent partner after the date of the order of adjudication.

6.6 LOSS ARISING FROM INSOLVENCY OF A PARTNER

When a partner is unable to pay his debt due to the firm, he is said to be insolvent and the share of loss is to be borne by other solvent partners following the decision in the English case of Garner vs. Murray.

According to this decision, solvent partners have to bear the loss due to insolvency of a partner and have to categorically put that the normal loss on realization of assets to be borne by all partners (including insolvent partner) in the profit-sharing ratio but a loss due to insolvency of a partner has to be borne by the solvent partners in the capital ratio.

The determination of capital ratio for this has been explained below. The provisions of the Indian Partnership Act are not contrary to Garner vs. Murray rule. However, if the partnership deed provides for a specific method to be followed in case of insolvency of a partner, the provisions as per the deed should be applied.

Capital Ratio on Insolvency

- The partners are free to have either fixed or fluctuating capitals in the firm.
- If they are maintaining capitals at fixed amounts then all adjustments regarding their share of profits, interest on capitals, drawings, interest on drawings, salary, etc. are done through Current Accounts, which may have debit or credit balances, and insolvency loss is distributed in the ratio of fixed capitals.
- But if capitals are not fixed and all transactions relating to drawings, profits, interest, etc., are passed through Capital Accounts then Balance Sheet of the business should not exhibit Current Accounts of the partners and capital ratio will be determined after adjusting all the reserves and accumulated profits to the date of dissolution, all drawings to the date of dissolution, all interest on capitals and drawings to the date of dissolution but before adjusting profit or loss on Realization Account.
- If some partner is having a debit balance in his Capital Account and is not insolvent then he cannot be called upon to bear the loss on account of the insolvency of other partner.

Insolvency of all Partners

- When the liabilities of the firm cannot be paid in full out of the firm's assets as well as personal assets of the partners, then all the partners of the firm are said to be insolvent. Under such circumstances, it is better not to transfer the amount of creditors to Realization Account. The balance of the creditors' accounts is transferred to Deficiency Account.
- Creditors may be paid the amount available including the amount contributed by the partners.
- The unsatisfied portion of the creditor account is transferred to the Capital Accounts of the partners in the profit-sharing ratio. Then Capital Accounts are closed. In doing so first close the Partners' Capital Account which is having the worst position. The last account will be automatically closed.

ILLUSTRATION 2

P, Q, and R were partners sharing profits and losses in the ratio of 3: 2: 1, no partnership salary or interest on capital being allowed. Their balance sheet on 30th June, 2022 is as follows:

Liabilities		₹	***Assets***	₹
Fixed Capital			*Fixed Assets:*	
P	*20,000*		*Trademark*	*40,000*
Q	*20,000*		*Freehold Property*	*8,000*

R	10,000	50,000	Plant and Equipment	12,800
Current Accounts:			Motor Vehicle	700
P	500		Current Assets	
Q	9,000	9,500	Stock	3,900
Loan from P		8,000	Trade Debtors 2,000	
Trade Creditors		12,400	Less: Provision (100)	1,900
			Cash at Bank	200
			Miscellaneous losses	
			R's Current Account	400
			Profit and Loss Account	12,000
		79,900		79,900

On 1st July, 2022 the partnership was dissolved. Motor Vehicle was taken over by Q at a value of ₹ 500 but no cash passed specifically in respect of this transaction. Sale of other assets realized the following amounts:

	₹
Trademark	Nil
Freehold Property	7,000
Plant and Equipment	5,000
Stock	3,000
Trade Debtors	1,600

Trade Creditors were paid ₹ 11,700 in full settlement of their debts. The costs of dissolution amounted to ₹ 1,500. The loan from P was repaid, P and Q were both fully solvent and able to bring in any cash required but R was forced into bankruptcy and was only able to bring 1/3 of the amount due.

Required

(a) Cash and Bank Account,

(b) Realization Account, and

(c) Partners Fixed Capital Accounts (after transferring Current Accounts' balances).

SOLUTION

Cash / Bank Account

Particulars	₹	Particulars	₹
To Balance b/d	200	By Realization A/c- Creditors	11,700
To Realization A/c-		By Realization A/c- Expenses	1,500
Freehold property	7,000	By P's Loan A/c	8,000

Plant and Equipment		5,000	By P's Capital A/c	14,200
Stock		3,000	By Q's Capital A/c	24,200
Trade Debtors		1,600		
To Capital Accounts:				
P	25,500			
Q	17,000			
R	300	42,800		
		59,600		59,600

Realization Account

Particulars	₹	***Particulars***		₹
To Trademark	40,000	By Trade Creditors		12,400
To Freehold Property	8,000	By Provision for Bad Debts		100
To Plant and Equipment	12,800	By Bank:		
To Motor Vehicle	700	Freehold Property	7,000	
To Stock	3,900	Plant and Equip.	5,000	
To Sundry Debtors	2,000	Stock	3,000	
To Bank (Creditors)	11,700	Debtors	1,600	16,600
To Bank (Expenses)	1,500	By Q (Car)		500
		By Capital Accounts: (Loss)		
		P	25,500	
		Q	17,000	
		R	8,500	51,000
	80,600			80,600

Partners' Capital Accounts

Particulars	***P*** ₹	***Q*** ₹	***R*** ₹	***Particulars***	***P*** ₹	***Q*** ₹	***R*** ₹
To Current A/c (Transfer) (WN)	5,500	—	2,400	By Balance b/d	20,000	20,000	10,000
To Realization A/c (Loss)	25,500	17,000	8,500	By Current A/c (Transfer) (WN)	—	5,000	—
To Realization A/c (Car)	—	500	—	By Bank	—	—	300
				By Bank	25,500	17,000	—
To R's Capital A/c	300	300	—	(realization			

	(Deficiency)				loss)			
To	Bank	14,200	24,200	—	By P & Q (Deficiency)	—	—	600
		45,500	42,000	10,900		45,500	42,000	10,900

Working Note

Particulars	P	Q	R
Current Account Balance	500 (Cr)	9000 (Cr)	400 (Dr)
Less: share of Profit & Loss A/c (debit balance)	6000 (Dr)	4000 (Dr)	2000 (Dr)
Adjusted Current Account Balance	5500 (Dr)	5000 (Cr)	2400 (Dr)

Note:

1. P, Q, and R will bring cash to make good their share of the loss on realization. In actual practice they will not be bringing any cash; only a notional entry will be made.
2. On following Garner Vs. Murray rule, solvent partners P and Q have to bear the loss due to insolvency of a partner R in their fixed capital ratio.

ILLUSTRATION 3

Amal and Bimal are in equal partnership. Their Balance Sheet stood as under on 31st March, 2021 when the firm was dissolved:

Liabilities	***₹***	***Assets***	***₹***
Creditors A/c	*4,800*	*Plant & Machinery*	*2,500*
Amal's Capital A/c	*750*	*Furniture*	*500*
		Debtors	*1,000*
		Stock	*800*
		Cash	*200*
		Bimal's drawings	*550*
	5,550		*5,550*

The assets realized as under:

Particulars	***₹***
Plant & Machinery	*1,250*
Furniture	*150*
Debtors	*400*
Stock	*500*

The expenses of realization amounted to ₹ 175. Amal's private estate is not sufficient even to pay his private debts, whereas Bimal's private estate has a surplus of ₹ 200 only.

Show necessary ledger accounts to close the books of the firm.

SOLUTION

In the books of M/s Amal and Bimal

Realization Account

Particulars	₹	***Particulars***		₹
To Sundry Assets:		By Cash A/c:		
Plant & Machinery	2,500	Plant & Machinery	1,250	
Furniture	500	Furniture	150	
Debtors	1,000	Debtors	400	
Stock	800	Stock	500	2,300
Cash A/c-expenses	175	By Partners' Capital A/c		
		Loss on realization (Bal. fig.)		
		Amal	1,337	
		Bimal	1,338	2,675
	4,975			4,975

Cash Account

Particulars	₹	***Particulars***	₹
To Balance b/d	200	By Realization A/c- expenses	175
To Realization A/c		By Sundry Creditors A/c (Bal. fig.)	2,525
- Sale of sundry assets	2,300		
To Bimal's Capital A/c	200		
	2,700		2,700

Sundry Creditors Account

Particulars	₹	***Particulars***	₹
To Cash A/c	2,525	By Balance b/d	4,800
To Deficiency A/c-transfer (bal. fig.)	2,275		
	4,800		4,800

Partners' Capital Accounts

Particulars	***Amal(₹)***	***Bimal (₹)***	***Particulars***	***Amal (₹)***	***Bimal (₹)***
To Balance b/f	—	550	By Balance b/f	750	—
To Realization A/c			By Cash A/c	—	200
- loss	1,337	1,338	By Deficiency		
			A/c- transfer (bal. fig.)	587	1,688
	1,337	1,888		1,337	1,888

Deficiency Account

Particulars	***₹***	***Particulars***	***₹***
To Partners' Capital A/c		By Sundry Creditors A/c	2,275
Amal	587		
Bimal	1,688		
	2,275		2,275

ILLUSTRATION 4

A, B, C, and D sharing profits in the ratio of 4:3:2:1 decided to dissolve their partnership on 31st March 2022 when their balance sheet was as under:

Liabilities	***₹***	***Assets***	***₹***
Creditors	*15,700*	*Bank*	*535*
Employees Provident Fund	*6,300*	*Debtors*	*15,850*
Capital Accounts:		*Stock*	*25,200*
A 40,000		*Prepaid Expenses*	*800*
B 20,000	*60,000*	*Plant & Machinery*	*20,000*
		Patents	*8,000*
		C's Capital A/c	*3,200*
		D's Capital A/c	*8,415*
	82,000		*82,000*

Following information is given to you: -

1. *One of the creditors took some of the patents whose book value was ₹ 5,000 at a valuation of ₹ 3,200. Balance of the creditors were paid at a discount of ₹ 400.*

2 *There was a joint life policy of ₹ 20,000 (not mentioned in the balance sheet) and this was surrendered for ₹ 4,500.*

3 *The remaining assets were realized at the following values: - Debtors ₹ 10,800; Stock ₹ 15,600; Plant and Machinery ₹ 12,000; and Patents at 60% of their book-values. Expenses of realization amounted to ₹ 1,500.*

D became insolvent and a dividend of 25 paise in a rupee was received in respect of the firm's claim against his estate. Prepare necessary ledger accounts.

SOLUTION

Realization Account

Particulars		₹	***Particulars***		₹
To Sundry Assets: -			By Creditors		15,700
Debtors	15,850		By Employee's Provident Fund		6,300
Stock	25,200				
Prepaid Expenses	800		By Bank A/c:		
Plant & Machinery	20,000		Joint Life Policy	4,500	
Patents	8,000	69,850	Debtors	10,800	
To Bank-Creditors: (₹ 15,700 –₹ 3,200 -₹ 400)		12,100	Stock	15,600	
			Plant and Machinery	12,000	
To Bank A/c Employee's (P.F)		6,300	Patents 60% of (₹ 8,000 – ₹ 5,000)	1,800	44,700
To Bank A/c (expenses)		1,500	By Loss transferred to:		
			A's Capital A/c	9,220	
			B's Capital A/c	6,915	
			C's Capital A/c	4,610	
			D's Capital A/c	2,305	23,050
		89,750			89,750

Capital Accounts

Particulars	**A (₹)**	**B (₹)**	**C (₹)**	**D (₹)**	**Particulars**	**A (₹)**	**B (₹)**	**C (₹)**	**D (₹)**
To Bal. b/d	—	—	3,200	8,415	By Bal. b/d	40,000	20,000	—	—
To Realization A/c	9,220	6,915	4,610	2,305	By Bank (Realization loss)	9,220	6,915	4,610	—
To D's Capital (Deficiency)	5,360	2,680	—	—	By Bank (Recovery)	—	—	—	2,680
To Bank	34,640	17,320	—	—	By A's Capital (2/3)	—	—	—	5,360

					By B's Capital (1/3)	—	—	—	2,680
					By Bank A/c		—	3,200	—
	49,220	26,915	7,810	10,720		49,220	26,915	7,810	10,720

Bank Account

Particulars	₹	***Particulars***	₹
To Balance b/d	535	By Realization A/c	12,100
To Realization A/c	44,700	By Realization A/c	6,300
To A's Capital A/c	9,220	By Realization A/c	1,500
To B's Capital A/c	6,915	By A's Capital A/c	34,640
To D's Capital A/c	2,680	By B's Capital A/c	17,320
To C's Capital A/c (4,610 + 3,200)	7,810		
	71,860		71,860

Working Note

D's loss will be borne by A and B only because only solvent partners having credit balance has to bear the loss on account of insolvency. C will bring his share of loss in cash.

ILLUSTRATION 5

M/s X, Y, and Z who were in partnership sharing profits and losses in the ratio of 2:2:1 respectively, had the following Balance Sheet as on December 31, 2022:

Liabilities		₹	₹	***Assets***	₹	₹
Capital:	*X*	*29,200*		*Fixed Assets*		*40,000*
	Y	*10,800*		*Stock*		*25,000*
	Z	*10,000*	*50,000*	*Book Debts*	*25,000*	
Z's Loan			*5,000*	*Less: Provision*	*(5,000)*	*20,000*
Loan from Mrs. X			*10,000*	*Cash*		*1,000*
Sundry Trade Creditors			*25,000*	*Advance to Y*		*4,000*
			90,000			*90,000*

The firm was dissolved on the date mentioned above due to continued losses. After drawing up the balance sheet given above, it was discovered that goods amounting to ₹ 4,000 have been purchased in November, 2022 and had been received but the purchase was not recorded in books.

Fixed assets realized ₹ 20,000; Stock ₹ 21,000 and Book Debt ₹ 20,500. Similarly, the creditors allowed a discount of 2% on average. The expenses of realization come to ₹ 1,080. X agreed to take over the loan of Mrs. X. Y is insolvent, and his estate is unable to contribute anything.

Give accounts to close the books; work according to the decision in Garner vs. Murray.

SOLUTION

Realization Account

Particulars	₹	***Particulars***		₹
To Sundry		By Provision for Doubtful Debts		5,000
Fixed Assets (transfer)	40,000	By Cash (20,000+21,000+20,500)		61,500
Stock	25,000	By Sundry Trade Creditors		
Book Debts	25,000	(Discount)		29,000
To Cash—Expenses	1,080	By Loss: X (2/5)	9,600	
- Creditors	28,420	Y (2/5)	9,600	
		Z (1/5)	4,800	24,000
	1,19,500			1,19,500

Sundry Trade Creditors

Particulars	₹	***Particulars***	₹
To Realization A/c	29,000	By Balance b/d	25,000
		By Partners Capital Accounts	
		(Purchase omitted)	4,000
	29,000		29,000

Z's Loan Account

Particulars	₹	***Particulars***	₹
To Cash Account	5,000	By Balance b/d	5,000

Mrs. X's Loan Account

Particulars	₹	***Particulars***	₹
To X's Capital A/c – transfer	10,000	By Balance b/d	10,000

Cash Account

Particulars	₹	Particulars	₹
To Balance b/d	1,000	By Sundry Trade Creditors (after deducting discount of 2%)	28,420
To Realization A/c-		By Realization A/c – expenses	1,080
assets realized	61,500	By Z's Loan	5,000
To X's Capital A/c*	9,600	By X's Capital A/c	34,300
To Z's Capital A/c*	4,800	By Z's Capital A/c	8,100
	76,900		76,900

*X and Z bring these amounts to make good their share of the loss on realization. In actual practice they will not be bringing any cash; only a notional entry will be made.

Capital Accounts

Particulars	X(₹)	Y (₹)	Z (₹)	Particulars	X (₹)	Y (₹)	Z (₹)
To Sundry Trade Creditors- omission	1,600	1,600	800	By Balance b/d	29,200	10,800	10,000
To Balance c/d	27,600	9,200	9,200				
	29,200	10,800	10,000		29,200	10,800	10,000
To Advance	-	4,000	-	By Balance b/d	27,600	9,200	9,200
To Realization A/c- loss	9,600	9,600	4,800	By Mrs. X's Loan	10,000	-	-
To Y's Capital A/c	3,300	-	1,100	By Cash (Realization loss)	9,600	-	4,800
				By X's Capital A/c		3,300	
To Cash	34,300	-	8,100	By Z's Capital A/c	-	1,100	-
	47,200	13,600	14,000		47,200	13,600	14,000

Note: Y's deficiency comes to ₹ 4,400 (difference in the two sides of his Capital Account); this has been debited to X and Z in the ratio of 27,600: 9,200 *i.e.*, capital standing up just before dissolution but after correction of error committed while drawing up the accounts for 2022.

6.7 PIECEMEAL PAYMENTS

Generally, the assets sold upon dissolution of partnership are realized only in small instalments over a period of time. In such circumstances, the choice is either to distribute whatever is collected or to wait till the whole amount is collected. Usually, the first course is adopted. In order to ensure that the distribution of cash among the partners is in proportion to their interest in the partnership concern either of the two methods described below may be followed for determining the order in which the payment should be made.

6.7.1 Maximum Loss Method

Each installment realized is considered to be the final payment *i.e.*, outstanding assets and claims are considered worthless and partners' accounts are adjusted on that basis each time when a distribution is made, following either *Garner* vs. *Murray* Rule or the profit-sharing ratio rule.

ILLUSTRATION 6

A, B, and C are partners sharing profits and losses in the ratio of 5:3:2. Their capitals were ₹ 9,600, ₹ 6,000 and ₹ 8,400 respectively.

After paying creditors, the liabilities and assets of the firm were:

Liabilities	***₹***	***Assets***	***₹***
Liability for interest on loans from:		*Investments*	*1,000*
Spouses of partners	*2,000*	*Furniture*	*2,000*
Partners	*1,000*	*Machinery*	*1,200*
		Stock	*4,000*

The assets realized in full in the order in which they are listed above. B is insolvent.

You are required to prepare a statement showing the distribution of cash as and when available, applying the maximum possible loss procedure.

SOLUTION

Statement of Distribution of Cash

Realization		Interest on loans from partner's spouses	Interest on loans from partners	Partners Capitals			Total
				A	B	C	
₹		₹	₹	₹	₹	₹	₹
Balances due (1)		2,000	1,000	9,600	6,000	8,400	24,000
(i) Sale of Investments	1,000	(1,000)					
		1,000	1,000				
(ii) Sale of furniture	2,000	(1,000)	(1,000)				
(iii) Sale of machinery	1,200						
Maximum possible loss ₹ 22,800 (total of capitals ₹ 24,000 less Cash available ₹ 1,200) allocated to partners in the profit sharing ratio i.e. 5:3: 2				(11,400)	(6,840)	(4,560)	(22,800)
Amounts at credit				(1,800)	(840)	3,840	1,200
Deficiency of A and B written off against C				1,800	840	(2,640)	

Amount paid (2)				-	-	1,200	1,200
Balances in capital accounts (1-2) = (3)				9,600	6,000	7,200	22,800
(iv) Sale of stock 4,000							
Max. possible loss 22,800-4,000= 18,800							
allocated to partner's in the ratio 5:3:2				(9,400)	(5,640)	(3,760)	(18,800)
Amounts at credit and cash paid (4)				200	360	3,440	4,000
Balances in capital accounts left unpaid - Loss (3-4) = (5)				9,400	5,640	3,760	18,800

ILLUSTRATION 7

The following is the Balance Sheet of A, B, C on 31st December, 2022 when they decided to dissolve the partnership:

Liabilities	₹	Assets	₹
Creditors	2,000	Sundry Assets	48,500
A's Loan	5,000	Cash	500
Capital Accounts:			
A	15,000		
B	18,000		
C	9,000		
	49,000		49,000

The assets realized the following sums in installments:

I	1,000
II	3,000
III	3,900
IV	6,000
V	20,100[1]
	34,000

The expenses of realization were expected to be ₹ 500 but ultimately amounted to ₹ 400 only. Show how at each stage the cash received should be distributed between partners. They share profits in the ratio of 2:2:1.

SOLUTION

First of all, the following table will be constructed to show the amounts available for distribution among the various interests:

Statement showing Realization and Distribution of Cash Payments

Particulars	Realization ₹	Creditors ₹	Partners' Loan ₹	Partners' Capitals ₹
1. After taking into account cash balance and amount set aside for expenses	1,000	1,000	-	-

[1] *includes saving in expenses i.e. ₹ 100 (₹ 500 - ₹ 400).*

2.	3,000	1,000	2,000	-
3.	3,900	-	3,000	900
4.	6,000	-	-	6,000
Including saving in expenses	20,100	-	-	20,100
	34,000	2,000	5,000	27,000

To ascertain the amount distributable out of each installment realized among the partners, the following table will be constructed:

Statement of Distribution on Capital Accounts

(1) Calculation to determine the mode of distribution of ₹ 900

Particulars	***Total (₹)***	***A (₹)***	***B (₹)***	***C (₹)***
Balance	42,000	15,000	18,000	9,000
Less: Possible loss, should remaining assets prove to be worthless (in their profit-sharing ratio)	(41,100)	(16,440)	(16,440)	(8,220)
	+ 900	– 1,440	+ 1,560	+ 780
Deficiency of A's capital written off against those of B and C in the ratio of their capital, 18,000:9,000 (*Garner* vs. *Murray*)			(960)	(480)
Manner in which the first ₹ 900 should be distributed			+ 600	+ 300

(2) Distribution of ₹ 6,000

Balance after making payment of amount shown in step (1)	41,100	15,000	17,400	8,700
Less: Possible Loss assuming remaining asset to be valueless (in their profit sharing ratio)	(35,100)	(14,040)	(14,040)	(7,020)
Balance available and to be distributed	6,000	960	3,360	1,680

(3) Distribution of ₹ 20,100

Balance after making payment of amount shown in step (2)	35,100	14,040	14,040	7,020
Less: Possible loss, assuming remaining				

assets to be valueless (in their profit sharing ratio)	(15,000)	(6,000)	(6,000)	(3,000)
Manner of distribution of ₹ 20,100	20,100	8,040	8,040	4,020
Summary:				
Balance	42,000	15,000	18,000	9,000
Total amounts paid	27,000	9,000	12,000	6,000
Loss	15,000	6,000	6,000	3,000

6.7.2 Highest Relative Capital Method

According to this method, the partner who has the higher relative capital, that is, whose capital is greater in proportion to his profit-sharing ratio, is first paid off. This method is also called as proportionate capital method.

For determining the amount by which the capital of each partner is in excess of his relative capital, partners' capitals are first divided by figures that are in proportion to their profit-sharing ratio; the smallest quotient will indicate the basic capital. Having ascertained the partner who has the smallest basic capital, the amount of capital of other partners proportionate to the profit-sharing ratio of the basic capital is calculated. These may be called as their hypothetical capitals. The amount of hypothetical capital of each partner is then subtracted from the amount of his actual capital; the resultant figure will be the amount of excess capital held by him. By repeating the process once or twice, as may be necessary between the partners having excess capital, the amount by which the capital of each partner is in excess will be ascertained. The partner with the largest excess capital will be paid off first, followed by payment to the other or others who rank next to him until the capitals of partners are reduced to their profit-sharing ratio.

The illustration given above is now worked out according to this method.

Particulars	***A***	***B***	***C***
Capital	₹ 15,000	18,000	9,000
Profit-sharing ratio	2	2	1
Capital divided by the profit-sharing ratio	7,500	9,000	9,000
Proportionate Capital of B and C, taking			
A's capital as the base	₹ 15,000	15,000	7,500
Excess of actual over proportionate capital	₹ nil	3,000	1,500

This indicates that A should not get anything till ₹ 3,000 is paid to B and ₹ 1,500 is paid to C. Since capital of B and C are already according to their mutual profit-sharing ratio (2:1), they will share the available cash in this ratio.

After paying off creditors and A's loan, the available amount will be distributed as below in this method:

Particulars	***Total***	***A***	***B***	***C***
		₹	₹	₹
Third Installment	900	-	600	300
Fourth Installment (i)	3,600	-	2,400	1,200
(ii)	2,400	960	960	480
Fifth Installment	20,100	8,040	8,040	4,020
Total	27,000	9,000	12,000	6,000

Total payment made to each partner will, of course be same under both the methods.

ILLUSTRATION 8

A partnership firm was dissolved on 30th June, 2022. Its Balance Sheet on the date of dissolution was as follows:

Liabilities	₹	₹	*Assets*	₹
Capitals:			*Cash*	*10,800*
A	*76,000*		*Sundry Assets*	*1,89,200*
B	*48,000*			
C	*36,000*	*1,60,000*		
Loan A/c – B		*10,000*		
Sundry Creditors		*30,000*		
		2,00,000		*2,00,000*

The assets were realized in instalments and the payments were made on the proportionate capital basis. Creditors were paid ₹ 29,000 in full settlement of their account. Expenses of realization were estimated to be ₹ 5,400 but actual amount spent was ₹ 4,000. This amount was paid on 15th September. Draw up a statement showing distribution of cash, which was realized as follows:

	₹
On 5th July, 2022	*25,200*
On 30th August, 2022	*60,000*
On 15th September, 2022	*80,000*

The partners shared profits and losses in the ratio of 2 : 2 : 1. Prepare a statement showing distribution of cash amongst the partners by 'Highest Relative Capital' method.

SOLUTION

Statement showing distribution of cash amongst the partners

	Creditors	*B's Loan*	*A*	*B*	*C*
2022	₹	₹	₹	₹	₹
June 30					
Balance b/d	30,000	10,000	76,000	48,000	36,000
Cash balance less Provision for expenses (₹ 10,800 – ₹ 5,400)	5,400	-	-	-	-
Balances unpaid	24,600	10,000	76,000	48,000	36,000
July 5					
1st Instalment of ₹ 25,200	23,600	1,600	-	-	-
Discount received on full settlement	1,000	8,400	76,000	48,000	36,000
Less: Transferred to Realisation A/c	1,000				
	Nil				
August 30					
2nd instalment of ₹ 60,000 (W.N. 2)		8,400	32,640	4,640	14,320
Balance unpaid		Nil	43,360	43,360	21,680
September 15					
Amount realised ₹ 80,000					
Add: Balance out of the Provision for Expenses A/c 1,400					
81,400			32,560	32,560	16,280
Amount unpaid being loss on Realisation in the ratio of 2 : 2 : 1			10,800	10,800	5,400

Working Notes:

1. Highest relative capital basis

		A	B	C
		₹	₹	₹
1.	Present Capitals	76,000	48,000	36,000
2.	Profit-sharing ratio	2	2	1
3	Capital per unit of Profit share (1 ÷ 2)	38,000	24,000	36,000
4.	Proportionate capitals taking B, whose capital is the least, as the basis	48,000	48,000	24,000
5.	Excess capital (1-4)	28,000	Nil	12,000
6.	Profit-sharing ratio	2	-	1
7.	Excess capital per unit of Profit share (5 ÷ 6)	14,000		12,000
8.	Proportionate capitals as between A and C taking C capital as the basis	24,000	-	12,000
9.	Excess of A's Capital over C's Excess capital (5-8)	4,000	-	-
10.	Balance of Excess capital (5-9)	24,000		12,000
11.	Distribution sequence:			
	First ₹ 4,000 (2 : 0 : 0)	4,000	-	-
	Next ₹ 36,000 (2 : 0 : 1)	24,000	-	12,000
	Over ₹ 40,000 (2 : 2 : 1)			

2. Distribution of Second instalment

			Creditors	A	B	C
First	₹ 8,400		8,400	-	-	-
Next	₹ 4,000	(2 : 0 : 0)		4,000	-	-
Next	₹ 36,000	(2 : 0 : 1)		24,000	-	12,000
Balance	₹ 11,600	(2 : 2 : 1)		4,640	4,640	2,320
	60,000		8,400	32,640	4,640	14,320

6.8 WINDING UP OF A LIMITED LIABILITY PARTNERSHIP (LLP)

The winding up of a LLP may be either voluntary or by the Tribunal and LLP, so wound up may be dissolved.

Winding up of a LLP may be initiated by Tribunal if:

- The LLP wishes to wind up;
- The LLP has less than 2 partners for more than 6 months;
- The LLP is unable to pay its debts;
- The LLP has not acted in the interest of the sovereignty and the integrity of India;
- The LLP has failed to submit with the statements of accounts and solvency or the LLP annual returns for more than five consecutive financial years with the Registrar;
- The Tribunal thinks that it is Just and Equitable that the LLP should be wound up.

The Central Government may make rules for the provisions in relation to winding up and dissolution of LLP.

ILLUSTRATION 9

P and Q were partners sharing profits equally in LLP. Their Balance Sheet as on March 31, 2022 was as follows:

Balance Sheet as on 31st March, 2022

Equity and Liabilities		₹	Assets	₹
Capitals:			Bank	30,000
P	1,00,000		Debtors	25,000
Q	50,000	1,50,000	Stock	35,000
Creditors		20,000	Furniture	40,000
Q's current account		10,000	Machinery	60,000
Reserves		15,000	P's current account	10,000
Bank overdraft		5,000		
		2,00,000		2,00,000

The firm was dissolved on the above date:

P took over 50% of the stock at 10% less on its book value, and the remaining stock was sold at a gain of 15%. Furniture and Machinery realized for ₹ 30,000 and ₹ 50,000 respectively; There *was an unrecorded investment which was sold for ₹ 25,000; Debtors realized 90% only and ₹ 1,245 were recovered for bad debts written off last year. There was an outstanding bill for repairs which had to be paid for ₹ 2,000.*

You are required to prepare Realization Account, Partners' capital accounts (including transfer of current account balances) and Bank Account in the books of the firm.

SOLUTION

Books of P & Q LLP.

Realization Account

Particulars		₹	Particulars		₹
To Debtors	25,000		By Creditors		20,000
To Stock	35,000		By Bank overdraft		5,000
To Furniture	40,000		By Bank:		
To Machinery	60,000	1,60,000	Investment	25,000	
To Bank:			Furniture	30,000	
Creditors	20,000		Machinery	50,000	
Bank overdraft	5,000		Debtors (90%)	22,500	
Outstanding bill	2,000	27,000	Stock	20,125	
To Profit transferred to:			Bad debts Recovered	1,245	1,48,870
P's capital	1,310		By P's capital		15,750
Q's capital	1,310	2,620	(stock taken over)		
		1,89,620			1,89,620

Partners' Capital Accounts

	P	Q		P	Q
To P's current Account	16,940		By Balance b/d	1,00,000	50,000
To Bank	83,060	68,810	By Q's current Account		18,810
	1,00,000	68,810		1,00,000	68,810

Bank Account

	₹		₹
To Balance b/d	30,000	By Realization	27,000
To Realization	1,48,870	By P's capital	83,060
		By Q's capital	68,810
	1,78,870		1,78,870

Working Note:

Partners' Current Accounts

	P	Q		P	Q
To Balance b/d	10,000		By Balance b/d		10,000
To Realization	15,750		By Reserves	7,500	7,500
To Q's capital		18,810	By Realization (profit)	1,310	1,310
			By P's Capital	16,940	
	25,750	18,810		25,750	18,810

SUMMARY

- Reasons for which a partnership could be dissolved are
  - expiry of term for which it was formed
  - death of a partner
  - insolvency of a partner.
- Reasons when a firm stands dissolved
  - when partners mutually decide to dissolve
  - partners except one becomes insolvent
  - business becomes illegal
  - if partnership is at will any partner can give notice for dissolution
  - Court orders.
- The winding up of a LLP may be either voluntary or by the Tribunal and LLP, so wound up may be dissolved.
- On dissolution assets are realized and all liabilities are paid off.

  (if any liability remains unpaid then it is to be realized from partners in their profit-sharing ratio).
- Piecemeal distribution involves either of two methods:
  - Maximum loss method
  - Highest relative capital method.

TEST YOUR KNOWLEDGE

True and False

1. *Books of accounts are closed in dissolution of partnership.*
2. *On the dissolution of a partnership, firstly, the assets of the firm are realized. Then the amount realized, is applied first towards repayment of liabilities to outsiders.*
3. *In event of the dissolution of the firm, the business ceases to end. In event of dissolution of the partnership, the partnership is reconstituted and the business discontinues.*
4. *Expenses of dissolution on realization of assets are credited to the Realization Account.*
5. *Revaluation Account is prepared at the time of dissolution of partnership but Realization Account is prepared at the time of dissolution of partnership firm.*

Multiple Choice Questions

1. *Partnership could be dissolved because of*
   - (a) *Death of a partner.*
   - (b) *Insolvency of a partner.*
   - (c) *Either (a) or (b).*
2. *On the dissolution of partnership, profit or loss on realization of assets and liabilities should be divided among partners*
   - (a) *In the ratio of their capitals.*
   - (b) *In the same ratio in which they share profits.*
   - (c) *Equally.*
3. *An unrecorded asset realized at the time of dissolution is credited to*
   - (a) *Realization account.*
   - (b) *Revaluation account.*
   - (c) *Capital accounts.*
4. *A liability taken over by a partner at the time of dissolution is credited to*
   - (a) *Profit and loss account.*
   - (b) *Partners' capital accounts.*
   - (c) *Realization account.*

5. *Realization account is a*

   (a) *Nominal account.*

   (b) *Real account.*

   (c) *Personal account.*

6. *Which of the following method/methods is adopted to ensure that distribution of cash among partners is in proportion to their interest in partnership?*

   (a) *Maximum loss method.*

   (b) *Highest relative capital method.*

   (c) *Either (a) or (b).*

Theoretical Questions

1 *State the circumstances when Garner V/S Murray rule not applicable.*

2 *W paid a premium to other partners of the firm at the time of his admission to the firm, with a condition that they will not be dissolved before the expiry of five years. The firm is dissolved after three years. W claims refund of premium.*

   (i) *List the criteria for the calculation of the amount of refund.*

   (ii) *Also list any two conditions when no claim in this respect will arise.*

Practical Questions

1. *P, Q, and R are partners sharing profits and losses as to 2:2:1. Their Balance Sheet as on 31st March, 2022 is as follows:*

Liabilities		₹	Assets	₹
Capital accounts			Plant and Machinery	1,08,000
P	1,20,000		Fixtures	24,000
Q	48,000		Stock	60,000
R	24,000	1,92,000	Sundry debtors	48,000
Reserve Fund		60,000	Cash	60,000
Creditors		48,000		
		3,00,000		3,00,000

They decided to dissolve the business. The following are the amounts realized:

Particulars	**₹**
Plant and Machinery	1,02,000
Fixtures	18,000
Stock	84,000
Sundry debtors	44,400

Creditors allowed a discount of 5% and realization expenses amounted to ₹ 1,500. There was an unrecorded asset of ₹ 6,000 which was taken over by Q at ₹ 4,800. An amount of ₹ 4,200 due for GST had come to notice during the course of realization and this was also paid.

You are required to prepare:

(i) *Realization account.*

(ii) *Partners' capital accounts.*

(iii) *Cash account.*

2. *'Thin', 'Short' and 'Fat' were in partnership sharing profits and losses in the ratio of 2:2:1.*

On 30th September, 2022 their Balance Sheet was as follows:

Liabilities		**₹**	**Assets**	**₹**
Capital Accounts:			Premises	50,000
Thin	80,000		Fixtures	1,25,000
Short	50,000		Plant	32,500
Fat	20,000	1,50,000	Stock	43,200
Current Accounts:			Debtors	54,780
Thin	29,700			
Short	11,300			
Fat (Dr.)	(14,500)	26,500		
Sundry Creditors		84,650		
Bank Overdraft		44,330		
		3,05,480		3,05,480

'Thin' decides to retire on 30th September, 2022 and as 'Fat' appears to be short of private assets, 'Short' decides that he does not wish to take over Thin's share of partnership, so

all three partners decide to dissolve the partnership with effect from 30th September, 2022. It then transpires that 'Fat' has no private assets whatsoever.

The premises are sold for ₹ 60,000 and the plant for ₹ 1,07,500. The fixtures realize ₹ 20,000 and the stock is acquired by another firm at a book value less 5%. Debtors realize ₹ 45,900. Realization expenses amount to ₹ 4,500.

The bank overdraft is discharged and the creditors are also paid in full.

You are required to write up the following ledger accounts in the partnership books following the rules in Garner vs. Murray:

(i) Realization Account;

(ii) Partners' Current Accounts;

(iii) Partners' Capital Accounts showing the closing of the firm's books.

3. *Amit, Sumit, and Kumar are partners sharing profit and losses in the ratio 2:2:1. The partners decided to dissolve the partnership on 31st March 2022 when their Balance Sheet was as under:*

Liabilities	***Amount***	***Assets***		***Amount***
Capital Accounts:		*Land & Building*		*1,35,000*
Amit	*55,200*	*Plant & Machinery*		*45,000*
Sumit	*55,200*	*Furniture*		*25,500*
General Reserve	*61,500*	*Investments*		*15,000*
Kumar's Loan A/c	*15,000*	*Book Debts*	*60,000*	
Loan from D	*1,20,000*	*Less: Prov. for bad debts*	*(6,000)*	*54,000*
Trade Creditors	*30,000*	*Stock*		*36,000*
Bills Payable	*12,000*	*Bank*		*13,500*
Outstanding Salary	*7,500*	*Capital Withdrawn:*		
		Kumar		*32,400*
	3,56,400			*3,56,400*

The following information is given to you:

(i) Realization expenses amounted to ₹ 18,000 out of which ₹ 3,000 was borne by Amit.

(ii) A creditor agreed to takeover furniture of book value ₹ 12,000 at ₹ 10,800. The rest of the creditors were paid off at a discount of 6.25%.

(iii) *The other assets realized as follows:*

Furniture	*- Remaining taken over by Kumar at 90% of book value*
Stock	*- Realized 120% of book value*
Book Debts	*- ₹ 12,000 of debts proved bad, remaining were fully realized*
Land & Building	*- Realized ₹ 1,65,000*
Investments	*-Taken over by Amit at 15% discount*

(iv) *For half of his loan, D accepted Plant & Machinery and ₹ 7,500 cash. The remaining amount was paid at a discount of 10%.*

(v) *Bills payable were due on an average basis of one month after 31st March 2022, but they were paid immediately on 31st March @ 6% discount "per annum".*

Prepare the Realization Account, Bank Account and Partners' Capital Accounts in the books of Partnership firm.

ANSWERS/HINTS

True and False

1. False. Books of accounts are not closed in dissolution of partnership but are closed in case of dissolution of partnership firm.

2. True. On the dissolution of a partnership, firstly, the assets of the firm, are realized. Then the amount realized, is applied first towards repayment of liabilities to outsiders and loans taken from partners; afterwards, the capital contributed by partners is repaid.

3. True. In event of the dissolution of the firm, the business ceases to end. However, in event of dissolution of the partnership, the business continues as usual, but the partnership is reconstituted.

4. False. Expenses of dissolution on realization of assets are debited to the Realization Account.

5. True. Revaluation Account is prepared at the time of dissolution of partnership but Realization Account is prepared at the time of dissolution of partnership firm.

Multiple Choice Questions

1.	(c)	**2.**	(b)	**3.**	(a)	**4.**	(b)	**5.**	(a)	**6.**	(c)

Theoretical Questions

1. Non-Applicability of Garner vs Murray rule:

(i) When the solvent partner has a debit balance in the capital account.

Only solvent partners will bear the loss of capital deficiency of insolvent partner in their capital ratio. If incidentally, a solvent partner has a debit balance in his capital account, he will escape the liability to bear the loss due to insolvency of another partner.

(ii) When the firm has only two partners.

(iii) When there is an agreement between the partners to share the deficiency in capital account of the insolvent partner.

(iv) When all the partners of the firm are insolvent.

2. If the firm is dissolved before the term expires, as is the case, W being a partner who has paid a premium on admission will have to be repaid/refunded

The criteria for calculation of refund amount are:

(i) Terms upon which admission was made,

(ii) The time period for which it was agreed that the firm will not be dissolved,

(iii) The time period for which the firm has already been in existence.

No claim for refund will arise if:

(i) The firm is dissolved due to the death of a partner,

(ii) If the dissolution of the firm is basically because of misconduct of W,

(iii) If the dissolution is through an agreement and such an agreement does not have a stipulation for a refund of premium.

Practical Questions

1. **Realization Account**

Particulars	₹	Particulars		₹
To Debtors	48,000	By Creditors		48,000
To Stock	60,000	By Cash A/c (Assets realized):		
To Fixtures	24,000	Plant and Machinery	1,02,000	

To Plant and machinery	1,08,000	Fixtures	18,000	
To Cash A/c (Creditors)	45,600	Stock	84,000	
To Cash A/c (GST)	4,200	Sundry Debtors	44,400	2,48,400
To Cash A/c (Realization expenses)	1,500	By Q (Unrecorded asset)*		4,800
To Profit on Realization				
P 3,960				
Q 3,960				
R 1,980	9,900			
	3,01,200			3,01,200

Partners' Capital Accounts

Particulars	***P***	***Q***	***R***	***Particulars***	***P***	***Q***	***R***
	₹	₹	₹		₹	₹	₹
To Realization A/c (unrecorded asset)		4,800		By Balance b/d	1,20,000	48,000	24,000
To Cash (Bal. Fig.)	1,47,960	71,160	37,980	By Reserve fund	24,000	24,000	12,000
				By Realization A/c (Profit)	3,960	3,960	1,980
	1,47,960	75,960	37,980		1,47,960	75,960	37,980

Cash Account

Particulars	₹	***Particulars***	₹
To Balance b/d	60,000	By Realization A/c (Creditors)	45,600
To Realization A/c (Assets)	2,48,400	By Realization A/c (Expenses)	1,500
		By Realization A/c (GST)	4,200
		By P's Capital A/c	1,47,960
		By Q's Capital A/c	71,160
		By R's Capital A/c	37,980
	3,08,400		3,08,400

* An unrecorded asset is in the nature of gain hence realization account is credited. Since this asset has been taken over by Q, therefore, his account has been debited.

2. **Realization Account**

Particulars	₹	Particulars		₹
To Premises	50,000	By Sundry Creditors		84,650
To Plant	1,25,000	By Bank:		
To Fixtures	32,500	Premises	60,000	
To Stock	43,200	Plant	1,07,500	
To Debtors	54,780	Fixtures	20,000	
To Bank (Creditors)	84,650	Stock	41,040	
To Bank (Expenses)	4,500	Debtors	45,900	2,74,440
		By Loss on Realization transferred to Partners' Current A/cs		
		Thin	14,216	
		Short	14,216	
		Fat	7,108	35,540
	3,94,630			3,94,630

Partners' Current Accounts

Particulars	Thin	Short	Fat	Particulars	Thin	Short	Fat
	₹	₹	₹		₹	₹	₹
To Balance b/d	–	–	14,500	By Balance b/d	29,700	11,300	–
To Realization	14,216	14,216	7,108	By Capital A/c Transfer	–	2,916	21,608
To Capital A/c transfer	15,484	–	–				
	29,700	14,216	21,608		29,700	14,216	21,608

Partners' Capital Accounts

Particulars	Thin	Short	Fat	Particulars	Thin	Short	Fat
	₹	₹	₹		₹	₹	₹
To Current A/c	–	2,916	21,608	By Balance b/d	80,000	50,000	20,000
To Fat's Capital A/c Deficiency in the ratio of 8:5	990	618	–	By Current A/c (transfer)	15,484	–	–
				By Bank (Realization loss)	14,216	14,216	

To Bank	1,08,710	60,682	–	By Thin & Short Capital A/cs			1,608
	1,09,700	64,216	21,608		1,09,700	64,216	21,608

Working Notes:

(i) **Bank Account**

Particulars	₹	***Particulars***	₹
To Realization A/c	2,74,440	By Balance b/d	44,330
To Thin's Capital A/c	14,216	By Realization A/c (Creditors)	84,650
To Short's Capital A/c	14,216	By Realization A/c (Expenses)	4,500
		By Thin's Capital A/c	1,08,710
		By Short's Capital A/c	60,682
	3,02,872		3,02,872

(ii) Fat's deficiency has been by borne Thin & Short in the ratio of their fixed capitals i.e., 8:5 following the rule in *Garner vs. Murray*.

3. Realization Account

	Particulars	₹		***Particulars***	₹
To	Land and Building	1,35,000	By	Provision for bad debts	6,000
To	Plant and Machinery	45,000	By	Loan from D	1,20,000
To	Furniture	25,500	By	Trade creditors	30,000
To	Investments	15,000	By	Bills payable	12,000
To	Book debts	60,000	By	Outstanding salary	7,500
To	Stock	36,000	By	Kumar - Furniture taken over (13,500 x .9)	12,150
To	Bank (Realization expenses)	15,000	By	Bank A/c -	
				Stock Realized 43,200	
To	Amit– Realization expenses	3,000		Land & Building 1,65,000	
				Debtors <u>48,000</u>	2,56,200
To	Bank A/c -				
	Bill payable	11,940	By	Amit (Investment taken over)	12,750
	D's Loan	61,500			
	Creditors	18,000			
	Salary	7,500			

To	Profit transferred to partners' capital Accounts Amit 9,264 Sumit 9,264 Kumar 4,632	23,160			
		4,56,600			4,56,600

Bank Account

Particulars	₹	Particulars	₹
To Balance b/d	13,500	By Realization A/c (payment of liabilities: 11,940+ 7,500 + 54,000 + 15,000 + 18,000 + 7,500)	1,13,940
To Realization A/c (assets realized)	2,56,200	By Amit	79,314
To Kumar	12,618	By Sumit	89,064
	2,82,318		2,82,318

Partners' Capital Accounts

Particulars	Amit ₹	Sumit ₹	Kumar ₹	Particulars	Amit ₹	Sumit ₹	Kumar ₹
To Balance b/d			32,400	By Balance b/d	55,200	55,200	
				By Kumar's Loan			15,000
To Realization A/c (Investment taken over)	12,750			By General Reserve	24,600	24,600	12,300
To Realization A/c (Furniture taken over)			12,150	By Realization A/c (expense)	3,000		
To Bank A/c	79,314	89,064		By Realization A/c (profit)	9,264	9,264	4,632
				By Bank A/c			12,618
	92,064	89,064	44,550		92,064	89,064	44,550

Working Notes:

1. Payment for Bills Payable

Particulars	Amount (₹)
Bills Payable as per Balance Sheet	12,000
Less: Discount for early payment {12,000 x 6% x (1/12)}	60
Amount Paid in Cash	11,940

2. Payment to D's Loan

Particulars	***Amount (₹)***
D's Loan as per Balance Sheet	120,000.00
50% of Loan adjusted as below:	
Plant & Machinery accepted at Book Value (₹ 45,000) and ₹ 7,500 in cash.	7,500
Balance 50% of Loan adjusted as below:	
In cash after allowing discount of 10% i.e. ₹ 60,000 – ₹ 6,000 = ₹ 54,000.	54,000

3. Payment to Trade Creditors

Particulars	***Amount (₹)***
Trade Creditors as per Balance Sheet	30,000
Less: Furniture of Book Value ₹ 12,000 accepted at value ₹ 10,800	10,800
	19,200
Less: Discount @ 6.25%	1,200
Amount paid in Cash	18,000

4. Furniture taken over by Kumar

Particulars	***Amount (₹)***
Furniture as per Balance Sheet	25,500
Less: Furniture of Book Value ₹ 12000 accepted by trade creditors	12,000
	13,500
Less: 10% of Book Value	1,350
Value of Furniture taken over by Kumar	12,150

NOTES

ANNEXURE-II
FORMATS OF FINANCIAL STATEMENTS FOR LIMITED LIABILITY PARTNERSHIPS

PART I – Form of BALANCE SHEET

Name of the Limited Liability Partnership................

Balance Sheet as at ....

(Rupees in............)

	Particulars	**Note No**	**Figures as at the end of (Current reporting period) (in ₹) _________ (DD/MM/YYYY)**	**Figures as at the end of (Previous reporting period) (in ₹) _________ (DD/MM/YYYY)**
	1	**2**	**3**	**4**
I.	**EQUITY AND LIABILITIES**			
	(1) Partner's Fund			
	(a) Partners Capital Account (i) Partners' Contribution (ii) Partners' Current Account			
	(b) Reserves and surplus			
(2)	**Non-current liabilities**			
	(a) Long-term borrowings			
	(b) Deferred tax liabilities (Net)			
	(c) Other Long term liabilities			
	(d) Long-term provisions			
(3)	**Current liabilities**			
	(a) Short-term borrowings			
	(b) Trade payables:- (A) total outstanding dues of micro, small and medium enterprises and			

	(B) total outstanding dues of creditors other than micro, small and medium enterprises .			
	(c) Other current liabilities			
	(d) Short-term provisions			
	TOTAL			
II.	**ASSETS**			
(1)	**Non-Current Assets**			
	(a) Property, Plant and Equipment and Intangible assets			
	(i) Property, Plant and Equipment			
	(ii) Intangible assets			
	(iii) Capital work-in-progress			
	(iv) Intangible assets under development			
	(b) Non-current investment			
	(c) Deferred tax assets (net)			
	(d) Long-term loans and advances			
	(e) Other non-current assets			
(2)	**Current assets**			
	(a) Current investments			
	(b) Inventories			
	(c) Trade receivables			
	(d) Cash and bank balances			
	(e) Short-term loans and advances			
	(f) Other current assets			
	TOTAL			

See accompanying notes which form part of the financial statements.

Notes

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as current when it satisfies any of the following criteria:

   (a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;

   (b) it is held primarily for the purpose of being traded;

   (c) it is expected to be realized within twelve months after the reporting date; or

   (d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

   All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.

3. A liability shall be classified as current when it satisfies any of the following criteria:

   (a) it is expected to be settled in the company's normal operating cycle;

   (b) it is held primarily for the purpose of being traded;

   (c) it is due to be settled within twelve months after the reporting date; or

   (d) the Limited Liability Partnership does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

   All other liabilities shall be classified as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

6. A Limited Liability Partnership may disclose the following in the Notes to Accounts:

   A. Partner Funds

   For each partner's contribution account/current account following items for the year to be disclosed separately, as agreed in the LLP Agreement:

   (a) opening balance;

(b) Introduced/Contributed during the year;

(c) remuneration for the year;

(d) interest for the year;

(e) withdrawals during the year;

(f) share of profit or loss for the year (share in % and amount);

(g) closing balance.

For partners' contribution account, the agreed contribution shall also be disclosed.

B. Reserves and Surplus

(i) Reserves and Surplus may be classified as:

(a) Capital Reserves;

(b) Revaluation Reserve;

(c) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);

(d) Undistributed Surplus i.e. balance in Statement of Profit and Loss.

(ii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Undistributed Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

C. Long-Term Borrowings

(i) Long-term borrowings may be classified as:

(a) Term loans

- From banks
- From other parties

(c) Deferred payment liabilities.

(d) Loans and advances from related parties.

(e) Long term maturities of finance lease obligations

(f) Other loans and advances (specify nature).

(ii) Borrowings may further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by partners/proprietor/owners or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Terms of repayment of term loans and other loans may be stated.

D. Long-term provisions

The amounts may be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

E. Short-term borrowings

(i) Short-term borrowings may be classified as:

(a) Loans repayable on demand

- From banks
- From other parties

(b) Loans and advances from related parties.

(b) Other loans and advances (specify nature).

(ii) Borrowings may further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by partners or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) current maturities of Long term borrowings may be disclosed separately.

F. Trade Payables

The following details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes:-

(a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;

(b) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

(c) the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;

(d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and

(e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

Explanation.-The terms 'appointed day', 'buyer',' enterprise', 'micro enterprise', 'small enterprise' and 'supplier', shall have the same meaning assigned to those under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.

G. Other current liabilities

The amounts may be classified as:

(a) Current maturities of finance lease obligations;

(b) Interest accrued but not due on borrowings;

(c) Interest accrued and due on borrowings;

(d) Income received in advance;

(e) Other payables (specify nature);

H. Short-term provisions

The amounts may be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

I. Property, Plant and Equipment

(i) Classification may be given as:

(a) Land.

(b) Buildings.

(c) Plant and Equipment.

(d) Furniture and Fixtures.

(e) Vehicles.

(f) Office equipment.

(g) Others (specify nature).

(ii) Assets under lease may be separately specified under each class of asset.

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment) and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

J. Intangible assets

(i) Classification may be given as:

(a) Goodwill.

(b) Brands /trademarks.

(c) Computer software.

(d) Mastheads and publishing titles.

(e) Mining rights.

(f) Copyrights, and patents and other intellectual property rights, services and operating rights.

(g) Recipes, formulae, models, designs and prototypes.

(h) Licenses and franchise.

(i) Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of intangible assets) and other adjustments and the related amortisation and impairment losses or reversals shall be disclosed separately.

K. Non-current investments

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:

(a) Investment property;

(b) Investments in Equity Instruments;

(c) Investments in preference shares;

(d) Investments in Government or trust securities;

(e) Investments in debentures or bonds;

(f) Investments in Mutual Funds;

(g) Investments in partnership firms;

(h) Other non-current investments (specify nature)

Under each classification, details may be given of names of the entities (indicating separately whether such entities are joint ventures or controlled special purpose entities) in whom investments have been made (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) may be given.

(ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.

(iii) The following shall also be disclosed:

(a) Aggregate amount of quoted investments and market value thereof;

(b) Aggregate amount of unquoted investments;

(c) Aggregate provision for diminution in value of investments.

L. Long-term loans and advances

(i) Long-term loans and advances may be classified as:

(a) Capital Advances;

(b) Loans and advances to related parties (giving details thereof);

(c) Other loans and advances (specify nature).

(ii) The above may also be separately sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed separately.

M. Other non-current assets

Other non-current assets may be classified as:

(i) Security Deposits;

(ii) Bank deposits with more than 12 months maturity;

(ii) Others (specify nature).

N. Current Investments

(i) Current investments shall be classified as:

(a) Investments in Equity Instruments;

(b) Investment in Preference Shares;

(c) Investments in government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms;

(g) Other investments (specify nature).

Under each classification, details may be given of names of the entities (indicating separately whether such entities are joint ventures or controlled special purpose entities) in whom investments have been made (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) may be given.

(ii) The following shall also be disclosed:

(a) The basis of valuation of individual investments;

(b) Aggregate amount of quoted investments and market value thereof;

(c) Aggregate amount of unquoted investments;

(d) Aggregate provision made for diminution in value of investments.

O. Inventories

(i) Inventories shall be classified as:

(a) Raw materials;

(b) Work-in-progress;

(c) Finished goods;

(d) Stock-in-trade (in respect of goods acquired for trading);

(e) Stores and spares;

(f) Loose tools;

(g) Others (specify nature).

(ii) Goods-in-transit may be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation may be stated.

P. Trade Receivables

(i) Aggregate amount of trade receivables outstanding for a period exceeding six months from the date they are due for receipt may be stated separately.

(ii) Trade receivables may be sub-classified as:

(a) Secured, considered good;

(b) Unsecured considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed separately.

Q. Cash and bank balances

(i) Cash and cash equivalents shall be classified as:

(a) Balances with banks;

(b) Cheques, drafts on hand;

(c) Cash on hand;

(d) Others (specify nature).

(ii) Other bank balances shall be classified as

(a) Bank Deposits - Earmarked balances with banks.

(b) Margin money or deposits under lien shall be disclosed separately.

(c) Bank deposits with original maturity for more than 3 months but less than 12 months from reporting date.

(d) others (specify nature)

R. Short-term loans and advances

(i) Short-term loans and advances may be classified as:

(a) Loans and advances to related parties (giving details thereof);

(b) Others (specify nature).

(ii) The above may also be sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances may be disclosed under the relevant heads separately.

S. Other current assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent liabilities (to the extent not provided for)

(i) Contingent liabilities may be classified as:

(a) Claims against the limited liability partnership not acknowledged as debt;

(b) Guarantees;

(c) Other money for which the limited liability partnership is contingently liable.

PART II – Form of STATEMENT OF PROFIT AND LOSS

Name of the LLP.......................

Statement of Profit and loss for the year ended ....

(Rupees in...........)

	Particulars	**Note**	**Figures for the current reporting period (in) From _______ (DD/MM/YYYY) To _________ (DD/MM/YYYY)**	**Figures for the previous reporting period (in) From_________ (DD/MM/YYYY) To___________ (DD/MM/YYYY)**
	1	**2**	**3**	**4**
I.	Revenue from operations			
II.	Other income			
III.	**Total Income (I + II)**			
IV.	Expenses			
	(a) Cost of Goods Sold			
	(b) Employee benefits expense			
	(c) Depreciation and amortization expense			
	(d) Finance Cost			
	(e) Other expenses			
	Total expenses			
V	Profit before exceptional and extraordinary items, partners' remuneration and tax (III-IV)			
VI	Exceptional items			
VII	Profit before extraordinary items, partners' remuneration			

	and tax (V - VI)			
VIII	Extraordinary Items			
IX	Profit before partners' remuneration and tax (VII- VIII)			
X	Partners' remuneration			
XI	Profit before tax (IX- X)			
XII	Tax expense:			
	(i) Current tax			
	(ii) Deferred tax			
XIII	Profit (Loss) for the period from continuing operations (XI-XII)			
XIV	Profit/(loss) from discontinuing operations			
XV	Tax expense of discontinuing operations			
XVI	Profit/(loss) from Discontinuing operations (after tax) (XIV-XV)			
XVII	Profit/ (Loss) (XIII + XVI)			

See accompanying notes which form part of the financial statements.

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part may be applied to the income and expenditure account in like manner as they apply to a statement of profit and loss.

2. (A) Revenue from operations may disclose separately in the notes revenue from—

   (a) Sale of products;

   (b) Sale of services;

   (c) Grants or donations received;

   (d) Other operating revenues;

   (e) Less: Excise duty

   (B) In respect of a finance Limited Liability Partnership, revenue from operations may include revenue from—

   (a) Interest; and

   (b) Other financial services.

3. Cost of Goods Sold

   Costs of Goods Sold shall be classified as:

   (a) Cost of materials consumed;

   (b) Purchases of Stock-in-Trade;

   (c) Changes in inventories of finished goods;

   (d) Work-in-progress and Stock-in-Trade.

4. Finance Costs

   Finance costs may be classified as:

   (a) Interest expense;

   (b) Other borrowing costs;

   (c) Applicable net gain/loss on foreign currency transactions and translation.

5. Other income

   Other income shall be classified as:

   (a) Interest Income;

   (b) Dividend Income;

   (c) Net gain/loss on sale of investments;

(d) Other non-operating income (net of expenses directly attributable to such income).

6. Following may be disclosed by way of notes regarding aggregate expenditure and income on the following items:—

(i) (a) Employee Benefits Expense showing separately (i) salaries and wages, (ii) Contribution to provident and other funds, (iii) staff welfare expenses;

(b) Any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹ 1,00,000 whichever is higher;

(c) Adjustments to the carrying amount of investments;

(d) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);

(e) Details of items of exceptional and extraordinary nature;

(f) Prior period items.

(ii) Expenditure incurred on each of the following items, separately for each item:—

(a) Consumption of stores and spare parts;

(b) Power and fuel;

(c) Rent;

(d) Repairs to buildings;

(e) Repairs to machinery;

(f) Insurance;

(g) Rates and taxes, excluding, taxes on income;

(h) Miscellaneous expenses.

NOTES

CHAPTER 11

COMPANY ACCOUNTS

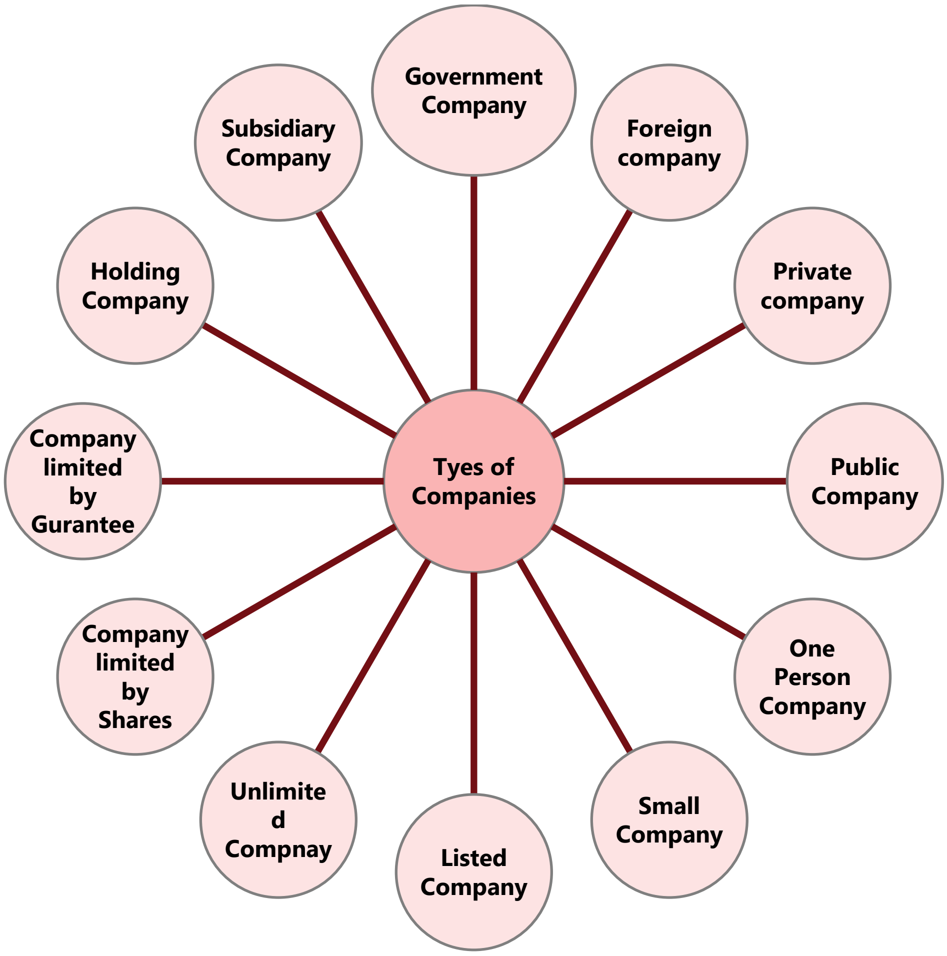
UNIT – 1 INTRODUCTION TO COMPANY ACCOUNTS

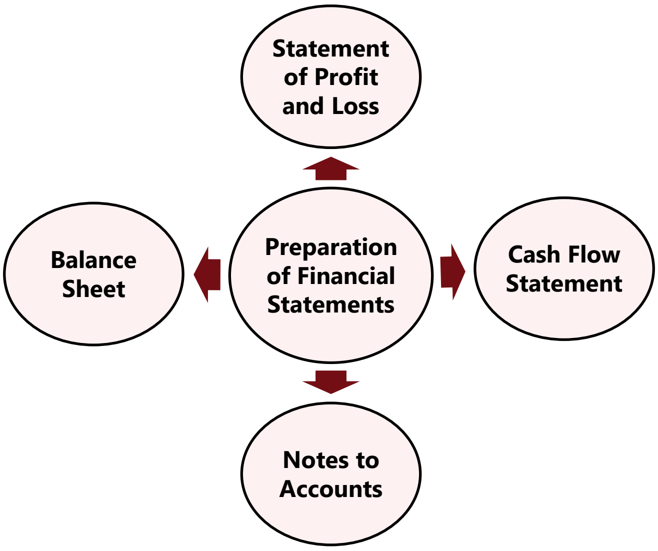
LEARNING OUTCOMES

After studying this unit, you would be able to:

- Understand the reason for the existence and survival of a company.
- Learn the nature and types of companies.
- Explain the salient features of a company.
- Understand the purpose of preparing the financial statements of the company.

UNIT OVERVIEW





1.1 INTRODUCTION

The never-ending human desire to grow and grow further has given rise to the expansion of business activities, which in turn has necessitated the need to increase the scale of operations so as to provide goods and services to the ever-increasing needs of the growing population of consumers. Large amount of money, modern technology, large human contribution etc. is required for it, which is not possible to arrange under partnership or proprietorship. To overcome this difficulty, the concept of 'Company' or 'Corporation' came into existence.

While the invention of steam power ignited the human imagination to build big machines for the mass production of goods, the need to separate the management from ownership gave birth to a form of organisation today known as 'company'.

Company form of organisation is one of the ingenious creations of human mind, which has enabled the business to carry on its wealth creation activities through optimum utilisation of resources. In course of time, a company structure has become an important institutional form for business enterprise, which has carved out a key place for itself in the field of business operations as well as in the wealth-generating functions of society.

1.2 MEANING OF COMPANY

The word 'Company', in everyday usage, implies an assemblage of persons for social purpose, companionship or fellowship. As a form of organisation, the word 'company' implies a group of people who voluntarily agree to form a company.

The word 'company' is derived from the Latin word 'com' i.e. with or together and 'panis' i.e. bread. Originally the word referred to an association of persons or merchant men discussing matters and taking food together. However, in law 'company' is termed as company which is formed and incorporated under the Companies Act, 2013 or an existing company formed and registered under any of the previous company laws. As per this definition of law, there must be group of persons who agree to form a company under the law and once so formed; it becomes a separate legal entity having perpetual succession with a distinct name of its own and a common seal. Its existence is not affected by the change of members.

Company begs its origin in law. It is an organisation consisting of individuals, called shareholders by virtue of holding the shares of a company, who are authorised by law to elect a board of directors and, through it, to act as a separate legal entity as regards its activities. Generally, the capital of the company consists of transferable shares, and members have limited liabilities.

To get to the heart of the nature of the company, let us examine the concept of company propounded under corporate jurisprudence.

According to Justice Marshal, "A corporation is an artificial being, invisible, intangible and existing only in the contemplation of law".

In the same manner, Lord Justice Hanay has defined a company as "an artificial person created by law with a perpetual succession and a common seal".

A common thread running through the various definitions of 'company' is that it is an association of persons created by law as a separate body for a special purpose. At the same time, definitions have laid down certain characteristics of a corporate organisation, which make it out as a separate and unique organisation which enables the people to contribute their wealth to the capital of the company by subscribing to its shares and appointing elected representatives to carry out the business.

1.3 SALIENT FEATURES OF A COMPANY

Following are the salient features of a company:

1. *Incorporated Association:* A company comes into existence through the operation of law. Therefore, incorporation of company under the Companies Act is must. Without such registration, no company can come into existence. Being created by law, it is regarded as an artificial legal person.

2. *Separate Legal Entity:* A company has a separate legal entity and is not affected by changes in its membership. Therefore, being a separate business entity, a company can contract, sue and be sued in its incorporated name and capacity.

3. *Perpetual Existence:* Since company has existence independent of its members, it continues to be in existence despite the death, insolvency or change of members.

4. *Common Seal:* Company is not a natural person; therefore, it cannot sign the documents in the manner as a natural person would do. In order to enable the company to sign its documents, it is provided with a legal tool called 'Common Seal'. The common seal is affixed on all documents by the person authorised to do so who in turn puts his signature for and on behalf of the company. Companies Act, 2013 required common seal to be affixed on certain documents (such as bill of exchange, share certificates, etc.) Now, the use of common seal has been made optional. All such documents which required affixing the common seal may now instead be signed by two directors or one director and a company secretary of the company. Further, every company registered in India are required to obtain unique Corporate Identification Number (CIN) that is assigned by Registrar of Companies.

5. *Limited Liability:* The liability of every shareholder of a company is limited to the amount he has agreed to pay to the company on the shares allotted to him. If such shares are fully paid-up, he is subject to no further liability.

6. *Distinction between Ownership and Management:* Since the number of shareholders is very large and may be distributed at different geographical locations, it becomes difficult for them to carry on the operational management of the company on a day-to-day basis. This gives rise to the need of separation of the management and ownership.

7. *Not a citizen:* A company is not a citizen in the same sense as a natural person is, though it is created by the process of law. It has a legal existence but does not enjoy the citizenship rights and duties as are enjoyed by the natural citizens.

8. *Transferability of Shares:* The capital is contributed by the shareholders through the subscription of shares. Such shares are transferable by its members except in case of a private limited company, which may have certain restrictions on such transferability.

9. *Maintenance of Books:* A limited company is required by law to keep a prescribed set of account books and any failure in this regard attracts penalties.

10. *Periodic Audit:* A company has to get its accounts periodically audited through the chartered accountants appointed for the purpose by the shareholders on the recommendation of board of directors.

11. *Right of Access to Information:* The right of the shareholders of a company to inspect its books of account, with the exception of books open for inspection under the Statute, is governed by the Articles of Association. The shareholders have a right to seek information from the directors by participating in the meetings of the company and through the periodic reports.

1.4 TYPES OF COMPANIES

1. Government Company

According to Section 2(45) of the Companies Act, 2013, "Government company" 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.

2. Foreign Company

According to Section 2 (42) of the Companies Act, 2013, "Foreign company" 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.

3. Private Company

Section 2(68) of the Companies Act, 2013 defines 'Private company' as a company which by its articles,

i. Restrict the right to transfer its shares;

ii. Except in case of One Person Company limits the number of its members to two hundred:

Provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this sub-clause, be treated as a single member:

Provided further that—

(A) Persons who are in the employment of the company; and

(B) persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after the employment ceased,

shall not be included in the number of members; and

(iii) Prohibits any invitation to the public to subscribe for any securities of the company. Shares of a Private Company are not listed on Stock Exchange.

4. Public Company

Section 2(71) of the Companies Act, 2013 defines Public Company as a company which—

(a) is not a private company; and

(b) has a minimum paid-up share 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;

A company which is a listed public company if it gets unlisted continues to be a public company.

No Minimum Paid-up Share Capital: The minimum paid-up share capital requirement of INR 1,00,000 (in case of a private company) and INR 5,00,000 (in case of a public company) has been done away with under Companies Act, 2013. Accordingly, no minimum paid-up capital requirements will now apply for incorporating private as well as public companies in India.

5. One Person Company

Section 2 (62) of the Companies Act, 2013 defines "One Person Company" as a company which has only one person as a member.

6. Small Company

Section 2(85) of the Companies Act, 2013 defines "Small company" means a company, other than a public company

(i) paid-up share capital of which does not exceed four crores rupees or such higher amount as may be prescribed which shall not be more than ten crore rupees; and

(ii) turnover of which as per its last profit and loss account for the immediately preceding financial year does not exceed forty crore rupees or such higher amount as may be prescribed which shall not be more than hundred crore rupees:

Provided that nothing in this clause should apply to:

(A) a holding company or a subsidiary company

(B) a company registered under section 8

(C) a company or body corporate governed by any special Act

7. Listed Company

As per Section 2 (52) of the Companies Act, 2013,''listed company" means a company which has any of its securities listed on any recognised stock exchange.

The company, whose shares are not listed on any recognised stock exchange, is called ''Unlisted Company''.

An unlisted company can be a public company or a private company.

8. Unlimited Company

Section 2 (92) of the Companies Act, 2013 defines ''Unlimited company" means a company not having any limit on the liability of its members.

9. Company limited by Shares

As per Section 2(22) of the Companies Act, 2013, "Company limited by shares" means a company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them.

10. Company limited by Guarantee

As per Section 2(21) of the Companies Act, 2013, "company limited by guarantee" means a company having the liability of its members limited by the memorandum to such amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound up.

11. Holding Company

According to Section 2 (46) of the Companies Act, 2103, "Holding company", in relation to one or more other companies, means a company of which such companies are subsidiary companies.

12. Subsidiary Company

Section 2(87) of the Companies Act, 2013 defines "subsidiary company" as 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 share capital either at its own or together
with one or more of its subsidiary companies.

A company shall be deemed to be a subsidiary company of the holding company even if there is indirect control through the subsidiary company (ies). The control over the composition of a subsidiary company's Board of Directors means exercise of some power to appoint or remove all or a majority of the directors of the subsidiary company.

1.5 MAINTENANCE OF BOOKS OF ACCOUNT

As per Section 128 of the Companies Act, 2013, every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting:

Provided further that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

1.6 PREPARATION OF FINANCIAL STATEMENTS

Under Section 129 of the Companies Act, 2013, the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the notified accounting standards and shall be in the form or forms as may be provided for different class or classes of companies, as prescribed in Schedule III. The Board of Directors of the company shall lay financial statements at every annual general meeting of a company.

Financial Statements as per Section 2(40) of the Companies Act, 2013, inter-alia include -

i. A balance sheet as at the end of the financial year;

ii. A profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;

iii. cash flow statement for the financial year;

iv. A statement of changes in equity, if applicable; and

v. (any explanatory not annexed to, or forming part of, any document referred to in sub-clause (i) to sub-clause (iv):

Provided that the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement.

Requisites of Financial Statements

It shall give a true and fair view of the state of affairs of the company as at the end of the financial year.

Provisions Applicable

(1) Specific Act is Applicable

For instance, any

(a) Insurance company

(b) Banking company or

(c) Any company engaged in generation or supply of electricity* or

(d) Any other class of company for which a Form of balance sheet or Profit and loss account has been prescribed under the Act governing such class of company.

(2) In case of all other companies:

Balance Sheet as per Form set out in Part I of Schedule III and Statement of Profit and Loss as per Part II of Schedule III.

Compliance with Accounting Standards

As per Section 129 of the Companies Act, it is mandatory to comply with accounting standards notified by the Central Government from time to time.

Schedule III of the Companies Act, 2013

As per Section 129 of the Companies Act, 2013, Financial statements shall give a true and fair view of the state of affairs of the company or companies and comply with the accounting standards notified under Section133 and shall be in the form or forms as may be provided for different class or classes of companies in Division I of Schedule III under the Act.

PART I – Form of BALANCE SHEET

Name of the Company........................

Balance Sheet as at..........................

(₹ in............)

Particulars			Notes No.	Figures as at end of the current reporting period	Figures as at end of the previous reporting period
	EQUITY AND LIABILITIES				
1.	**Shareholders' funds**				
	a.	Share capital (A)		xxx	xxx
	b.	Reserves and Surplus (B)		xxx	xxx
	c.	Money received against share warrants		xxx	xxx
2.	**Share application money pending allotment**			xxx	xxx
3.	**Non-current liabilities**				
	a.	Long-term borrowings (C)		xxx	xxx
	b.	Deferred tax liabilities (Net)		xxx	xxx
	c.	Other long term liabilities		xxx	xxx
	d.	Long-term provisions (D)		xxx	xxx
4.	**Current liabilities**				
	a.	Short-term borrowings (E)		xxx	xxx
	b.	Trade Payables (A) total outstanding dues of micro enterprises and small enterprises; and (B) total outstanding dues of creditors other than micro enterprises and small enterprises.]		 xxx xxx	 xxx xxx
	c.	Other current liabilities (F)		xxx	xxx
	d.	Short-term provisions		xxx	xxx
	Total			xxx	xxx

	ASSETS					
1.	**Non-current assets**					
	a.	i.	Property, Plant and Equipment		xxx	xxx
		ii.	Intangible assets (H)		xxx	xxx
		iii.	Capital Work-in-progress		xxx	xxx
		iv.	Intangible assets under development		xxx	xxx
	b.	Non-current investments (I)			xxx	xxx
	c.	Deferred tax assets (Net)			xxx	xxx
	d.	Long-term loans and advances (J)			xxx	xxx
	e.	Other non-current assets			xxx	xxx
2.	**Current assets**					
	a.	Current investments (K)			xxx	xxx
	b.	Inventories (L)			xxx	xxx
	c.	Trade receivables			xxx	xxx
	d.	Cash and cash equivalents (M)			xxx	xxx
	e.	Short-term loans and advances			xxx	xxx
	f.	Other current assets			xxx	xxx
	Total				xxx	xxx

Certain items are to be explained as follows (list not exhaustive):

A. SHARE CAPITAL

For each class of share capital following points is to be kept in mind:

i. The number and amount of shares authorised.

ii. The number of shares which are issued, subscribed and fully paid and which are issued, subscribed but not fully paid.

iii. The par value per share.

iv. Shares outstanding at the beginning and at the end of the reporting period should be reconciled.

v. Calls unpaid.

vi. Forfeited shares.

B. RESERVES AND SURPLUS

Reserves and surplus can be distributed among the following sub-heads:

i. Capital reserves

ii. Capital redemption reserves

iii. Securities Premium

iv. Debenture Redemption reserve

v. Revaluation reserve

vi. Surplus; the balance as per profit and loss statement

vii. Other reserves (specify the nature and purpose)

C. LONG TERM BORROWINGS

Long term borrowings can be classified under the following sub-heads:

i. Bonds/Debentures

ii. Term loans

iii. Deferred payment liabilities

iv. Deposits

v. Long term maturities of finance lease obligations

vi. Loans and advances from related parties

vii. Other loans and advances (specify nature)

D. LONG TERM PROVISIONS

This can be classified as follows:

i. Employee benefits provision like gratuity, provident fund etc.

ii. Other provisions (specify the nature)

E. SHORT TERM BORROWINGS

Short term borrowings can be classified among the following sub-heads:

i. Loans repayable on demand

ii. Loans and advances from related parties

iii. Deposits

iv. Other loans and advances (specify the nature)

F. OTHER CURRENT LIABILITIES

Some of the other current liabilities can be grouped as under:

i. Interest accrued but not/and due on borrowings

ii. Income received in advance

iii. Unpaid dividends

iv. Application money received for allotment of securities and due for refund and interest accrued thereon

v. Other current liabilities (specify the nature)

G. PROPERTY, PLANT AND EQUIPMENT

Property, Plant and Equipment can be classified as follows:

i. Land

ii. Buildings

iii. Plant and Equipment

iv. Furniture and Fixtures

v. Vehicles

vi. Office equipment

vii. Others (specify the nature)

A detailed report showing additions, disposals, acquisitions through business combinations and other adjustments and amount related to depreciation, impairment losses, revaluation etc. should be provided for each class of asset.

H. INTANGIBLE ASSETS

Intangible assets can be classified as follows:

i. Goodwill

ii. Brands/trademarks

iii. Computer software

iv. Mining rights

v. Publishing titles

vi. Copyrights, patents and other intellectual property rights, services and operating rights.

vii. Licence and franchise

viii. Recipes, models, designs, formulae and prototypes

ix. Others (specify the nature)

A detailed report showing additions, disposals, acquisitions through business combinations and other adjustments and amount related to depreciation, impairment losses, revaluation etc. should be provided for each class of asset.

I. NON-CURRENT INVESTMENTS

Investments can be classified as under:

i. Investments in property

ii. Investments in equity instruments

iii. Investments in preference shares

iv. Investments in governments or trust securities

v. Investments in debentures or bonds

vi. Investments in mutual funds

vii. Investments in partnership firms

viii. Other non-current investments (specify the nature)

J. LONG TERM LOANS AND ADVANCES

It can be classified under the following sub-groups:

i. Capital advances

ii. Security deposits

iii. Loans and advances to related parties

iv. Other loans and advances (specify nature)

The above shall also be sub-classified as follows:

i. Secured, considered goods

ii. Unsecured, considered goods

iii. Doubtful

K. CURRENT INVESTMENTS

It can be classified as follows:

i. Investments in equity instruments

ii. Investments in preference shares

iii. Investments in government or trust securities

iv. Investments in bonds or debentures

v. Investments in mutual funds

vi. Investments in partnership firms

vii. Other investments (specify the nature)

L. INVENTORIES

Inventories can be classified as:

i. Raw materials

ii. Work-in-progress

iii. Stores and spares

iv. Finished goods

v. Loose tools

vi. Stock in trade

vii. Goods in transit

viii. Others (specify the nature)

M. CASH AND CASH EQUIVALENTS

The following head can be classified as follows:

i. Balances with banks

ii. Cheques, drafts in hand

iii. Cash in hand

iv. Others (specify the nature)

PART II – Form of STATEMENT OF PROFIT AND LOSS

Name of the Company.........................

Profit and Loss Statement for the year ended .... *(₹ in............)*

Particulars		Note No.	Figures for the current reporting period		Figures for the previous reporting period	
I.	Revenue from operations			xxx		xxx
II.	Other income			xxx		xxx
III.	Total Revenue (I + II)			xxx		xxx
IV.	Expenses:			xxx		xxx
	Cost of materials consumed			xxx		xxx
	Purchases of Stock-in-Trade			xxx		xxx
	Changes in inventories of finished goods, Work-in-Progress and Stock-in-Trade			xxx		xxx
	Employee benefits expense			xxx		xxx
	Finance costs			xxx		xxx
	Depreciation and amortization expense			xxx		xxx
	Other expenses			xxx		xxx
Total expenses				xxx		xxx
V.	Profit before exceptional and extraordinary items and tax (III-IV)			xxx		xxx
VI.	Exceptional items			xxx		xxx
VII.	Profit before extraordinary items and tax (V-VI)			xxx		xxx
VIII.	Extraordinary Items			xxx		xxx
IX.	Profit before tax (VII-VIII)			xxx		xxx
X.	Tax expense:					
	(1) Current tax		xxx		xxx	
	(2) Deferred tax		xxx	xxx	xxx	xxx
XI.	Profit (Loss) for the period from continuing operations (VII-VIII)			xxx		xxx
XII.	Profit/(Loss) from discontinuing operations			xxx		xxx
XIII.	Tax expense of discontinuing operations			xxx		xxx

XIV.	Profit/(Loss) from discontinuing operations (after tax) (XII-XIII)			xxx		xxx
XV.	Profit (Loss) for the period (XI + XIV)			xxx		xxx
XVI.	Earnings per equity share:					
	(1) Basic			xxx		xxx
	(2) Diluted			xxx		xxx

SUMMARY

1. 'Company' is termed as an entity which is formed and incorporated under the Companies Act, 2013 or an existing company formed and registered under any of the previous company laws.
2. Salient features of a company include: Incorporated Association; Separate Legal Entity; Perpetual Existence; Common Seal; Limited Liability; Distinction between Ownership and Management; Not a citizen; Transferability of Shares; Maintenance of Books; Periodic Audit; Right of Access to Information.
3. Types of companies: Government Company: Foreign Company; Private Company; Public Company; One Person Company; Small Company; Listed Company; Unlimited Company; Company limited by Shares; Company limited by Guarantee; Holding Company; Subsidiary Company.
4. The financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the notified accounting standards and shall be in the form or forms as may be provided for different class or classes of companies, as prescribed in Schedule III to the Companies Act, 2013. Financial Statements as per Section 2(40) of the Companies Act, 2013, include balance sheet as at the end of the financial year; profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year; cash flow statement for the financial year; statement of changes in equity, if applicable; and any explanatory note annexed to.

TEST YOUR KNOWLEDGE

True and False

1. *Every public company is a listed company.*
2. *Shares of a private company are not listed on stock exchange.*
3. *It is not mandatory to incorporate a company under the companies act.*

4. *Company is an artificial, legal person created by law.*
5. *Death, insolvency or change of members affects the existence of a company.*
6. *If the shares are fully paid-up by the shareholder, he is subject to no further liability.*
7. *Public limited company has restrictions on transferability of shares.*
8. *Financial statements of company show the financial position of the business.*
9. *Schedule I gives proforma of Balance Sheet.*
10. *Schedule III prescribes the format of Directors' Report*
11. *Financial statements need to be true and correct as per Companies Act.*

Multiple Choice Questions

1. *Which of the following statement is not a feature of a Company?*
   - (a) *Separate legal entity*
   - (b) *Perpetual Existence*
   - (c) *Members have unlimited liability*
2. *In a Government Company, the holding of the Central Government in paid-up capital should not be less than*
   - (a) *25%*
   - (b) *50 %*
   - (c) *51%*
3. *Which of the following statement is true in case of a Foreign Company?*
   - (a) *A Company incorporated in India and has place of business outside India.*
   - (b) *A Company incorporated outside India and has a place of business in India.*
   - (c) *A Company incorporated in India and has a place of business in India.*
4. *Which of the following statements is not a feature of a private company?*
   - (a) *Restricts the rights of members to transfer its shares.*
   - (b) *Does not restrict on the number of its members to any limit.*
   - (c) *Does not involve participation of public in general.*

5. *Under Schedule III of the Companies Act, assets and liabilities are to be disclosed based on:*

   (a) *Current/ non-current.*

   (b) *Financial /non-financial.*

   (c) *Owned /not-owned.*

6. *Schedule III of the Companies Act prescribes the format and content of*

   (a) *Balance sheet and statement of profit and loss*

   (b) *Auditors' report.*

   (c) *Directors' report.*

7. *A company is required to maintain its books of accounts at*

   (a) *its registered office.*

   (b) *its largest branch office.*

   (c) *Managing Director's residence.*

8. *Cash flow statements are not required for*

   (a) *Private company.*

   (b) *One person company.*

   (c) *Public company.*

9. *The presentation and disclosure requirements of a company are prescribed by*

   (a) *Schedule III.*

   (b) *Schedule II.*

   (c) *Schedule I.*

10. *Following is an example of current assets*

    (a) *Inventories.*

    (b) *Property, Plant & Equipment.*

    (c) *Intangible Assets.*

11. *Earnings per share (EPS) is to be disclosed in which of the following section of the financial statements*

    (a) *Balance Sheet.*

(b) Statement of Profit and Loss.

(c) Cash Flow Statements.

12. *Following is NOT an example of a company under Companies Act, 2013*

    (a) Small company.

    (b) Private company.

    (c) Large company.

Theory Questions

1. *Explain salient features of a company in brief.*

2. *Write short note on:*

    (i) Foreign company.

    (ii) Small company.

    (iii) Company limited by guarantee.

ANSWER/HINTS

True and False

1. False: Listed companies are those which are listed on the stock exchange. Shares of listed companies are open to general public. Every listed company is a public company but every public company is not a listed company.

2. True: Only the shares of public company are listed on stock exchange. Every listed company is a public company.

3. False: It is mandatory to incorporate a company under the Companies Act. Without such incorporation, a company cannot come into existence.

4. True: Company comes into existence through the operation of law. It is a separate entity distinct from it's members.

5. False: Company is a separate legal entity created by law. Death, insolvency or change of member does not affect it's existence.

6. True: Liability of shareholders is limited to the extent of the unpaid share capital. So, if shares are fully paid-up, he is subject to no further liability.

7. False: Shares of public company are freely transferable. Transferability of shares is restricted in a private limited company.

8. True: Financial statements give a true & fair view of the state of affairs of the company. Financial statements include profit and loss account, balance sheet, etc.

9. False: Schedule III Part I explains proforma of Balance Sheet.

10. False: Schedule III Part I explains proforma of Balance Sheet and Profit and Loss.

11. False: As per Section 128, every company shall prepare financial statement for every financial year which give a true and fair view of the state of the affairs of the company.

Multiple Choice Questions

1.	(c)	**2.**	(c)	**3.**	(b)	**4.**	(b)	**5.**	(a)	**6.**	(a)
7.	(a)	**8.**	(b)	**9.**	(a)	**10.**	(a)	**11.**	(b)	**12.**	(c)

Theoretical Question

1. Refer para 1.3 of this unit for salient features of a company.

2. **(i) Foreign Company**

According to Section 2 (42) of the Companies Act, 2103, "Foreign company" 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.

(ii) Small Company

Section 2(85) of the Companies Act, 2013 defines "Small company" means a company, other than a public company.

(i) paid-up share capital of which does not exceed four crores rupees or such higher amount as may be prescribed which shall not be more than ten crore rupees; or

(ii) turnover of which as per its last profit and loss account for the immediately preceding financial year does not exceed forty crores rupees or such higher amount as may be prescribed which shall not be more than hundred crore rupees.

Provided that nothing in this clause should apply to:

(A) a holding company or a subsidiary company

(B) a company registered under section 8

(C) a company or body corporate governed by any special Act

(iii) Company limited by Guarantee

As per Section 2(21) of the Companies Act, 2013, "company limited by guarantee" means a company having the liability of its members limited by the memorandum to such amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound up.

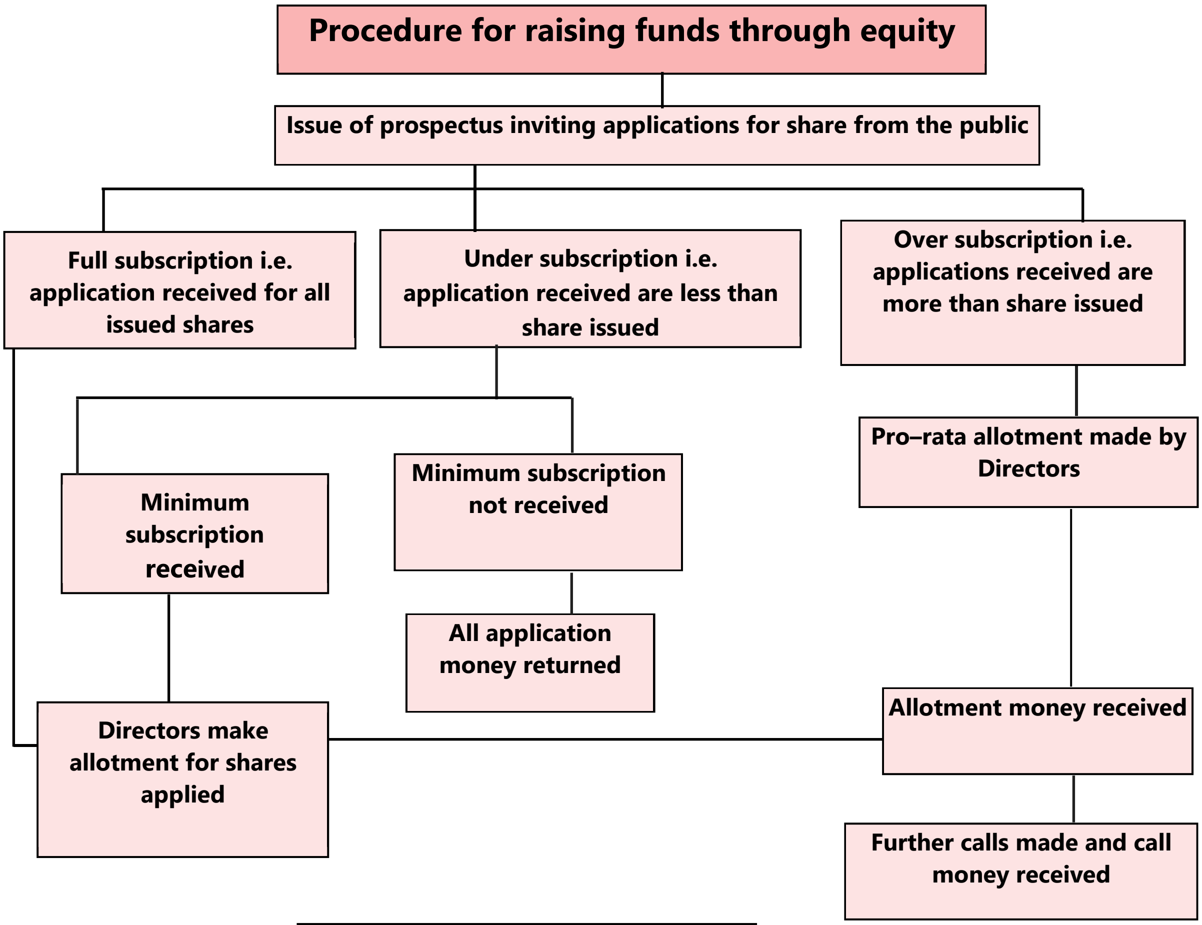
UNIT – 2 ISSUE, FORFEITURE AND RE-ISSUE OF SHARES

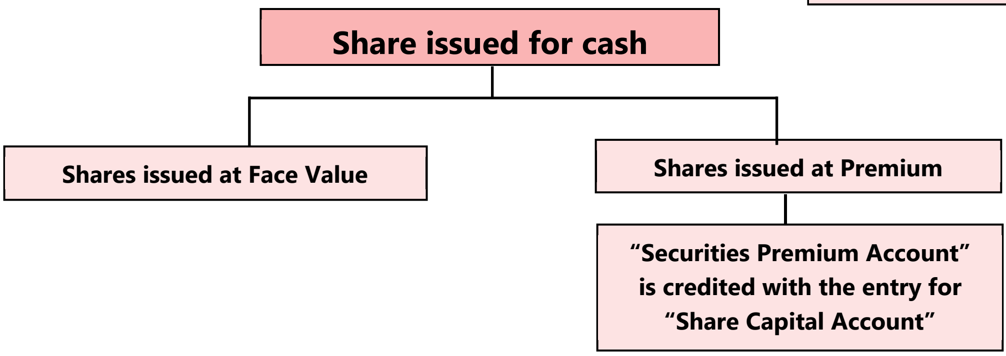
LEARNING OUTCOMES

After studying this unit, you would be able to:

- Appreciate various types of shares and share capital.
- Learn the accounting treatment if shares issued under different circumstances.
- Differentiate the accounting treatment for under-subscription and over-subscription of shares.
- Understand the concept and accounting treatment of call-in-arrears and call-in-advance.
- Deal with the forfeiture of shares issued with different conditions.
- Journalize the entry for re-issue of shares.
- Know the treatment of shares issued for consideration other than cash.

UNIT OVERVIEW





Note: As per Section 53 of Companies Act, 2013 a company cannot issue shares at discount except for in case of sweat equity shares and therefore any issue on discount by the company will be void with company being punishable with fine. Sweat equity shares means such equity shares as are issued by a company to its directors or employees at a discount or for consideration, other than cash, for providing their know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

2.1 INTRODUCTION

Funds provided by the owner(s) into a business are recorded as capital. Capital of the business depends upon the form of business organisation. Proprietor provides capital in a sole-proprietorship business. In case of a partnership, there is more than one proprietor, called partners. Partners introduce capital in a partnership firm. As the maximum number of members in a partnership firm is restricted, therefore only limited capital can be provided in such form of businesses. Moreover, the liability of the proprietor(s) is unlimited in case of non-corporate business, namely, sole-proprietorship and partnership.

Capital funding process for different types of business forms can be summarised as follows:

Business Organisation	Ownership	Type of Capital	Liability of Owners
Sole - Proprietorship	Proprietor - He alone is the owner of business	Capital	Unlimited
Partnership	Partners	Partners' Capital	Unlimited
Company	Shareholders	Share Capital	Limited to issue price of shares held

With the onset of industrial revolution, requirement of capital investment soared to a new height and the attached risk of failure increased due to pace of technological developments. Non-corporate entities could not cope with the pressure of increased capital and degree of risk involved. This led to the emergence of corporate form of organisation.

2.2 SHARE CAPITAL

Total capital of the company is divided into a number of small indivisible units of a fixed amount and each such unit is called a share. The fixed value of a share, printed on the share certificate, is called nominal/par/face value of a share. However, a company can issue shares at a price different from the face value of a share. The liability of holder of shares (called shareholders) is limited to the **issue price of shares** acquired by them.

Note: The issue price need not be equal to market price of the share. These days the shares are generally priced on the basis of book building process. (Book building is a process through which company determines it's share prices. Under this method company determines a price band of its shares and on the basis of bids received from potential investors at various prices within the price band finally fixes its issue price.)

The total capital of the company is divided into shares, the capital of the company is called 'Share Capital'. At the time of issue of shares, every Company is required to follow SEBI Regulations.

Share capital of a company is divided into following categories:

(i) *Authorised Share Capital or Nominal Capital:* A company estimates its maximum capital requirements. This amount of capital is mentioned in 'Capital Clause' of the 'Memorandum of Association' registered with the Registrar of Companies. It puts a limit on the amount of capital, which a company is authorised to raise during its lifetime and is called 'Authorised Capital'. It is shown in the Share Capital schedule in the financial statements as per the prescribed format at face value.

(ii) *Issued Share Capital:* A company need not issue total authorised capital. Whatever portion of the share capital is issued by the company, it is called 'Issued Capital'. Issued capital means and includes the nominal value of shares issued by the company for:

1. Cash, and
2. Consideration other than cash to:
   (i) Promoters of a company; and
   (ii) Others.

It is also presented in the balance sheet at nominal value.

The remaining portion of the authorised capital which is not issued either in cash or consideration may be termed as **'Un-issued Capital'**. It is not shown in the balance sheet.

(iii) *Subscribed Share Capital:* It is that part of the issued share capital, which is subscribed by the public i.e., applied by the public and allotted by the company. It also includes the face value of shares issued by the company for consideration other than cash.

(iv) *Called-up Share Capital:* Companies generally receive the issue price of shares in instalments. The portion of the issue price of shares which a company has demanded or called from shareholders is known as 'Called-up Capital' and the balance, which the company has decided to demand in future may be referred to as **Uncalled Capital.**

(v) *Paid-up Share Capital:* It is the portion of called up capital which is paid by the shareholders. Whenever a particular amount is called by the company and the shareholder(s) fails to pay the amount fully or partially, it is known as ***'unpaid calls' or 'instalments (or Calls) in Arrears'.*** Thus, instalments in arrears mean the amount not paid although it has been demanded by the company as payment towards the issue price of shares. To calculate paid-up capital, the amount of instalments in arrears is deducted from called up capital.

Call-in-advance is that portion of capital which is yet to be called by the company but has already been paid by shareholder.

In the financial statements, called-up and paid-up capital are shown together.

(vi) *Reserve Share Capital:* As per Section 65 of the Companies Act, 2013, a Company may decide by passing a resolution that a certain portion of its subscribed uncalled capital shall not be called up except in the event of winding up of the company. Portion of the uncalled capital which a company has decided to call only in case of liquidation of the company is called Reserve Capital.

Reserve Capital is different from Capital reserve, Capital reserves are part of 'Reserves and Surplus' and refer to those reserves which are not available for declaration of dividend. Thus, reserve capital which is portion of the uncalled capital to be called up in the event of winding up of the company is entirely different in nature from capital reserve which is created out of capital profits only.

1. Authorised Capital = Issued Capital + Unissued Capital.
2. Subscribed Capital can be equal to or grater than or less than Issued Capital resulting in 3 situations respectively: Fully Subscribed; Over Subscribed and Under Subscribed.
3. Called up Capital = Paid up Capital + Calls in arrears if any – Calls in advance if any.

ILLUSTRATION 1

A company had an authorised capital of ₹ 10,00,000 divided into 1,00,000 equity shares of ₹ 10 each. It decided to issue 60,000 shares for subscription and received applications for 70,000 shares. It allotted 60,000 shares and rejected remaining applications. Upto 31-3 -2022, it has demanded or called ₹ 9 per share. All shareholders have duly paid the amount called, except one shareholder, holding 5,000 shares who has paid only ₹ 7 per share.

Prepare a balance sheet assuming there are no other details.

SOLUTION

Balance Sheet as at 31st March, 2022

Particulars	Notes No.	₹
EQUITY AND LIABILITIES		
Shareholders' funds		
Share capital	1	5,30,000
Total		5,30,000

ASSETS		
Current assets		
Cash and cash equivalents	2	5,30,000
Total		5,30,000

Notes to accounts

		₹	₹
1.	**Share Capital**		
	Equity share capital		
	Authorised share capital		
	1,00,000 Equity shares of ₹ 10 each	10,00,000	
	Issued share capital		
	60,000 Equity shares of ₹ 10 each	6,00,000	
	Subscribed share capital		
	60,000 Equity shares of ₹ 10 each	6,00,000	
	Called up and Paid up share capital		
	60,000 Equity shares of ₹ 10 each ₹ 9 called up	5,40,000	
	Less: Calls unpaid on 5,000 shares @ ₹ 2 per share	(10,000)	5,30,000
2.	**Cash and cash equivalents**		
	Balances with banks		5,30,000

It is clear from above, that details of authorised, issued and subscribed capital are given in the Notes to Accounts but are not counted. It is only the paid-up capital i.e., the portion of the issued capital subscribed by shareholders which is taken into account while totalling the liabilities side of the balance sheet.

2.3 TYPES OF SHARES

Share issued by a company can be divided into following categories :

(i) **Preference Shares:** According to Section 43 of the Companies Act, 2013 persons holding preference shares, called preference shareholders, are assured of a preferential dividend at a fixed rate during the life of the company. They also carry a preferential right over other shareholders to be paid first in case of winding up of the company. Thus, they enjoy preferential rights in the matter of:

(a) Payment of dividend, and

(b) Repayment of capital

Generally, holders of these shares do not get voting rights. Companies use this mode of financing as it is cheaper than raising debt. Dividend is generally cumulative in nature and need not be paid every year in case of deficiency of profits. The Companies Act, 2013 prohibits the issue of any preference share which is irredeemable. Preference shares are cumulative and non-participating unless expressly stated otherwise.

Types of Preference Shares

Preference shares can be of various types, which are as follows :

(a) **Cumulative Preference Shares:** A cumulative preference share is one that carries the right to a fixed amount of dividend or dividend at a fixed rate. Such a dividend is payable even out of future profit if current year's profits are insufficient for the purpose. This means that dividend on these shares accumulates unless it is paid in full and, therefore, the shares are called Cumulative Preference Shares. The companies are required to disclose the arrears of fixed cumulative dividends on preference shares separately in the financial statement. In case, the dividend remains in arrears for a period of not less than two years, holders of such shares will be entitled to take part and vote on every resolution on every matter in the general body meeting of the shareholders.

(b) **Non-cumulative Preference Shares:** A non-cumulative preference share carries with it the right to a fixed amount of dividend. In case no dividend is declared in a year due to any reason, the right to receive such dividend for that year expires. It implies that holder of such a share is not entitled to arrears of dividend in future.

(c) **Participating Preference Shares:** Notwithstanding the right to a fixed dividend, this category of preference share confers on the holder the right to participate in the surplus profits, if any, after the equity shareholders have been paid dividend at a stipulated rate. Similarly, in the event of winding up of the company, this type of share carries the right to receive a pre-determined proportion of surplus as well once the equity shareholders have been paid off.

(d) **Non-participating Preference Shares:** A share on which only a fixed rate of dividend is paid every year, without any accompanying additional rights in profits and in the surplus on winding-up, is called 'Non-participating Preference Shares.' Unless otherwise specified, the preference shares are generally non-participating.

(e) Redeemable Preference Shares: These are shares that a company may issue on the condition that the company will repay after the fixed period or even earlier at company's discretion. The repayment on these shares is called redemption and is governed by Section 55 of the Companies Act, 2013.

(f) Non-redeemable Preference Shares: The preference shares, which do not carry with them the arrangement regarding redemption, are called Non-redeemable Preference Shares. According to Section 55, no company limited by shares shall issue irredeemable preference shares or preference shares redeemable after the expiry of 20 years from the date of issue. However, a Company may issue preference shares redeemable after 20 years for such infrastructure projects as may be specified, under the Companies Act, 2013.

(g) Convertible Preference Shares: These shares give the right to the holder to get them converted into equity shares at their option according to the terms and conditions of their issue.

(h) Non-convertible Preference Shares: When the holder of a preference share has not been conferred the right to get his holding converted into equity share, it is called Non-convertible Preference Shares. Preference shares are non-convertible unless otherwise stated.

Note: Unless mentioned otherwise Preference Shares are Non-Cumulative, Non Participating, Non-Convertible and Redeemable in nature.

(ii) Equity Shares: Equity shares are those shares, which are not preference shares. It means that they do not enjoy any preferential rights in the matter of payment of dividend or repayment of capital. The rate of dividend on equity shares is recommended by the Board of Directors and may vary from year to year. Rate of dividend depends upon the dividend policy and the availability of profits after satisfying the rights of preference shareholders. These shares carry voting rights. Companies Act, 2013 permits issue of equity share capital with differential rights as to dividend, voting or otherwise in accordance with prescribed rules.

The shares can be issued by a company either

(1) for cash or

(2) for consideration other than cash.

2.4 ISSUE OF SHARES FOR CASH

To issue shares, private companies depend upon 'Private Placement' of shares. Public companies issue a 'Prospectus' and invite general public to subscribe for shares. To discuss accounting treatment, we shall concentrate on public companies who invite general public to subscribe for equity shares. Similar accounting treatment is applicable in other cases. However, for journal entries in case of issue of preference shares, the word 'Equity' is replaced with the word 'Preference'.

A public company issues a prospectus inviting general public to subscribe for its shares. On the basis of prospectus, applications are deposited in a scheduled bank by the interested parties along with the amount payable at the time of application, in cash. First instalment paid along with application is called 'Application Money'. **As per Section 39 of the Companies Act, 2013. Application money must be at least 5% of the nominal value of shares.** After the closing date of the issue (the last date for filing applications), company decides about allotment of shares in consultation with the SEBI and stock exchange concerned. According to the Companies Act, 2013, a company cannot proceed to allot shares unless minimum subscription is received by the company.

Minimum Subscription: A public limited company cannot make any allotment of shares unless the amount of minimum subscription stated in the prospectus has been subscribed and the sum payable as application money for such shares has been paid to and received by the company. The amount of minimum subscription to be disclosed in prospectus by the Board of Directors taking into account the following:

(a) Preliminary expenses of the company,

(b) Commission payable on issue of shares,

(c) Cost of fixed assets purchased or to be purchased,

(d) Working capital requirements of the company, and

(e) Any other expenditure for the day to day operation of the business.

As per guidelines of the Securities Exchange Board of India (SEBI), the minimum subscription to be received in an issue shall not be less than ninety per cent of the offer through offer document [Provided that in the case of an initial public offer, the minimum subscription to be received shall be subject to allotment of minimum number of specified securities, as prescribed by Securities Contracts (Regulation) Rules, 1957]. If the Company does not receive the minimum subscription of 90% of the issue, all application moneys received shall be refunded to the applicants forthwith, but not later than:

(a) fifteen days of the closure of the issue, in case of a non-underwritten issue; and

(b) seventy days of the closure of the issue, in the case of an underwritten issue where minimum subscription including devolvement obligations paid by the underwriters is not received within sixty days of the closure of the issue.

The company reserves the right to reject or accept an application fully or partially. Successful applicants become shareholders of the company and are required to pay the second instalment which is known as 'Allotment Money' and unsuccessful applicants get back their money. However, in case of delay in refunding the money, the Company becomes liable to pay interest on the amount of refund. Subsequent instalments, if any, to be called by the company are known as 'Calls'.

As per Section 39 of the Companies Act, 2013, application money must be at least 5% of the face value of shares. However, as per SEBI Regulations, the minimum application moneys to be paid by an applicant along with the application money shall not be less than 25% of the issue price. According to Section 24 of the Companies Act, 2013 matters related to issue and transfer of securities will be administered by the SEBI and not by the Company Law Board.

The issue price of shares is generally received by the company in instalments and these instalments are known as under :

First instalment	....	Application Money
Second Instalment	....	Allotment Money
Third Instalment	....	First Call Money
Fourth Instalment	....	Second Call Money and so on.
Last Instalment		Final Call Money

2.4.1 Journal Entries for Issue of Shares for Cash

Upon the issue of share capital by a company, the undermentioned entries are made in the financial books:

(1) On receipt of the application money

Bank Account Dr. (With the actual amount received.)

To Share Application Account

(Being application money received)

(2) On allotment of share

Share Allotment Account Dr. (With the amount due on allotment.)

Share Application Account Dr. (With the application amount received on allotted shares.)

To Share Capital Account (With the amount due on allotment and application.)

(Being the sum due on allotment and application money transferred to capital account)

(3) On receipt of allotment money

Bank Account Dr. (With the amount actually received on allotment.)

To Share Allotment A/c

(Being money received on allotment)

Sometimes separate Application and Allotment Accounts are not prepared and entries relating to application and allotment monies are passed through a combined Application and Allotment Account.

On receipt of Application Money:

Bank A/c Dr

To Share Application and Allotment A/c

On allotment of shares:

Share Application & Allotment A/c Dr (With total application and allotment amount)

To Share Capital A/c

On Allotment money being received:

Bank A/c Dr

To Share Application & Allotment A/c

(4) On a call being made

Share Call Account Dr. (With the amount due on the call)

To Share Capital Account

(Being share call made due at ₹...)

(5) On receipt of call money

Bank Account Dr. (With the due amount actually received on call)

To Share Call Account

(Being share call money received)

2.5 SUBSCRIPTION OF SHARES

Accounting for issue of shares depends upon the type of subscription. Whenever a company decides to issue shares to public, it invites applications for subscription by issuing a prospectus. It is not necessary that company receives applications for the number of shares to be issued by it. There are three possibilities:

2.5.1 Full Subscription

Issue is fully subscribed if the number of shares offered for subscription and the number of shares actually subscribed by the public are same. To start discussion on accounting treatment for issue of shares, let us assume that the issue is fully subscribed.

ILLUSTRATION 2

A company invited applications for 10,000 equity shares of ₹ 50 each payable on application ₹ 15, on Allotment ₹ 20, on first and final call ₹15. Applications are received for 10,000 shares and all the applicants are allotted the number of shares they have applied for and instalment money was duly received by the company. Show Journal entries in the books of the company.

SOLUTION

Journal entries in the books of a company

For application money received: Amount received along with application is accounted as follows:

Bank A/c	Dr.	(Application money on allotted share i.e.,10,000 × ₹15 = ₹1,50,000)
To Equity Share Application A/c		

At the time of allotment: Application money received from successful applicants become part of share capital and is transferred to share capital as under:

Equity Share Application A/c	Dr.	(Application money on allotted share i.e.,10,000 × ₹ 15 = ₹ 1,50,000)
To Equity Share Capital A/c		

To record amount due on allotment: When the decision is taken to allot shares, allotment money on allotted shares falls due and is recorded as follows:

Equity Share Allotment A/c	Dr.	(Allotment money due at the allotted share i.e.,10,000 × ₹ 20 = ₹ 2,00,000)
To Equity Share Capital A/c		

For allotment money received: Allotment money received from shareholders is recorded as follows:

Bank A/c	Dr.	(Allotment money received from shareholders i.e.10,000 × ₹ 20 =₹ 2,00,000)
To Equity Share Allotment A/c		

When decision to demand first call is made: After allotment of share, when the Board of Directors decide to demand the next instalment from shareholders, first call money falls due and is accounted for, as under:

Equity Share First Call A/c	Dr.	(No. of shares × first call money per share i.e.,10,000 × ₹ 15 = ₹ 1,50,000)
To Equity Share Capital A/c		

On receiving first and final call money: The journal entry passed to record the money received on account of first call is as under:

Bank A/c	Dr.	(Amount actually received on account of first call i.e., ₹ 10,000 × ₹ 15 = ₹ 1,50,000)
To Equity First Call A/c		

2.5.2 Under Subscription

It means the number of shares offered for subscription is more than the number of shares subscribed by the public. In this case, the journal entries as discussed above are passed but with one change i.e., calculation of application, allotment and for that matter, the call money is based on number of shares actually applied and allotted. It must be remembered that shares can be allotted, in this case, only when the minimum subscription is received.

ILLUSTRATION 3

On 1st April, 2021, A Ltd. issued 43,000 shares of ₹ 100 each payable as follows:

₹ 20 on application;

₹ 30 on allotment;

₹ 25 on 1st October, 2021; and

₹ 25 on 1st February, 2022.

By 20th May, 40,000 shares were applied for and all applications were accepted. Allotment was made on 1st June. All sums due on allotment were received on 15th July; those on 1st call were received on 20th October. Journalise the transactions when accounts were closed on 31st March, 2022.

SOLUTION

A Ltd.

Journal

2021		₹	₹
May 20	Bank Account Dr.	8,00,000	
	To Share Application A/c		8,00,000
	(Application money on 40,000 shares at ₹ 20 per share received.)		
June 1	Share Application A/c Dr.	8,00,000	
	To Share Capital A/c		8,00,000
	(The amount transferred to Capital Account on 40,000 shares at - ₹ 20 on application. Directors' resolution no...... dated ......)		
	Share Allotment A/c Dr.	12,00,000	
	To Share Capital A/c		12,00,000
	(Being share allotment made due at ₹ 30 per share. Directors' resolution no...... dated ......)		
July 15	Bank Account Dr.	12,00,000	
	To Share Allotment A/c		12,00,000
	(The sums due on allotment received.)		
Oct. 1	Share First Call Account Dr.	10,00,000	
	To Share Capital Account		10,00,000
	(Amount due from members in respect of first call-on 40,000 shares at ₹ 25 as per Directors, resolution no... dated...)		
Oct. 20	Bank Account Dr.	10,00,000	
	To Share First Call Account		10,00,000
	(Receipt of the amounts due on first call.)		
2022			
Feb. 1	Share Second and Final Call A/c Dr.	10,00,000	
	To Share Capital A/c		10,00,000
	(Amount due on 40,000 share at ₹ 25 per share on second and final call, as per Directors resolution no... dated...)		

Mar. 31	Bank Account To Share Second & Final Call A/c (Amount received against the final call on 40,000 shares at ₹ 25 per share.)	Dr.	10,00,000	 10,00,000

2.5.3 Over Subscription

In actual practice, issue of shares is either under or over-subscribed. If an issue is over-subscribed, some applications may be rejected and application money refunded and in respect of others, only a part of the shares applied for may be allotted and the excess amount received can be utilised towards allotment or call money which has fallen due or will soon fall due for payment. The entries are:

(1) On refund of application money to applicants to whom shares have not been allotted:

Share Application A/c Dr.

To Bank Account

(Being application money refunded)

(2) When only a part of shares applied for are allotted.

Share Application A/c Dr.

To Share Allotment* A/c (With the application money accepted for allotment)

To Share Calls-in-Advance* A/c (With the amount received in advance)

To Bank A/c (With any excess amount to be refunded)

(Being application money adjusted)

*Credited to Share Capital A/c subsequently.

(**Note:** This type of share allotment is termed as Pro-rata allotment and has been discussed in detail in para 2.8)

ILLUSTRATION 4

Pant Ltd. invited applications for 50,000 equity shares at ₹50 each, which are payable as on application ₹20, on allotment ₹10 and on first and final call ₹20. The company received applications for 60,000 shares. The directors accepted application for 50,000 shares and rejected the rest. Show Journal entries if company refunded the application money to rejected applicants and allotment money was received for 45,000 shares.

SOLUTION

Pant Ltd.

Journal

	₹	₹
Bank A/c Dr.	12,00,000	
To Equity Share Application A/c		12,00,000
(Being the application money received for 60,000 shares at ₹ 20 per share)		
Equity Share Application A/c Dr.	12,00,000	
To Equity Share Capital A/c		10,00,000
To Bank A/c		2,00,000
(Being share allotment made for 50,000 shares and excess refunded.)		
Equity Share Allotment A/c Dr.	5,00,000	
To Equity Share Capital A/c		5,00,000
(Being allotment amount due on 50,000 equity shares at ₹ 10 per share as per Directors' resolution no... dated...)		
Bank A/c Dr.	4,50,000	
Calls in Arrears A/c Dr.	50,000	
To Equity Share Allotment A/c		5,00,000
(Being allotment money received for 45,000 shares at ₹ 10 per share.)		

ILLUSTRATION 5

The Delhi Artware Ltd. issued 50,000 equity shares of ₹ 100 each and 1,00,000 preference shares of ₹ 100 each. The Share Capital was to be collected as under:

	Equity Shares (₹)	*Preference Shares (₹)*
On Application	*25*	*20*
On Allotment	*20*	*30*
First Call	*30*	*20*
Final Call	*25*	*30*

All these shares were subscribed. Final call was received on 42,000 equity shares and 88,000 preference shares. Prepare the cash book and journalise the remaining transactions in the books of the company.

SOLUTION

Delhi Artware Ltd.

Cash Book

Dr. Cr.

		₹		₹
To	Equity Shares Applications Account (application money on 50,000 shares at ₹ 25)	12,50,000	By Balance c/d	14,440,000
To	Preference Share Application A/c (application money on 1,00,000 shares at ₹ 20)	20,00,000		
To	Equity Share Allotment A/c (allotment money on 50,000 shares at ₹ 20)	10,00,000		
To	Preference Share Allotment A/c (allotment money on 1,00,000 shares at ₹ 30)	30,00,000		
To	Equity Shares First Call A/c (₹ 30 on 50,000 shares)	15,00,000		
To	Preference Share First Call A/c (₹ 20 on 1,00,000 shares)	20,00,000		
To	Equity Shares Final Call A/c (₹ 25 on 42,000 shares)	10,50,000		
To	Preference Share Final A/c (₹ 30 on 88,000 shares)	26,40,000		
		14,440,000		14,440,000
To	Balance b/d	14,440,000		

Journal

	₹	₹
Equity Share Application A/c Dr.	12,50,000	
Equity Share Allotment A/c Dr.	10,00,000	
To Equity Share Capital A/c		22,50,000
[The Credit to share capital on allotment of 50,000 equity shares at ₹ 45 per share (₹ 25 on application and ₹ 20 on allotment) allotted as per Directors resolution no.... dated.....]		
Preference Share Application A/c Dr.	20,00,000	
Preference Share Allotment A/c Dr.	30,00,000	
To Preference Share Capital A/c		50,00,000
[The credit to Preference Share Capital on allotment of 1,00,000 preference shares at ₹ 50 per share (₹ 20 on application and ₹30 on allotment), allotted as per Directors' resolution no... dated...]		
Equity Share First Call A/c Dr.	15,00,000	
To Equity Share Capital A/c		15,00,000
(Amount due on 50,000 equity shares at ₹ 30 per share as per Directors' resolution no... dated...)		
Preference Share First Call A/c Dr.	20,00,000	
To Preference Share Capital A/c		20,00,000
(Amount due on 1,00,000 preference shares at ₹ 20 per share, as per Directors' resolution no...dated...)		
Equity Share Final Call A/c Dr.	12,50,000	
To Equity Share Capital A/c		12,50,000
(Amount due on final call on 50,000 equity shares at ₹ 25 per share, as per Directors' resolution no... dated...)		
Preference Share Final Call A/c Dr.	30,00,000	
To Preference Share Capital A/c		30,00,000
(Amount due on final call on 1,00,000 preference shares at ₹ 30 per share, as per Directors' resolution no... dated...)		

Note: Students may note that cash transactions have not been journalised as these have been entered in the Cash Book.

2.6 SHARES ISSUED AT DISCOUNT

Shares are regarded to be issued at a discount, if issue is at an amount less than the nominal or par value of shares. The excess of the nominal value over the issue price represents discount on the issue of shares. For example, when a share of the nominal value of ₹ 100 is issued at ₹ 98, it is said to have been issued at a discount of 2 per cent.

According to Section 53 of the Companies Act, 2013, a Company cannot issue shares at a discount except in the case of issue of sweat equity shares (issued to employees and directors). Thus, any issue of shares at discount shall be void.

2.7 SHARES ISSUED AT PREMIUM

When a company issues its securities at a price more than the face value, it is said to be an issue at a premium. Premium is the excess of issue price over face value of the security. It is quite common for the financially strong, and well-managed companies to issue their shares at a premium, i.e. at an amount more than the nominal or par value of shares. Thus, where a share of the nominal value of ₹ 100 is issued at ₹ 105, it is said to have been issued at a premium of 5 per cent.

When the issue is at a premium, the amount of premium may technically be called at any stage of share capital transactions. However, premium is generally called with the amount due on allotment, sometimes with the application of money and rarely with the call money.

2.7.1 Accounting Treatment

When shares are issued at a premium, the premium amount is credited to a separate account called *"Securities Premium Account"* because it is not a part of share capital. Rather, it represents a gain of a capital nature to the company.

Being a credit balance, Securities premium Account is shown under the heading, "Reserves and Surplus". However, 'Reserves and Surplus' is shown as 'shareholders' funds in the Balance Sheet as per Schedule III. According to Section 52 of the Companies Act, 2013, Securities Premium Account may be used by the company:

(a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities.

(b) To write off preliminary expenses of the company.

(c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company.

(d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.

(e) For the purchase of own shares or other securities.

Note : It may be noted that certain class of Companies as prescribed under Section 133 of the Companies Act, 2013, whose financial statements comply with the accounting standards prescribed for them (i.e. those companies to whom Indian Accounting Standards are applicable), can't apply the securities premium account for the purposes (b) and (d) mentioned above.

When shares are issued at a premium, the journal entries are as follows:

(a) Premium amount called with Application money

(i)	Bank A/c	Dr.	[Total Application money + Premium Amount]
	To Share Application A/c		[Amount received]
	(Money received on applications For Shares @ ₹______ per share including premium)		
(ii)	Share Application A/c	Dr.	[No. of Shares Applied for x Application Amount per share]
	To Securities Premium A/c		[No. of Shares allotted x Premium Amount per share]
	To Share Capital A/c		[No. of Shares allotted x Nominal value per share for capital]

(b) Premium Amount called with Allotment Money

(i)	Share Allotment A/c	Dr.	[No. of Shares Allotted x Allotment and Premium Money per share]
	To Share Capital A/c		[No. of Shares Allotted x Allotment Amount per share]
	To Securities Premium A/c		[No. of Share Allotted x Premium Amount per share]
	(Amount due on allotment of shares @ ₹____ per share including premium)		

(ii) Bank A/c Dr.

To Share Allotment A/c

(Money received including premium consequent upon allotment).

ILLUSTRATION 6

On 1st October, 2022 Pioneer Equipment Limited received applications for 2,50,000 Equity Shares of ₹ 100 each to be issued at a premium of 25 per cent payable as :

On Application ₹ 25

On Allotment ₹ 75 (including premium)

Balance Amount on Shares As and when required

The shares were allotted by the Company on October 20, 2022 and the allotment money was duly received on October 31, 2022.

Record journal entries in the books of the company to record the transactions in connection with the issue of shares.

SOLUTION

Pioneer Equipment Limited

Journal

Date	Particulars	L.F.	Debit Amount	Credit Amount
2022			(₹000)	(₹000)
Oct. 1	Bank A/c Dr.		6,250	
	To Equity Share Application A/c			6,250
	(Money received on applications for 2,50,000 shares @ ₹ 25 per share)			
Oct. 20	Equity Share Application A/c Dr.		6,250	
	To Equity Share Capital A/c			6,250
	(Transfer of application money on allotment to share capital)			
Oct. 20	Equity Share Allotment A/c Dr.		18,750	
	To Equity Share Capital A/c			12,500

	To Securities Premium A/c			6,250
	(Amount due on allotment of 2,50,000 shares @ ₹ 75 per share including premium)			
Oct. 31	Bank A/c Dr.		18,750	
	To Equity Share Allotment A/c			18,750
	(Money received including premium consequent upon allotment)			

Note: Bifurcation of Allotment amount

Security premium per share = 25% x ₹100

= ₹ 25

Money received on allotment per share = ₹ 75

	Premium	Capital
Per Share (75)	₹ 25	₹ 50
No. of Shares (in '000)	250	250
Total Amount (In '000)	₹ 6,250	₹12,500

2.8 OVER SUBSCRIPTION AND PRO-RATA ALLOTMENT

Over subscription is the application money received for more than the number of shares offered to the public by a company. It usually occurs in the case of good issues and depends on many other factors like investors' confidence in the company, general economic conditions, pricing of the issue etc. When the shares are oversubscribed, the company cannot satisfy all the applicants. It means that a decision is to be made on how the shares are going to be allotted. Shares can be allotted to the applicants by a company in any manner it thinks proper. The company may reject some applicants in full, i.e., no shares are allotted to some applicants and application money is refunded. Usually, multiple applications by the same persons are not considered. Allotment may be given to the rest of the applicants in full, i.e., for the number of shares they have applied for. A third alternative is that a company may allot shares to the applicants on **pro-rata** basis. 'Pro-rata allotment' means allotment in proportion of shares applied for.

For example, a company offers to the public 10,000 shares for subscription. The company receives applications for 12,000 shares. If the shares are to be allotted on pro-rata basis, applicants for 12,000 shares are to be allotted 10,000 shares, i.e., on the 12,000: 10,000 or 6:5 ratio. Any applicant who has applied for 6 shares will be allotted 5 shares.

Under pro-rata allotment, the excess application money received is adjusted against the amount due on allotment or calls. Surplus money after making adjustment against future calls is returned to the applicants. The applicants are informed about the allotment procedure through an advertisement in leading newspapers.

When there is a pro-rata allotment, the total application money paid by an applicant is more than the exact amount due on application. The excess amount is treated as an advance against allotment or any other future calls. The net amount due on allotment or any other calls is the difference between the amount due on allotment or any other calls and the excess amount received in application.

Accounting Entries

(a) *For rejected applications:*

Share Application Account Dr.

To Bank Account

(Being application money refunded for rejected applications as per Board's Resolution No....dated....)

(b) For pro-rata allotment:

Share Application Account Dr.

To Share Allotment Account

(Being excess application money adjusted against allotment money as per Board's Resolution No....dated....)

Illustration 7

JHP Limited is a company with an authorised share capital of ₹10,00,000 in equity shares of ₹10 each, of which 6,00,000 shares had been issued and fully paid on 30th June, 2021. The company proposed to make a further issue of 1,00,000 of these ₹10 shares at a price of ₹14 each, the arrangements for payment being:

(a) ₹ 2 per share payable on application, to be received by 1st July, 2021;

(b) Allotment to be made on 10th July, 2021 and a further ₹ 5 per share (including the premium) to be payable;

(c) The final call for the balance to be made, and the money received by 30th April, 2022.

Applications were received for 3,55,000 shares and were dealt with as follows:

(i) *Applicants for 5,000 shares received allotment in full;*

(ii) *Applicants for 30,000 shares received an allotment of one share for every two applied for; no money was returned to these applicants, the surplus on application being used to reduce the amount due on allotment;*

(iii) *Applicants for 3,20,000 shares received an allotment of one share for every four applied for; the money due on allotment was retained by the company, the excess being returned to the applicants; and*

(iv) *the money due on final call was received on the due date.*

You are required to record these transactions (including cash items) in the Journal of JHP Limited.

SOLUTION

Journal of JHP Limited

Date		₹	₹
2021	**Particulars**		
	Bank A/c (Note 1 – Column 3) Dr.	7,10,000	
July 1	To Equity Share Application A/c		7,10,000
	(Being application money received on 3,55,000 shares @ ₹ 2 per share)		
July 10	Equity Share Application A/c Dr.	7,10,000	
	To Equity Share Capital A/c		2,00,000
	To Equity Share Allotment A/c (Note 1 Column 5)		4,30,000
	To Bank A/c (Note 1 – Column 6)		80,000
	(Being application money on 1,00,000 shares transferred to Equity Share Capital Account; on 2,15,000 shares adjusted with allotment and on 40,000 shares refunded as per Board's Resolution No.....dated...)		
	Equity Share Allotment A/c Dr.	5,00,000	
	To Equity Share Capital A/c		1,00,000

	To Securities Premium a/c		4,00,000
	(Being allotment money due on 1,00,000 shares @ ₹ 5 each including premium at ₹4 each as per Board's Resolution No....dated....)		
	Bank A/c (Note 1 – Column 8) Dr.	70,000	
	To Equity Share Allotment A/c		70,000
	(Being balance allotment money received)		
2022	Equity Share Final Call A/c Dr.	7,00,000	
	To Equity Share Capital A/c		7,00,000
	(Being final call money due on 1,00,000 shares @ ₹ 7 per share as per Board's Resolution No.....dated....)		
April 30	Bank A/c Dr.	7,00,000	
	To Equity Share Final Call A/c		7,00,000
	(Being final call money on 1,00,000 shares @ ₹ 7 each received)		

Working Notes:

Calculation for Adjustment and Refund

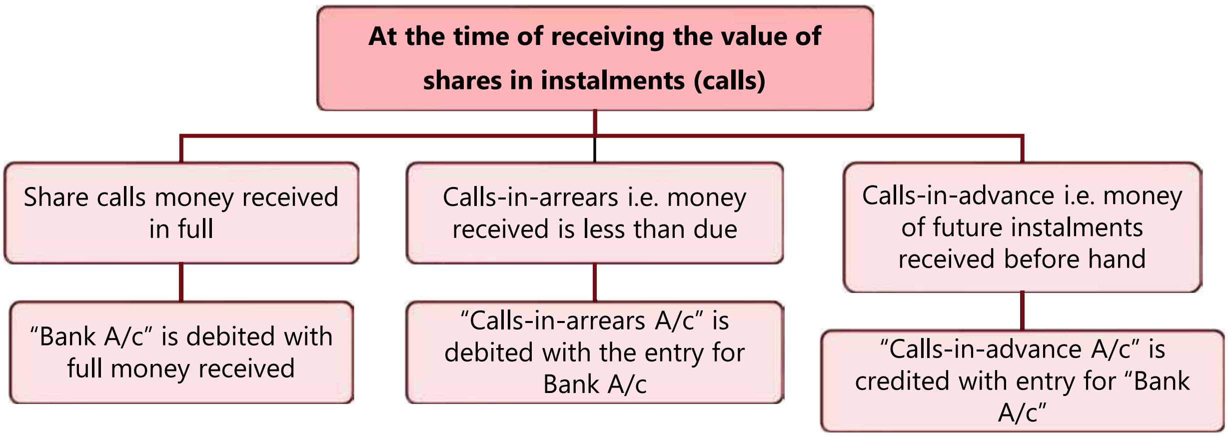
Category	No. of Shares Applied for	No. of Shares Allotted	Amount Received on Application	Amount Required on Application	Amount adjusted on Allotment	Refund [3 - 4 + 5]	Amount due on Allotment	Amount received on Allotment
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
(i)	5,000	5,000	10,000	10,000	Nil	Nil	25,000	25,000
(ii)	30,000	15,000	60,000	30,000	30,000	Nil	75,000	45,000
(iii)	3,20,000	80,000	6,40,000	1,60,000	4,00,000	80,000	4,00,000	Nil
TOTAL	**3,55,000**	**1,00,000**	**7,10,000**	**2,00,000**	**4,30,000**	**80,000**	**5,00,000**	**70,000**

Also,

(i) Amount Received on Application (3) = No. of shares applied for (1) x ₹ 2

(ii) Amount Required on Application (4) = No. of shares allotted (2) x ₹ 2

2.9 CALLS-IN-ARREARS AND CALLS-IN-ADVANCE



Calls-in-Arrears

Sometimes shareholders fail to pay the amount due on allotment or calls. The total unpaid amount on one or more instalments is known as *Calls-in-Arrears* or *Unpaid Calls*. Such amount represents the uncollected amount of capital from the shareholders; hence, it is shown by way of deduction from 'called-up capital' to arrive at paid-up value of the share capital.

For recording 'Calls-in-Arrears', the following journal entry is recorded :

Calls-in-Arrears A/c	Dr.	[Amount of Unpaid Calls]
Bank A/c	Dr.	[Amount received]
To Share Allotment A/c		[Total allotment money due]
To Share Calls A/c		[Total Call money due]

(Being call money/ allotment money received on .... shares at ₹.... per share.)

Calls-in-Advance

Some shareholders may sometimes pay a part, or whole, of the amount not yet called up, such amount is known as Calls-in-advance. According to Table F, interest at a rate not exceeding 12 per cent p.a. is to be paid on such advance call money. This amount is credited in Calls-in-Advance Account. The following entry is recorded:

Bank A/c	Dr.	[Call amount received in advance]
To Call-in-Advance A/c		

When calls become actually due, calls-in-advance account is adjusted at the time of the call. For this the following journal entry is recorded:

Calls-in-Advance A/c	Dr.	[Call amount received in advance]

Bank A/c Dr. [Remaining call money received, if any]

To Particular Call A/c [Call money due]

(Being call in advance adjusted and call money due received)

ILLUSTRATION 8

Shreyas Ltd. did not receive the first call on 10,000 equity shares @ ₹ 3 per share which was due on 1.7.2021. This amount was received on 1.4.2022.

Open Calls in arrears account and journalise the entries in the books of the company on 1.7.2021 and 1.4.2022.

SOLUTION

Shreyas Ltd

Journal

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
1.7.2021	Calls in Arrears A/c Dr. To Equity Share First Call A/c (Being amount due on first call on 10,000 shares at ₹3 per share transferred to calls in arrears account)		30,000	30,000
1.4.2022	Bank A/c Dr. To Calls in Arrears A/c (Being calls in arrears received)		30,000	30,000

2.10 INTEREST ON CALLS-IN-ARREARS AND CALLS-IN-ADVANCE

Interest on calls in arrears is recoverable and that in respect of calls in advance is payable, according to provisions in this regard in the articles of the company, at the rates mentioned therein or those to be fixed by the directors, within the limits prescribed by the Articles. Table F prescribes 10% and 12% p.a. as the maximum rates respectively for calls in arrears and those in advance.

Interest on Calls in Arrears	Interest on Calls in Advance
It is payable by shareholders to company on the calls due but remaining unpaid.	It is payable by the Company to Shareholders on the call money received in advance but not yet due.

As per Table F maximum prescribed rate is 10%.	As per Table F maximum prescribed rate is 12%.
Period considered : From the date call money was due to the date money is finally received.	Period considered: From the date money was received to the day call was finally made due.
Directors have a right to waive off such interest in individual cases at their own discretion.	Shareholders are not entitled for any dividend on calls in advance.
It is a nominal account in nature and is credited to statement of profit and loss as an income.	It is a nominal account in nature with interest being an expense for the company.

The book entries to be passed for the adjustment of such interest are much the same as those in case of temporary borrowings or loans raised, the only difference being that debits are raised and credits are given to Sundry Members Account (and not the individual accounts of shareholders) in respect of interest recoverable on calls in arrear or that payable on call received in advance, the corresponding entries being made in the Interest Receivable on Calls in Arrears and Interest Payable on Calls in Advance, respectively.

The journal entries for calls-in-arrears are as follows :

(i) For interest receivable on calls-in-arrears

Shareholders' A/c Dr.

To Interest on calls-in-arrears A/c

(Being interest on calls in arrears at the rate of ...% made due)

(ii) For receipt of interest

Bank A/c Dr.

To Shareholders' A/c

(Being interest money received)

The accounting treatment of interest on Calls-in-Advance is as follows:

(i) Interest Due

Interest on Calls-in-Advance A/c Dr. [Amount of interest due for payment]

To Shareholder's A/c

(Being interest on calls in advance made due)

(ii) Payment of Interest

Shareholder's A/c Dr. [Amount of interest paid]

To Bank A/c

(Being interest paid on calls-in-advance)

ILLUSTRATION 9

Rashmi Limited issued at par 1,00,000 Equity shares of ₹10 each payable ₹2.50 on application; ₹3 on allotment; ₹ 2 on first call and balance on the final call. All the shares were fully subscribed. Mr. Nair who held 10,000 shares paid full remaining amount on first call itself. The final call which was made after 3 months from first call was fully paid except a shareholder having 1000 shares who paid his due amount after 2 months along with interest on calls in arrears. Company also paid interest on calls in advance to Mr. Nair. Give journal entries to record these transactions.

SOLUTION

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr. To Equity Share Application A/c (Money received on applications for 1,00,000 shares @ ₹ 2.50 per share)		2,50,000	2,50,000
	Equity Share Application A/c Dr. To Equity Share Capital A/c (Transfer of application money on 1,00,000 shares to share capital)		2,50,000	2,50,000
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c (Amount due on the allotment of 1,00,000 shares @ ₹ 3 per share)		3,00,000	3,00,000
	Bank A/c Dr. To Equity Share Allotment A/c (Allotment money received)		3,00,000	3,00,000

	Equity Share First Call A/c Dr.		2,00,000	
	To Equity Share Capital A/c			2,00,000
	(Being first call made due on 1,00,000 shares at ₹ 2 per share)			
	Bank A/c Dr.		2,25,000	
	To Equity Share First Call A/c			2,00,000
	To Calls in Advance A/c			25,000
	(Being first call money received along with calls in advance on 10,000 shares at ₹ 2.50 per share)			
	Equity Share Final Call A/c Dr.		2,50,000	
	To Equity Share Capital A/c			2,50,000
	(Being final call made due on 1,00,000 shares at ₹ 2.50 each)			
	Bank A/c Dr.		2,22,500	
	Calls in Advance A/c Dr.		25,000	
	Calls in Arrears A/c Dr.		2,500	
	To Equity Share Final Call A/c			2,50,000
	(Being final call received for 89,000 shares and calls in advance for 10,000 shares adjusted)			
	Interest on Calls in Advance A/c Dr.		750	
	To Shareholders A/c			750
	(Being interest made due on calls in advance of ₹25,000 at the rate of 12% p.a.)			
	Shareholders A/c Dr.		750	
	To Bank A/c			750
	(Being payment of interest made to shareholder)			

	Shareholders A/c Dr.		41.67	
	To Interest on Calls in Arrears A/c			41.67
	(Being interest on calls in arrears made due at the rate of 10%)			
	Bank A/c Dr.		2,541.67	
	To Calls in Arrears A/c			2,500
	To Shareholders A/c			41.67
	(Being money received from shareholder for calls in arrears and interest thereupon)			

2.11 FORFEITURE OF SHARES

The term 'forfeit' actually means taking away of property on breach of a condition. It is very common that one or more shareholders fail to pay their allotment and/or calls on the due dates. Failure to pay call money results in forfeiture of shares. Forfeiture of shares is the action taken by a company to cancel the shares. The directors are usually empowered by the Articles of Association to forfeit those shares by serving proper notice to the defaulting shareholder(s). When shares are forfeited, the title of such shareholder is extinguished but the amount paid to date is not refunded to him. The shareholder then has no further claim on the company. The power of forfeiture must be exercised strictly having regard to the rules and regulations provided in the Articles of Association and it should be bonafide in the interests of the company.

The Articles of a company usually authorise the Directors to forfeit shares of a member on account of non-payment of a call or interest thereon after serving him a prior notice as prescribed by the Articles. Directors also have the right to cancel such forfeiture before the forfeited shares are re-allotted.

Accounting Entries

At the time of passing entry for forfeiture of shares, students must be careful about the following matters:

(i) Amount called-up (i.e., amount credited to capital) in respect of forfeited shares.

(ii) Amount already received in respect of those shares.

(iii) Amount due but has not been received in respect of those shares.

We know that shares can be issued at par or at a premium. Accounting entries for forfeiture will vary according to situations.

2.11.1 Forfeiture of Shares which were issued at Par

In this case, Share Capital Account will be debited with the called-up value of shares forfeited. Allotment or Calls Account will be credited with the amount due but not paid by the shareholder(s). (Alternatively, Calls-in-Arrears Account can be credited for all amount due, if it was transferred to Calls-in-Arrears Account). Forfeited Shares Account or Shares Forfeiture Account will be credited with the amount already received in respect of those shares.

Share Capital Account	Dr.	[No. of shares x called-up value per share]
To Forfeited Shares Account		[Amount already received on forfeited shares]
To Share Allotment Account		[If amount due, but not paid]
To Share First Call Account		[If amount due, but not paid]
To Share Final Call Account		[If amount due, but not paid]

Where all amounts due on allotment, first call and final call have been transferred to Calls-in-Arrears Account, the entry will be :

Share Capital Account	Dr.	[No. of shares x called-up value per share]
To Calls-in-Arrears Account		[Total amount due, but not paid]
To Forfeited Shares Account		[Amount received]

ILLUSTRATION 10

A Ltd forfeited 30,000 equity shares of ₹ 10 fully called-up, held by Mr. X for non-payment of final call @ ₹ 4 each. However, he paid application money @ ₹ 2 per share and allotment money @ ₹ 4 per share. These shares were originally issued at par. Give Journal Entry for the forfeiture.

SOLUTION

In the books of A Ltd.

Journal

Date	Particulars		₹	₹
	Equity Share Capital A/c (30,000 x ₹ 10)	Dr.	3,00,000	
	To Equity Share Final Call A/c (30,000 x ₹ 4)			1,20,000
	To Forfeited Shares A/c (30,000 x ₹ 6)			1,80,000
	(Being the forfeiture of 30,000 equity shares of ₹ 10 each fully called-up for non-payment of final call money @ ₹ 4 each as per Board's Resolution No.... dated....)			

ILLUSTRATION 11

X Ltd forfeited 20,000 equity shares of ₹ 10 each, ₹ 8 called-up, for non-payment of first call money @ ₹ 2 each. Application money @ ₹ 2 per share and allotment money @ ₹ 4 per share have already been received by the company. Give Journal Entry for the forfeiture (assume that all money due is transferred to Calls-in-Arrears Account).

SOLUTION

In the books of X Ltd

Journal

Date	Particulars		₹	₹
	Equity Share Capital A/c (20,000 x ₹ 8)	Dr.	1,60,000	
	To Calls-in-Arrears A/c (20,000 x ₹ 2)			40,000
	To Forfeited Shares A/c (20,000 x ₹ 6)			1,20,000
	(Being the forfeiture of 20,000 equity shares of ₹ 10each, ₹ 8 called-up for non-payment of first call money @ ₹ 2 each as per Board's Resolution No......dated.....)			

2.11.2 Forfeiture of Shares which were issued at a Premium

In this case, Share Capital Account will be debited with the called-up value of shares forfeited. If the premium on such shares has not been paid by the shareholder, the Securities Premium Account will be debited to cancel it (if it was credited earlier). Allotment, Calls and Forfeited Accounts will be credited in the usual manner.

If the premium has already received by the company, it cannot be cancelled even if the shares are forfeited in the future.

If premium not received

Share Capital A/c	Dr.	[Called-up value]
Securities Premium A/c	Dr.	[Amount of Security premium not received]
To Share Allotment Account		[If amount due, but not paid]
To Share First Call Account		[If amount due, but not paid]
To Share Final Call Account		[If amount due, but not paid]
To Forfeited Shares Account		[Amount received on forfeited shares]

If premium received

Share Capital A/c	Dr.	[Called-up value]
To Share Allotment Account		[If amount due, but not paid]
To Share First Call Account		[If amount due, but not paid]
To Share Final Call Account		[If amount due, but not paid]
To Forfeited Shares Account		[Amount received on forfeited shares]

ILLUSTRATION 12

X Ltd. forfeited 5,000 equity shares of ₹100 each fully called-up which were issued at a premium of 20%. Amount payable on shares were: on application ₹ 20; on allotment ₹ 50 (including premium); on First and Final call ₹ 50. Only application money was paid by the shareholders in respect of these shares. Pass Journal Entries for the forfeiture.

SOLUTION

In the books of X Ltd.

Journal

Date	Particulars		₹	₹
	Equity Share Capital A/c (5,000 x ₹ 100)	Dr.	5,00,000	
	Securities Premium A/c (See Note)	Dr.	1,00,000	
	To Equity Share Allotment A/c (5,000 x ₹ 50)			2,50,000
	To Equity Share First and Final Call A/c (5000 x ₹ 50)			2,50,000
	To Forfeited Shares A/c (5000 x ₹ 20)			1,00,000
	(Being the forfeiture of 5,000 equity shares of ₹ 100 each fully called-up, issued at a premium of 20%, for non-payment of allotment and call money as per Board's Resolution No.....dated....)			

Tutorial Note: Share premium @ ₹ 20 on 5,000 shares has not been received by the company. Therefore, at the time of forfeiture, Securities Premium Account will be debited to cancel it (because Securities Premium Account was credited at the time of allotment).

Also, in case of pro-rata allotment where shares are issued at premium, the excess money received on application will be first adjusted to capital account and then for securities premium.

ILLUSTRATION 13

Mr. Shami has applied for 1,000 shares of Company XYZ Ltd. paying application money @ ₹ 2 per share but has been allotted only 600 shares. The shares have a face value of ₹ 10 and a premium of ₹ 2 per share, which are payable as: on Allotment- ₹ 5 (including premium) and on final call ₹ 5. Now in case Mr. Shami doesn't pay allotment money and final call and his shares are forfeited, then following entry will be passed on forfeiture:

SOLUTION

Share Capital A/c (600 x ₹ 10)	Dr.	6,000	
Securities Premium A/c (600 x ₹ 2)	Dr.	1,200	
To Share Forfeiture A/c			2,000
To Share Allotment A/c			2,200
To Share Final Call A/c (600 x 5)			3,000
(Being 600 shares forfeited due to non-payment of allotment money and call money as per Board Resolution no..... dated.....)			

Note:

Total Amount Received on application (1,000 x 2)	2,000
Less: Amount used for application money (600 x 2)	(1,200)
Excess money received on application	800
Amount due on Allotment (600 x 5)	3,000
For premium (600 x 2)	1,200
For Capital A/c (600 x 3)	1,800
Thus amount not received on allotment (3,000 - 800)	2,200

	For Premium A/c	For Capital A/c
Amount not received on allotment (2,200)	₹ 1,200	₹ 1,000

2.11.3 Forfeiture of Fully Paid-Up Shares

Forfeiture for non-payment of calls, premium, or the unpaid portion of the face value of the shares is one of the many causes for which a share may be forfeited. But fully paid-up shares may be forfeited for realization of debts of the shareholder if the Articles specifically provide it.

2.12 RE-ISSUE OF FORFEITED SHARES

A forfeited share is merely a share available to the company for sale and remains vested in the company for that purpose only. Reissue of forfeited shares is not allotment of shares but only a sale.

The share, after forfeiture, in the hands of the company is subject to an obligation to dispose it off. In practice, forfeited shares are disposed off by auction. These shares can be re-issued at any price so long as the total amount received (from the original allottee and the second purchaser) for those shares is not less than the amount in arrear on those shares.

Accounting Entries :

(a) Bank Account Dr. [Actual amount received]

Forfeited Shares Account Dr. [Loss on re-issue]

To Share Capital Account

(Being the re-issue of....shares @ ₹ .... each as per Board's Resolution No.... dated.)

(b) Forfeited Shares Account Dr.

To Capital Reserve Account

(Being the profit on re-issue, transferred to capital reserve).

2.12.1 Points for Consideration

In connection with re-issue, the following points are important:

1. Loss on re-issue should not exceed the forfeited amount.
2. If the loss on re-issue is less than the amount forfeited, the surplus should be transferred to Capital Reserve.
3. The forfeited amount on shares (amount originally paid-up) not yet reissued should be shown under the heading 'share capital.'
4. When only a portion of the forfeited shares are re-issued, then the profit made on re-issue of such portion of shares only must be transferred to Capital Reserve.
5. When the shares are re-issued at a loss, such loss is to be debited to "Forfeited Shares Account".
6. If the shares are re-issued at a price which is more than the face value of the shares, the excess amount will be credited to Securities Premium Account.

7. If the re-issued amount and forfeited amount (taken together) exceeds the face value of the shares re-issued, it is not necessary to transfer such amount to Securities Premium Account.

2.12.2 Calculation of Profit on Re-Issue of Forfeited Shares

Students will appreciate that the credit balance of forfeited shares account cannot be considered a surplus until the shares forfeited have been re-issued, because the company may, on re-issue, allow the discount to the new purchaser equivalent to the amount held in credit in this regard in the forfeited shares Account. Suppose 120 shares of a nominal value of ₹ 10 have been forfeited upon which ₹ 5 per share was paid up and transferred to Forfeited Share Account. Afterwards, 50 shares are re-issued, ₹ 6 per share being collected to make them fully paid up; ₹ 200 (50 shares x ₹ 10- 50 shares x ₹ 6) out of shares forfeited will be credited to Share Capital Account to make up the deficiency on re-issued shares, and ₹ 50 (50 shares x ₹ 5 - ₹ 200) will be transferred to the Capital Reserve Account being the surplus on re-issue of the 50 shares. It would have in the Forfeited shares Account balance equivalent to the amount collected on the remaining 70 forfeited shares i.e. ₹ 350 which will be carried forward till these are re-issued.

In the above case, it has been assumed that the amount paid up on all the 120 forfeited shares was ₹ 5 per share. But in practice, shares may be forfeited on which varying amounts are out-standing. For instance, if in the above case 70 shares were forfeited with ₹ 5 paid up thereon and 50 shares with ₹ 7.50 was paid up thereon then:

Share Forfeited Account Balance = (70 x 5) + (50 x 7.50)

= ₹ 725

Thus if 50 shares with ₹ 7.50 paid up are re-issued for ₹ 6 per share then Capital Reserve balance will be as follows:

₹ (7.50 + 6 -10) x 50 shares = ₹ 175

ILLUSTRATION 14

Mr. Long who was the holder of 2,000 preference shares of ₹ 100 each, on which ₹ 75 per share has been called up could not pay his dues on Allotment and First call each at ₹ 25 per share. The Directors forfeited the above shares and reissued 1500 of such shares to Mr. Short at ₹ 65 per share paid-up as ₹ 75 per share.

Give Journal Entries to record the above forfeiture and re-issue in the books of the company.

SOLUTION

	Particulars		₹	₹
	Preference Share Capital A/c (2,000 x ₹ 75)	Dr.	1,50,000	
	To Preference Share Allotment A/c			50,000
	To Preference Share First Call A/c			50,000
	To Forfeited Share A/c			50,000
	(Being the forfeiture of 2,000 preference shares ₹ 75 each being called up for non-payment of allotment and first call money as per Board's Resolution No.... dated.....)			
	Bank A/c (1,500 x ₹ 65)	Dr.	97,500	
	Forfeited Shares A/c (1,500 x ₹ 10)	Dr.	15,000	
	To Preference Share Capital A/c			1,12,500
	(Being re-issue of 1500 shares at ₹ 65 per share paid-up as ₹ 75 as per Board's Resolution No.....dated....)			
	Forfeited Shares A/c	Dr.	22,500	
	To Capital Reserve A/c (Note 1)			22,500
	(Being profit on re-issue transferred to Capital/Reserve)			

Working Note:

Calculation of amount to be transferred to Capital Reserve

Forfeited amount per share = ₹ 50,000/2000	=	₹ 25
Loss on re-issue = ₹ 75 – ₹ 65	=	₹ 10
Surplus per share re-issued		₹ 15
Transferred to capital Reserve ₹ 15 x 1500	=	₹ 22,500

ILLUSTRATION 15

Beautiful Co. Ltd issued 30,000 equity shares of ₹ 10 each payable as ₹ 3 per share on application, ₹ 5 per share (including ₹ 2 as premium) on allotment and ₹ 4 per share on call. All the shares were subscribed. Money due on all shares was fully received except from Ram, holding 500 shares, who failed to pay the Allotment and Call money and Shyam, holding 1,000 shares, who failed to pay the Call Money. All those 1,500 shares were forfeited. Of the shares forfeited, 1,250 shares (including whole of Ram's shares) were subsequently re-issued to Jadu as fully paid up at a discount of ₹ 2 per share.

Pass the necessary entries in the Journal of the company to record the forfeiture and re-issue of the share. Also prepare the Balance Sheet of the company.

SOLUTION

In the books of Beautiful Co. Ltd.

Journal

Date	Particulars		₹	₹
	Equity Share Capital A/c (1,500 x ₹ 10)	Dr.	15,000	
	Securities Premium A/c (500 x ₹ 2)	Dr.	1,000	
	To Equity Share Allotment A/c (500 x ₹ 5)			2,500
	To Equity Share Call A/c (1,500 x ₹ 4)			6,000
	To Forfeited Shares A/c			7,500
	(Being forfeiture of 1,500 equity shares for non payment of allotment and call money on 500 shares and for non-payment of call money on 1,000 shares as per Board's Resolution No.....dated ....)			
	Bank A/c	Dr.	10,000	
	Forfeited Shares A/c	Dr.	2,500	
	To Equity Share Capital A/c			12,500
	(Being re-issue of 1250 shares @ ₹ 8 each as per Board's Resolution No.....dated....)			
	Forfeited Shares A/c	Dr.	3,500	
	To Capital Reserve A/c			3,500
	(Being profit on re-issue transferred to Capital Reserve)			

Balance Sheet of Beautiful Limited as at......

Particulars	Notes No.	₹
EQUITY AND LIABILITIES		
Shareholders' funds		
Share capital	1	2,99,000
Reserves and Surplus	2	62,500
Total		**3,61,500**
ASSETS		
Current assets		
Cash and cash equivalents (bank)		3,61,500
Total		**3,61,500**

Notes to accounts

		₹	₹
1.	**Share Capital**		
	Equity share capital		
	Issued share capital		
	30,000 Equity shares of ₹ 10 each	3,00,000	
	Subscribed, called up and paid up share capital		
	29,750 Equity shares of ₹ 10 each	2,97,500	
	Add: Forfeited shares	1,500	2,99,000
2.	**Reserves and Surplus**		
	Securities Premium	59,000	
	Capital Reserve	3,500	62,500

Working Note :

(1) Calculation of Amount to be Transferred to Capital Reserve

Amount forfeited per share of Ram	₹ 3	Amount forfeited per share of Shyam	₹ 6
Less: Loss on re-issue per share	(₹ 2)	*Less*: Loss on re-issue per share	(₹ 2)
Surplus	₹ 1	Surplus	₹ 4
Transferred to Capital Reserve: Ram share (500 x ₹ 1)		₹ 500	
Shyam's Share (750 x ₹ 4)		₹ 3,000	
Total		**₹ 3,500**	

(2) Balance of Security Premium

Total Premium amount receivable on allotment	=	60,000
Less: Amount reversed on forfeiture	=	(1,000)
Balance remaining	=	59,000

ILLUSTRATION 16

A holds 2,000 shares of ₹ 10 each on which he has paid ₹ 2 as application money. B holds 4,000 shares of ₹ 10 each on which he has paid ₹ 2 per share as application money and ₹ 3 per share as allotment money. C holds 3,000 shares of ₹ 10 each and has paid ₹ 2 on application, ₹ 3 on allotment and ₹ 3 for the first call. They all fail to pay their arrears on the second and final call and the directors, therefore, forfeited their shares. The shares are re-

issued subsequently for ₹ 12 per share fully paid-up. Journalise the transactions relating to the forfeiture and re-issue.

SOLUTION

Journal

Date	Particulars		₹	₹
	Share Capital A/c (9,000 x ₹ 10)	Dr.	90,000	
	To Share Allotment A/c (2,000 x ₹ 3)			6,000
	To Share First Call A/c (6,000 x ₹ 3)			18,000
	To Share Final Call A/c (9,000 x ₹ 2)			18,000
	To Forfeited Shares A/c			48,000
	(Being forfeiture of 9,000 shares of ₹ 10 each for non-payment of allotment, first and final call money as per Board's Resolution No.....dated....)			
	Bank A/c (9,000 x ₹ 12)	Dr.	1,08,000	
	To Share Capital A/c			90,000
	To Securities Premium A/c			18,000
	(Being the re-issue of 9,000 shares of ₹ 10 each @ ₹ 12 as per Board's Resolution No.....dated...)			
	Forfeited Shares A/c	Dr.	48,000	
	To Capital Reserve A/c			48,000
	(Being profit on re-issue transferred to Capital Reserve).			

Working Note:

Shareholders	Money Received				Money Not Received On		
	Application	Allotment	First Call	Final Call	Allotment	First Call	Final Call
A	2,000	-	-	-	2,000	2,000	2,000
B	4,000	4,000	-	-	-	4,000	4,000
C	3,000	3,000	3,000	-	-	-	3,000
TOTAL	9,000	7,000	3,000	-	2,000	6,000	9,000
Money	₹ 2	₹ 3	₹ 3	₹ 2	₹ 3	₹ 3	₹ 2
Receivable	₹ 18,000	₹21,000	₹ 9,000	-	₹ 6,000	₹ 18,000	₹ 18,000

2.13 ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

Public limited companies, generally, issue their shares for cash and use such cash to buy the various types of assets needed in the business. Sometimes, however, a company may issue shares in a direct exchange for land, buildings or other assets. Shares may also be issued in payment for services rendered by promoters, lawyers in the formation of the company. These shares should be shown separately under the heading 'Share Capital'.

Within specified time of allotment, the company must produce before the Registrar a written contract of sale of service in respect of which shares have been allotted.

Under accounting standards, if an asset is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost is the fair value of the securities issued (which, in appropriate cases, may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued.

Accounting Entries

When assets are purchased in exchange of shares

Assets Account Dr.

To Share Capital Account

ILLUSTRATION 17

X Co. Ltd. was incorporated with an authorized share capital of 90,000 equity shares of ₹ 10 each. The company purchased land and buildings from Y Co. Ltd for ₹ 4,00,000 payable in fully paid-up shares of the company. The balance of the shares were issued to the public, which were fully subscribed and paid for.

You are required to pass Journal Entries and to prepare the Balance Sheet.

SOLUTION

Journal

Date	Particulars	₹	₹
	Land and Buildings A/c Dr.	4,00,000	
	To Y Co. Ltd A/c		4,00,000
	(Being the land and buildings purchased from Y Co. Ltd as per agreement dated...).		

	Y.Co. Ltd A/c Dr. To Equity Share Capital A/c (Being 40,000 shares of ₹ 10 each issued to Y Co. Ltd. on purchase of land and building)	4,00,000	4,00,000
	Bank A/c Dr. To Equity Share Application and Allotment A/c (Being the issue of 50,000 shares of ₹ 10 each as per Board's Resolution No.....dated...)	5,00,000	5,00,000
	Equity Share Application and Allotment A/c Dr To Equity Share Capital A/c (Being shares allotted for application money received.)	5,00,000	5,00,000

Balance Sheet of X Company Limited as at....

	Particulars	**Notes No.**	₹
	EQUITY AND LIABILITIES		
	Shareholders' funds		
	Share capital	1	9,00,000
	Total		9,00,000
	ASSETS		
1.	**Non-current assets**		
	a Fixed assets		
	i. Plant Property and Equipment	2	4,00,000
2.	**Current assets**		
	Cash and cash equivalents	3	5,00,000
	Total		9,00,000

Notes to accounts

		₹
1.	**Share Capital**	
	Equity share capital	
	Authorised share capital	
	90,000 Equity shares of ₹ 10 each	9,00,000
	Issued share capital	
	90,000 Equity shares of ₹ 10 each	9,00,000
	Subscribed Share Capital	
	90,000 Equity Shares of ₹ 10 each	9,00,000
	Called up and Paid up Capital	
	90,000 Equity Shares of ₹ 10 each	9,00,000
	(Out of the above 40,000 shares have been allotted as fully paid up pursuant to contract(s) without payment being received in cash)	
2.	**Plant Property and Equipment**	
	Land and Building	4,00,000
3.	**Cash and cash equivalents**	
	Balances with banks	5,00,000

SUMMARY

- Total capital of the company is divided into a number of small indivisible units of a fixed amount and each such unit is called a share.
- The total capital of the company is divided into shares, the capital of the company is called 'Share Capital'.
- Share capital of a company is divided into following categories:

  (i) Authorised Share Capital or Nominal Capital; (ii) Issued Share Capital; (iii) Subscribed Share Capital (iv) Called-up Share Capital; (v) Paid-up Share Capital; (vi) Reserve Share Capital

- Types of shares are:
  - (i) Preference Shares. Preference shares can be of various types, e.g.: (a) Cumulative Preference Shares (b) Non-cumulative Preference Shares (c) Participating Preference Shares (d) Non-participating Preference Shares (e) Redeemable Preference Shares (f) Non-redeemable Preference Shares (g) Convertible Preference Shares (h) Non-convertible Preference Shares.
  - (ii) Equity Shares
- A company can issue shares either
  - (1) for cash or
  - (2) for consideration other than cash.
- A public limited company cannot make any allotment of shares unless the amount of minimum subscription stated in the prospectus has been subscribed and the sum payable as application money for such shares has been paid to and received by the company.
- When a company issues its securities at a price more than the face value, it is said to be an issue at a premium. Premium is the excess of issue price over face value of the security.
- According to Section 52 of the Companies Act, 2013, Securities Premium Account may be used by the company:
  - (a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities.
  - (b) To write off preliminary expenses of the company.
  - (c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company.
  - (d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.
  - (e) For the purchase of own shares or other securities.
- Sometimes shareholders fail to pay the amount due on allotment or calls. The total unpaid amount on one or more instalments is known as *Calls-in-Arrears or Unpaid Calls.*
- Some shareholders may sometimes pay a part, or whole, of the amount not yet called up, such amount is known as *Calls-in-advance.*

- Interest on calls in arrear is recoverable and that in respect of calls in advance is payable, according to provisions in this regard in the articles of the company, at the rates mentioned therein or those to be fixed by the directors, within the limits prescribed by the Articles. Table F prescribes 10% and 12% p.a. as the maximum rates respectively for calls in arrears and those in advance.
- The term 'forfeit' actually means taking away of property on breach of a condition. It is very common that one or more shareholders fail to pay their allotment and/or calls on the due dates. Failure to pay call money results in forfeiture of shares.
- A forfeited share is merely a share available to the company for sale and remains vested in the company for that purpose only. Reissue of forfeited shares is not allotment of shares but only a sale.
- Public limited companies, generally, issue their shares for cash and use such cash to buy the various types of assets needed in the business. Sometimes, however, a company may issue shares in a direct exchange for land, buildings or other assets. These shares should be shown separately under the heading 'Share Capital'.

TEST YOUR KNOWLEDGE

True and False

1. *Liability of a holder of shares is limited to the face value of shares acquired by them.*
2. *Authorised capital appears in the balance sheet at face value.*
3. *The rate of dividend on preference shares may vary From year to year.*
4. *A company may issue shares at a discount to the public in general.*
5. *Sweat equity shares are those which are issued to employees & directors at a discount.*
6. *As per table F, rate of interest on calls in arrears is 12%.*
7. *As per Table F, rate of interest on calls in advance is 10%.*
8. *Non-participating preference shareholders enjoy voting rights.*
9. *Forfeited shares are available to the company for the purpose of resale.*
10. *Loss on reissue should exceed the forfeited amount.*

Multiple Choice Questions

1. *The excess price received over the par value of shares, should be credited to _________.*

   (a) *Calls-in-advance account*

   (b) *Share capital account*

   (c) *Securities premium account*

2. *The Securities Premium amount may be utilized by a company for _________.*

   (a) *Writing off any loss on sale of fixed asset*

   (b) *Writing off any loss of revenue nature*

   (c) *Writing off the expenses/discount on the issue of debentures*

3. *When shares are forfeited, the share capital account is debited with _______ and the share forfeiture account is credited with _________.*

   (a) *Paid-up capital of shares forfeited; Called up capital of shares forfeited*

   (b) *Called up capital of shares forfeited; Calls in arrear of shares forfeited*

   (c) *Called up capital of shares forfeited; Amount received on shares forfeited*

4. *T Ltd. proposed to issue 6,000 equity shares of ₹ 100 each at a premium of 40%. The minimum amount of application money to be collected per share as per the Companies Act, 2013*

   (a) *₹ 5.00*

   (b) *₹ 6.00*

   (c) *₹ 7.00*

5. *Dividends are usually paid as a percentage of ______.*

   (a) *Authorized share capital*

   (b) *Net profit*

   (c) *Paid-up capital*

6. *As per the SEBI guidelines, on issue of shares, the application money should not be less than*

   (a) *2.5% of the nominal value of shares*

   (b) *2.5% of the issue price of shares*

   (c) *25.0% of the issue price of shares*

7. *G Ltd. acquired assets worth ₹ 7,50,000 from H Ltd. by issue of shares of ₹ 100 at a premium of 25%. The number of shares to be issued by G Ltd. to settle the purchase consideration = ?*

   (a) 6,000 shares

   (b) 7,500 shares

   (c) 9,375 shares

8. *Securities Premium is presented as a part of*

   (a) Reserves & Surplus

   (b) Share Capital

   (c) Liabilities

9. *Schedule III of Companies Act 2013 prescribes the format for*

   (a) Financial statements

   (b) Directors' Report

   (c) Auditors' Report

10. *Dividend on ____________ shares have to be paid before dividend on __________shares.*

   (a) Equity, Preference

   (b) Preference, Equity

   (c) Convertible, Non-Cumulative

11. *Preference shares are _____________ unless expressly stated otherwise.*

   (a) Non-participating

   (b) Convertible

   (c) Interest-bearing

Theory Questions

1. *Write short notes on:*

   (i) Utilization of securities premium account

   (ii) Re-issue of forfeited shares

2. *Distinguish between:*

   (i) Calls-in-Arrears and Calls-in-advance

(ii) *Issue of shares for cash and Issue of Shares for Consideration other than Cash*

3. *Can a company issue shares at discount?*

Practical Questions

1. *X Ltd. invited applications for 10 lakhs shares of ₹ 100 each payable as follows :*

	₹
On Application	20
On Allotment (on 1st May, 2022)	30
On First Call (on 1st Oct., 2022)	30
On Final Call (on 1st Feb., 2023)	20

All the shares were applied for and allotted. A shareholder holding 20,000 shares paid the whole of the amount due along with allotment. Journalise the transactions, assuming all sums due were received. Interest was paid to the shareholder concerned on 1st February, 2023.

2. *A limited Company, with an authorized capital of ₹ 20,00,000 divided into shares of ₹ 100 each, issued for subscription 10,000 shares payable at ₹ 25 per share on application, ₹ 30 per share on allotment, ₹ 20 per share on first call three months after allotment and the balance as and when required.*

The subscription list closed on January 31, 2022 when application money on 10,000 shares was duly received and allotment was made on March 1, 2022. All amounts due were received within one month of the date they were called.

The allotment amount was received in full but, when the first call was made, one shareholder failed to pay the amount on 1,000 shares held by him and another shareholder with 500 shares paid the entire amount on his shares.

Give journal entries in the books of the Company to record these share capital transactions.

3. *A Ltd. forfeits 100 shares of Rs.10 each fully called upon. The shareholder failed to pay the first call money of Rs. 4 per share and the second and final Call Money of Rs. 4 per share. Give journal entry to show the effect of this transaction.*

4. *B Ltd. issued 20,000 equity shares of ₹ 100 each at a premium of ₹ 20 per share payable as follows: on application ₹ 50; on allotment ₹ 50 (including premium); on final call ₹ 20. Applications were received for 24,000 shares. Letters of regret were issued to applicants for 4,000 shares and shares were allotted to all the other applicants. Mr. A, the holder of 150 shares, failed to pay the allotment and call money, the shares were forfeited. Show the Journal Entries and Cash Book in the books of B Ltd.*

ANSWERS/ HINTS

True and False

1. False: Liability of the holder of shares is limited to the issue price of shares acquired by them.

2. True: Authorised capital is the amount of capital mentioned in 'capital clause' of the 'Memorandum of Association'. Authorised capital is considered only as presentation and not considered in total of balance sheet.

3. False: Rate of preference dividend is always fixed.

4. False: According to Section 53 of the Companies Act, 2013, a Company cannot issue shares at a discount except in the case of issue of sweat equity shares (issued to employees and directors). Thus any issue of shares at discount shall be void.

5. True: According to Section 53 of the Companies Act, 2013, a Company cannot issue shares at a discount except in the case of issue of sweat equity shares (issued to employees and directors).

6. False: As per table F, rate of interest on calls in arrears is 10%.

7. False: As per Table F, rate of interest on calls in advance is 12%.

8. False: A share on which only a fixed rate of dividend is paid every year, without any accompanying additional rights in profits and in the surplus on winding-up, is called 'Non-participating Preference Shares. Non-participating preference shareholders do not enjoy voting rights.

9. True: Reissue of forfeited shares is not allotment of shares but only a sale.

10. False: Loss on re-issue should not exceed the forfeited amount.

Multiple Choice Questions

1.	(c)	**2.**	(c)	**3.**	(c)	**4.**	(a)	**5.**	(c)	**6.**	(c)
7	(a)	**8.**	(a)	**9.**	(a)	**10.**	(b)	**11.**	(a)		

Theoretical Questions

1. **(i)** Refer para 2.7.1 for utilization of securities premium account.

(ii) A forfeited share is merely a share available to the company for sale and remains vested in the company for that purpose only. Reissue of forfeited shares is not allotment of shares but only a sale. The share, after forfeiture, in the hands of the company is subject to an obligation to dispose it off. In practice, forfeited shares are disposed off by auction. These shares can be re-issued at any price so long as the total amount received (from the original allottee and the second purchaser) for those shares is not less than the amount in arrears on those shares.

2. (i) **Calls-in-Arrears:** Sometimes shareholders fail to pay the amount due on allotment or calls. The total unpaid amount on one or more instalments is known as Calls-in-Arrears or Unpaid Calls. Such amount represents the uncollected amount of capital from the shareholders; hence, it is shown by way of deduction from 'called-up capital' to arrive at paid-up value of the share capital.

Calls-in-advance: Some shareholders may sometimes pay a part, or whole, of the amount not yet called up, such amount is known as Calls-in-advance.

(ii) The shares can be issued by a company either for cash or for consideration other than cash. Public limited companies, generally, issue their shares for cash and use such cash to buy the various types of assets needed in the business. Sometimes, however, a company may issue shares in a direct exchange for land, buildings or other assets.

3. According to Section 53 of the Companies Act, 2013, a Company cannot issue shares at a discount except in the case of issue of sweat equity shares (issued to employees and directors). Thus any issue of shares at discount shall be void.

Practical Question

1. **Journal of X Ltd.**

2022		₹ in lakhs	₹ in lakhs
May 1	Bank A/c Dr.	200	
	To Share Application A/c		200
	(Receipt of applications for 10 lakh shares along with application money of ₹ 20 per share.)		
May 1	Share Application A/c Dr.	200	
	Share Allotment A/c Dr.	300	

	To Share Capital A/c (The allotment of 10 lakh shares: payable on application ₹ 20 share and ₹ 30 on allotment as per Directors' resolution no... dated...)		500
May 1	Bank A/c Dr. To Shares Allotment A/c To Calls in Advance A/c [Receipt of money due on allotment @ ₹ 30, also the two calls (₹ 30 and ₹ 20) on 20,000 shares.]	310	300 10
Oct. 1	Share First Call A/c Dr. To Share Capital A/c (The amount due on 10 lakh shares @ ₹ 30 on first call, as per Directors, resolution no... dated...)	300	300
	Bank A/c Dr. Calls in Advance A/c Dr. To Share First Call A/c (Receipt of the first call on 9.80 lakh shares, the balance having been previously received and now debited to call in advance account.)	294 6	300
2023 Feb. 1	Share Final Call A/c Dr. To Share Capital A/c (The amount due on Final Call on 10 lakh shares @ ₹ 20 per share, as per Directors' resolution no... dated...)	200	200
Feb. 1	Bank A/c Dr. Calls in Advance A/c Dr. To Share Final Call A/c (Receipt of the moneys due on final call on 9.80 lakhs shares, the balance having been previously received.)	196 4	200

Feb. 1	Interest on calls in Advance A/c Dr.	0.66	
	To Shareholder A/c		0.66
	(Being interest on call in advance made due)		
Feb 1	Shareholder A/c Dr.	0.66	
	To Bank A/c		0.66
	(Being interest paid)		

Working Note:

The interest on calls in advance paid @ 12% on :	₹
₹ 6,00,000 (first call) from 1st May to 1st Oct., 2022–5 months	30,000
₹ 4,00,000 (final call) from 1st May to 1st Feb., 2023–9 months	36,000
Total Interest Amount Due	66,000

2. Journal Entries in the Books of the Company

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
2022				
Jan. 31	Bank A/c Dr.		2,50,000	
	To Equity Share Application A/c			2,50,000
	(Money received on applications for 10,000 shares @ ₹ 25 per share)			
March 1	Equity Share Application A/c Dr.		2,50,000	
	To Equity Share Capital A/c			2,50,000
	(Transfer of application money on 10,000 shares to share capital)			
March 1	Equity Share Allotment A/c Dr.		3,00,000	
	To Equity Share Capital A/c			3,00,000
	(Amount due on the allotment of 10,000 shares @ ₹ 30 per share)			
April 1	Bank A/c Dr.		3,00,000	

	To Equity Share Allotment A/c (Allotment money received)			3,00,000
June 1	Equity Share First Call A/c Dr. To Equity Share Capital A/c (First call money due on 10,000 shares @ ₹ 20 per share)		2,00,000	2,00,000
July 1	Bank A/c Dr. Calls-in-Arrears A/c Dr. To Equity Share First Call A/c To Calls-in-Advance A/c (First call money received on 9000 shares and calls-in-advance on 500 shares @ ₹ 25 per share)		1,92,500 20,000	 2,00,000 12,500

3. **In the Books of A Ltd.**
Journal Entries

Date	**Journal Entries** ***Particulars***	₹	₹
	Equity Share Capital A/c (100X10) Dr. To Share First Call A/c (100X4) To Second and Final Call A/c (100X4) To Share Forfeiture A/c (100X2) (Being share forfeiture of 100 shares as per Board's Resolution No.....dated...)	1,000	 400 400 200

4. **In the Books of B Ltd.**
Cash Book (Bank column only)

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Application A/c (Being application money received on 24,000 shares @ ₹ 50 each)	12,00,000		By Equity Share Application A/c (Being excess money refunded on 4,000 shares @ ₹ 50 each as	2,00,000

				per Board's Resolution No...dated....)	
	To Equity Share Allotment A/c	9,92,500		By Balance c/d	23,89,500
	(Being allotment money received on 19,850 shares @ ₹ 50 each)				
	To Equity Share Final Call A/c	3,97,000			
	(Being final call money received on 19,850 shares @ ₹ 20 each)				
		25,89,500			25,89,500

Journal Entries

Date	*Particulars*		₹	₹
	Equity Share Application A/c	Dr.	10,00,000	
	To Equity Share Capital A/c			10,00,000
	(Being application money on 20,000 shares @₹ 50 each transferred to Equity Share Capital Account as per Board's Resolution No.....dated...)			
	Equity Share Allotment A/c	Dr.	10,00,000	
	To Equity Share Capital A/c			6,00,000
	To Securities Premium A/c			4,00,000
	(Being allotment money @ ₹ 50 per share including premium of ₹ 20 per share being made due as per Board's Resolution No......dated....)			
	Equity Share Capital A/c (150 x ₹ 100)	Dr.	15,000	
	Securities Premium A/c (150 x ₹ 20)	Dr.	3,000	
	To Equity Share Allotment A/c			7,500
	To Equity Share Final Call A/c			3,000
	To Forfeited Shares A/c			7,500
	(Being forfeiture of 150 shares for non-payment of allotment money and final call money as per Board's Resolution No....dated...)			

	Equity Share Final Call A/c (19,850 x ₹ 20) Dr. To Equity Share Capital A/c (Being final call money received for ₹ 20 per share being made as per Board's resolution No.... dated ......)	3,97,000	3,97,000

Note: Here, securities premium on forfeited shares has not been realised, so Securities Premium Account will be debited at the time of forfeiture of these shares.

Also, alternatively Calls in arrears A/c could have been used in which case following entries would have been passed in place of the entry (given above) for forfeiture:

On non- receipt of allotment money:		
Calls in Arrears A/c Dr.	7,500	
To Equity Share Allotment A/c		7,500
(Being allotment money on 150 shares @ ₹ 50 not received transferred to calls in arrears.)		
On non - receipt of Call money:		
Calls in Arrears A/c Dr.	3,000	
To Equity Share Final Call A/c		3,000
(Being final call on 150 shares @ ₹ 20 not received transferred to calls in arrears)		
On Forfeiture:		
Share Capital A/c (150 x ₹ 100)	15,000	
Securities Premium A/c (150 x ₹ 20)	3,000	
To Calls in Arrears A/c		10,500
To Share Forfeiture A/c		7,500
(Being forfeiture of 150 shares for non-payment of allotment money and final call money as per Board's Resolution No....dated...)		

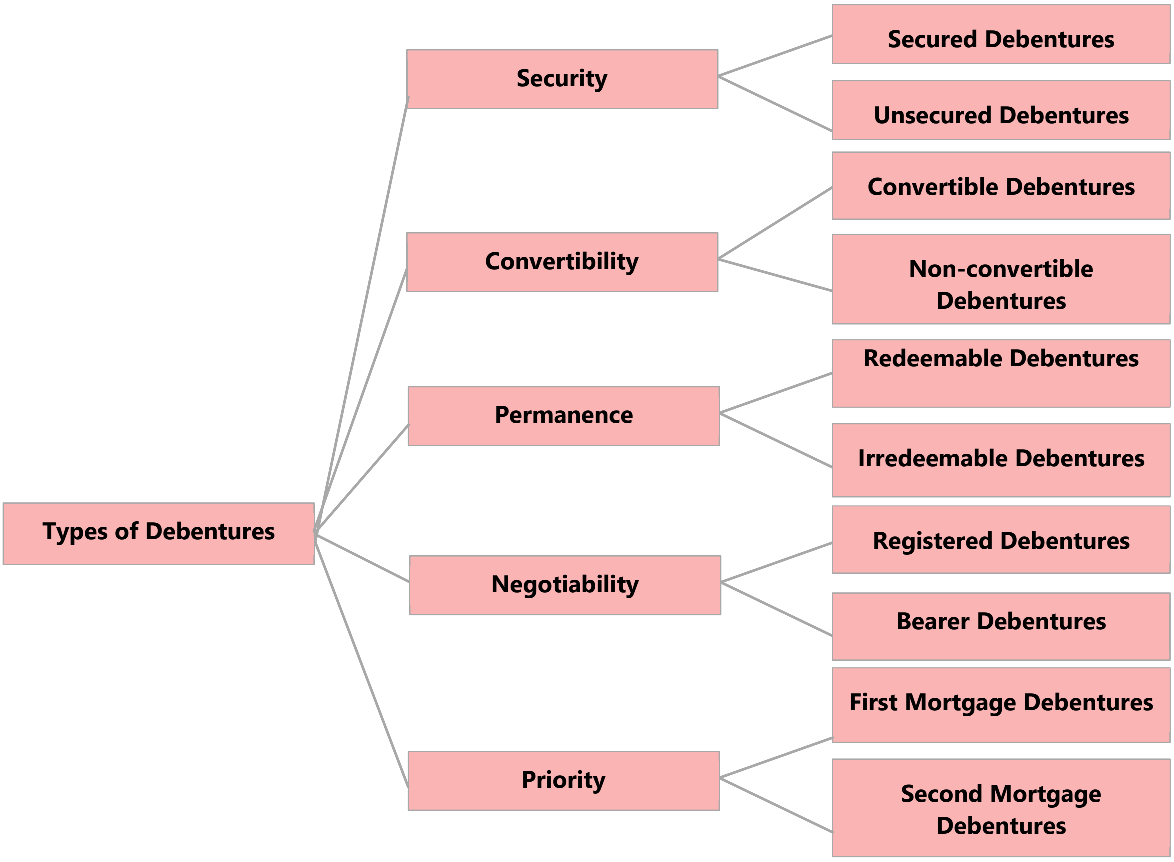
UNIT – 3 ISSUE OF DEBENTURES

LEARNING OUTCOMES

After studying this unit, you would be able to:

- Understand the meaning and basic purpose for raising debentures by the company
- Differentiate between shares and debentures of a company
- Understand various types of debentures
- Pass entries for issue of debentures payable in instalments
- Make entries for issue of debentures considering the conditions of redemption
- Pass entries for issue of debentures as collateral security
- Pass entries for debentures issued for consideration other than for cash
- Write off discount on issue of debentures
- Calculate interest on debentures.

UNIT OVERVIEW



3.1 INTRODUCTION

In the earlier units of this chapter, we have studied the issue of share capital as a means of raising funds for financing the business activities. But with increasing and evergrowing needs of the corporate expansion and growth, equity source of financing is not sufficient. Hence corporates turn to debt financing through various means. Issuing debt instruments by offering the same for public subscription is one of the sources of financing the business activities. Debt financing does not only helps in reducing the cost of the capital but also helps in designing appropriate capital structure of the company. Debenture is one of the most commonly used debt instrument issued by the company to raise funds for the business.

3.2 MEANING

The most common method of supplementing the capital available to a company is to issue debentures which may either be simple or naked carrying no charge on assets, or mortgage debentures carrying either a fixed or a floating charge on some or all of the assets of the company.

A debenture is a bond issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest. If a charge* has been created on any or on the entire assets of the company, the nature of the charge and the assets charged are described therein. Since the charge is not valid unless registered with the Registrar, and the certificate registering the charge is printed on the bond. It is also customary to create a trusteeship in favour of one or more persons in the case of mortgage debentures. The trustees of debenture holders have all powers of a mortgage of a property and can act in whatever way they think necessary to safeguard the interest of debenture holders.

Section 2 (30) of the Companies Act, 2013 defines debentures as "Debenture" includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.

Thus, It is clear from definition that debenture may be Secured Debenture or Unsecured Debenture.

Note: No company shall issue any debentures carrying any voting rights.

3.3 FEATURES OF DEBENTURES

1. It is a document which evidences a loan made to a company.
2. It is a fixed interest-bearing security where interest falls due on specific dates.
3. Interest is payable at a predetermined fixed rate, regardless of the level of profit.
4. The original sum is repaid at a specified future date or it is converted into shares or other debentures.
5. It may or may not create a charge on the assets of a company as security.
6. It can generally be bought or sold through the stock exchange at a price above or below its face value.

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*Charge is an incumbrance to meet the obligation under the Trust Deed, whereby the company agrees to mortgage specific portion either by way of a first or second charge. Such charge implies right of lenders to secure their payment from such asset(s) or from the liquidator in the event of winding up or from the company when the charge becomes void.

3.4 DISTINCTION BETWEEN DEBENTURES AND SHARES

Debentures	Shares
1. Debenture holders are the creditors of the company.	1. Shareholders are the owners of the company.
2. Debenture holders have no voting rights and consequently do not pose any threat to the existing control of the company.	2. Shareholders have voting rights and consequently control the total affairs of the company.
3. Debenture interest is generally paid at a pre- determined fixed rate. It is payable, whether there is any profit or not. Debentures rank ahead of all types of shares for payment of the interest due on them.	3. Dividend on equity shares is paid at a variable rate which is vastly affected by the profits of the company (however, dividend on preference shares is paid at a fixed rate).
4. Interest on debentures are the charges against profits and they are deductible as an expense in determining taxable profit of the company.	4. Dividends are appropriation of profit and these are not deductible in determining taxable profit of the company.
5. There are different kinds of debentures, such as Secured/ Unsecured; Redeemable/ Irredeemable; Registered / Bearer; Convertible/ Non-convertible, etc.	5. There are only two kinds of shares– Equity Shares and Preference Shares.
6. In the Company's Balance Sheet, Debentures are shown under "Long Term Borrowings".	6. In the Company's Balance Sheet, shares are shown under "Shareholder's Fund" detailed in 'Share Capital' of Notes to Accounts.
7. Debentures can be converted into other debentures or shares as per the terms of issue of debentures.	7. Shares cannot be converted into other shares in any circumstances.
8. Debentures cannot be forfeited for non-payment of call moneys.	8. Shares can be forfeited for non-payment of allotment and call moneys.
9. At maturity, debenture holders get back their money as per the terms and conditions of redemption.	9. Equity shareholders cannot get back their money before the liquidation of the company (however, preference shareholders can get back their money before liquidation).
10. At the time of liquidation, debenture holders are paid-off before the shareholders.	10. At the time of liquidation shareholders are paid at last, after paying debenture holders, Trade payable, etc.

3.5 TYPES OF DEBENTURES

The following are the types of debentures issued by a company. They can be classified on the basis of:

Security → **Convertibility** → **Permanence** → **Negotiability** → **Priority**

1. **Security**

   (a) *Secured Debentures:* These debentures are secured by a charge upon some or all assets of the company. There are two types of charges: (i) Fixed charge; and (ii) Floating charge. A fixed charge is a mortgage on specific assets. These assets cannot be sold without the consent of the debenture holders. The sale proceeds of these assets are utilized first for repaying debenture holders. A floating charge generally covers all the assets of the company including future one.

   (b) *Unsecured or "Naked" Debentures:* These debentures are not secured by any charge upon any assets. A company merely promises to pay interest on due dates and to repay the amount due on maturity date. These types of debentures are very risky from the view point of investors.

2. **Convertibility**

   (a) *Convertible Debentures:* These are debentures which will be converted into equity shares (either at par or premium or discount) after a certain period of time from the date of its issue. These debentures may be fully or partly convertible. In future, these debenture holders get a chance to become the shareholders of the company.

   (b) *Non-Convertible Debentures:* These are debentures which cannot be converted into shares in future. As per the terms of issue, these debentures are repaid.

3. **Permanence**

   (a) *Redeemable Debentures:* These debentures are repayable as per the terms of issue, for example, after 8 years from the date of issue.

   (b) *Irredeemable Debentures:* These debentures are not repayable during the life time of the company. These are also called perpetual debentures. These are repaid only at the time of liquidation.

4. Negotiability

(a) *Registered Debentures:* These debentures are payable to a registered holder whose name, address and particulars of holding is recorded in the Register of Debenture holders. They are not easily transferable. The provisions of the Companies Act, 2013 are to be complied with for effecting transfer of these debentures. Debenture interest is paid either to the order of registered holder as expressed in the warrant issued by the company or the bearer of the interest coupons.

(b) *Bearer Debentures:* These debentures are transferable by delivery. These are negotiable instruments payable to the bearer. No kind of record is kept by the company in respect of the holders of such debentures. Therefore, the interest on it is paid to the holder irrespective of any identity. No transfer deed is required for transfer of such debentures.

5. Priority

(a) *First Mortgage Debentures:* These debentures are payable first out of the property charged.

(b) *Second Mortgage Debentures:* These debentures are payable after satisfying the first mortgage debentures.

3.6 ISSUE OF DEBENTURES

3.6.1 Accounting entries for issue of redeemable debentures

The issue of redeemable debentures can be categorized into the following:

1. Debentures issued at a par and redeemable at par or at a discount;
2. Debentures issued at a discount and redeemable at par or at discount;
3. Debentures issued at premium and redeemable at par or at discount;
4. Debentures issued at par and redeemable at premium;
5. Debentures issued at a discount and redeemable at premium.
6. Debentures issued at premium and redeemable at premium.

Note: Redemption at a discount may be a rare circumstance in practical life.

Journal entries in each of the above cases are discussed below:

1. **Debentures issued at par redeemable at par:** When debenture are issued at par, the issue price is equal to par value, in this regard the following entries are recorded:

   (a) For receipt of application money :

   Bank A/c Dr.

   To Debenture Application A/c

   (b) For transfer of application money to debentures account :

   Debenture Application A/c Dr.

   To ...% Debenture A/c

ILLUSTRATION 1

Amol Ltd. issued 40,00,000, 9% debentures of ₹ 50 each, payable on application as per term mentioned in the prospectus and redeemable at par any time after 3 years from the date of issue. Record necessary entries for issue of debentures in the books of Amol Ltd.

SOLUTION

Books of Amol Ltd.

Journal

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr.		20,00,00,000	
	To Debenture Application A/c			20,00,00,000
	(Debenture application money received)			
	Debenture Application A/c Dr.		20,00,00,000	
	To 9% Debentures A/c			20,00,00,000
	(Application money transferred to 9% debentures account consequent upon allotment)			

2. **Debentures issued at Discount and Redeemable at par or at discount :** When debentures are issued at discount, issue price will be less than par value. The difference between the two is considered as loss on issue on debentures and is to be written-off over the life of debentures. The entries with regards to issue are given below :

(a) For receipt of application money

Bank A/c Dr.

To Debenture Application A/c

(b) At the time of making allotment

(i) Debenture Application A/c Dr.

Discount on issue of debentures A/c Dr.

To ...% Debentures A/c

ILLUSTRATION 2

Atul Ltd. issued 1,00,00,000, 8% debenture of ₹100 each at a discount of 10% redeemable at par at the end of 10th year. Money was payable as follows :

₹ 30 on application

₹ 60 on allotment

Record necessary journal entries regarding issue of debenture.

SOLUTION

Books of Atul Ltd.

Journal

Date	Particulars	L.F.	Debit	Credit
			(₹)	(₹)
	Bank A/c Dr.		30,00,00,000	
	To Debenture Application A/c			30,00,00,000
	(Debenture application money received)			
	Debenture Application A/c Dr.		30,00,00,000	
	To 8% Debentures A/c			30,00,00,000
	(Application money transferred to 8% debentures account consequent upon allotment)			
	Debenture allotment A/c Dr.		60,00,00,000	

	Discount on issue of debentures A/c	Dr.	10,00,00,000	
	To 8% Debentures A/c			70,00,00,000
	(Amount due on allotment)			
	Bank A/c	Dr.	60,00,00,000	
	To Debenture Allotment A/c			60,00,00,000
	(Money received consequent upon allotment)			

3. Debentures Issued at Premium and Redeemable at par or at discount

When debenture are issued at premium, the issue price is more than the par value. The premium is transferred to securities premium account. In this regard, the following journal entries are recorded:

When premium amount is received at the time of application;

(a) For receipt of application money

Bank A/c Dr.

To Debenture Application A/c

(b) For transfer of application of money at the time of allotment

Debenture application A/c Dr.

To ...% Debentures A/c

To Securities Premium A/c

When debentures are issued at par or premium value but redeemed at discount, then it means that the company will gain by paying less. This gain will not be recognised in the books at the time of issue of debentures as per the conservatism concept. The utlisation of premium on debentures shall be based on the provisions of Section 52 of Companies Act, 2013,

ILLUSTRATION 3

Koinal Chemicals Ltd. issued 15,00,000, 10% debenture of ₹50 each at premium of 10%, payable as ₹20 on application and balance on allotment. Debentures are redeemable at par after 6 years. All the money due on allotment was called up and received. Record necessary entries when premium money is included in application money.

SOLUTION

Books of Koinal Chemicals Ltd.

Journal

When premium money is received along with application money:

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c	Dr.	3,00,00,000	
	To Debenture Application A/c			3,00,00,000
	(Debenture application money received)			
	Debentures Application A/c	Dr.	3,00,00,000	
	To 10% Debentures A/c			2,25,00,000
	To Securities Premium A/c			75,00,000
	(Application money transferred to 10% debentures account and securities premium account consequent upon allotment)			
	Debenture Allotment A/c	Dr.	5,25,00,000	
	To 10% Debentures A/c			5,25,00,000
	(Call made consequent upon allotment)			
	Bank A/c	Dr.	5,25,00,000	
	To Debenture Allotment A/c			5,25,00,000
	(Call made consequent upon allotment money received)			

4. Debentures issued at par and redeemable at a premium

Where debentures are to be redeemed at premium, an extra entry is to be made at the time of issue and allotment of debentures. This extra entry is to be passed for providing premium payable on redemption. Debenture Redemption Premium Account is a personal account which represents a liability of the company in respect of premium payable on redemption.

In this case, the issue price is same as par value but the redemption value is more than the par value, therefore redemption premium is recorded as a loss on issue of debentures at the time of allotment of debentures. Following journal entries are recorded in this regard:

(a) For receipt of application money

Bank A/c Dr.

To Debenture application A/c

(b) At the time of making allotment

(i) Transfer of application money to debenture account

Debenture Application A/c Dr.

To ...% Debenture A/c

(ii) Call made consequent upon allotment

Debenture Allotment A/c Dr.

Loss on issue of debenture A/c Dr. [Equal to Debenture Redemption Premium]

To ...% Debenture A/c

To Debenture redemption premium A/c

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c Dr.

Loss on issue of debenture A/c Dr.

To ...% Debenture A/c

To Debenture redemption premium A/c

ILLUSTRATION 4

Modern Equipments Ltd. issued 4,00,000, 12% debentures of ₹ 100 payable as follows :

On application ₹ 30

On allotment ₹ 70

The debenture were fully subscribed and all the money was duly received. As per the terms of issue, debentures are redeemable at ₹110 per debenture. Record necessary entries regarding issue of debentures.

SOLUTION

Books of Modern Equipments Ltd.

Journal

Date	Particulars		Debit Amount (₹ Lakhs)	Credit Amount (₹ Lakhs)
	Bank A/c	Dr.	120	
	To Debentures application A/c			120
	(Debenture application money received)			
	Debentures Application A/c	Dr.	120	
	To 12% Debentures A/c			120
	(Application money transferred to 12% debentures account consequent to allotment)			
	Debentures Allotment A/c	Dr.	280	
	Loss on issue of Debentures A/c	Dr.	40	
	To 12% Debentures A/c			280
	To Debenture redemption premium A/c			40
	(Call made on allotment of debentures at par and entry for debentures redeemable at premium)			
	Bank A/c	Dr.	280	
	To Debentures allotment A/c			280
	(Call made consequent upon allotment money received)			

5. Debentures Issued at discount and redeemable at premium

In this situation the issue price is less than par value but redemption value is more than par value. The difference between the redemption price and the issue price is treated as discount/loss on issue of debentures. Suppose, a 10% debentures of ₹ 1,000 is issued at a discount of ₹ 100 and redeemable at a premium of ₹5 per debenture, the amount of loss will be equal to ₹ 1,005 – ₹ 900 = ₹ 105. This is to be treated as loss on issue. It is to be noted that premium on redemption of debentures is also credited by ₹ 5.

(a) For the receipt of application money

Bank A/c	Dr.	
To Debenture Application A/c		

(b) At the time of making allotment

(i) Transfer of application money to debenture account

Debenture Application A/c	Dr.	
To % Debentures A/c		

(ii) Call made consequent upon allotment of debentures at discount and redeemable at premium

Debenture Allotment A/c	Dr.	
Discount/Loss on issue of debenture A/c	Dr.	[Amount equal to the discount on issue of debenture plus Premium on redemption]
To ...% Debenture A/c		

(c) For receipt of call made on allotment

Bank A/c	Dr.	
To Debenture Allotment A/c		

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c	Dr.	
Discount/Loss on issue of debentures A/c	Dr.	
To ...% Debentures A/c		
To Debenture redemption premium A/c		

ILLUSTRATION 5

Agrotech Ltd. issued 150 lakh 9% debentures of ₹ 100 each at a discount of 6%, redeemable at a premium of 5% after 3 years payable as: ₹ 50 on application and ₹ 44 on allotment. Record necessary journal entries for issue of debentures.

SOLUTION

Books of Agrotech Ltd.

Journal

Date	Particulars	L.F.	Debit Amount (₹ Lakhs)	Credit Amount (₹ Lakhs)
	Bank A/c Dr.		7,500	
	To Debenture Application A/c			7,500
	(Debentures application money received)			
	Debenture Application A/c Dr.		7,500	
	To 9% Debentures A/c			7,500
	(Application money transferred to 9% debentures account)			
	Debenture Allotment A/c Dr.		6,600	
	Loss on issue of debenture A/c Dr.		1,650	
	To 9% Debentures A/c			7,500
	To Debenture redemption premium A/c			7,50
	(Call made consequent upon allotment of debentures issued at discount and redeemable at premium)			
	Bank A/c Dr.		6,600	
	To Debenture Allotment A/c			6,600
	(Allotment amount received)			

Working Notes :

Loss on issue of debentures =

(Amount of discount on issue + Premium payable on redemption) x No. of Debentures

= (6% of ₹100 + 5% of ₹100) x 150 lakh

= (₹ 6 + ₹ 5) x 150 lakh

= ₹ 1,650 lakh

6. Debentures Issued at premium and redeemable at premium

In this situation, the issue price is more than par value and also redemption value is more than par value. The premium received at the time of issue of debentures is credited to Securities premium account and premium paid at the time of redemption is a loss to be provided at the time of issue of debentures. Suppose, a 10% debenture of ₹1,000 is issued at a premium of ₹100 and redeemable at a premium of ₹50 per debenture. In the given case ₹100 is to be credited to Securities premium account and ₹50 will be the loss to be provided at the time of issue of debentures. It is to be noted that premium on redemption of debentures is also credited by ₹ 50.

(a) For the receipt of application money

Bank A/c	Dr.	
To Debenture Application A/c		

(b) At the time of making allotment

(i) Transfer of application money to debenture account

Debenture Application A/c	Dr.	
To % Debentures A/c		

(ii) Call made consequent upon allotment of debenture at premium and Redeemable at premium

Debenture Allotment A/c	Dr.	
Loss on issue of debenture A/c	Dr.	[Amount equal to the premium on redemption]
To ...% Debenture A/c		
To Securities Premium A/c		[Amount equal to premium on issue]
To Premium on Redemption of Debentures		[Amount equal to premium on Debentures A/c redemption]

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c	Dr.
Loss on issue of Debentures A/c	Dr.
To ...% Debentures A/c	
To Securities Premium A/c	
To Premium on redemption of debentures A/c	

3.6.2 Accounting for issue of debentures payable in instalments

Just like shares, money payable on debentures may be paid either in full with application or by instalments. Accounting entries will differ to some extent in either case.

3.6.2.1 Debentures Payable in Full on Application

Where the amount due on debentures are payable in full on application, it is usual to open a separate Debentures Application Account for each class of debentures, such as 10% Debentures Application Account or 12% Debentures Application Account. These accounts record moneys received from the applicants of debentures. If an issue is over-subscribed, these accounts can be used to record the refund of moneys to the unsuccessful applicants. At the time of allotment of debentures, the amount in Debentures Application Account is transferred to the respective Debentures Account.

As discussed above, debentures may be issued at par, at a premium, or at a discount.

3.6.2.2 Debentures Issued at Par

The debentures which are issued at par are issued at the same price as their nominal value; that is, if a debenture with a nominal value of ₹ 100 is issued at par, the company receives ₹ 100.

The accounting entries would be as follows:

(a) When cash is received

Bank A/c Dr.

To Debentures Application A/c

(Being money received on.... debentures @₹ ....each)

(b) When excess money is refunded or adjusted for future calls

Debentures Application A/c Dr.

To Bank A/c (Amount refunded)

To Debenture Allotment A/c (Amount adjusted for allotment)

(Being excess money...debentures adjusted as per Board's Resolution No....dated.....)

(c) When the debentures are allotted

Debentures Application A/c Dr.

To % Debentures A/c

(Being the allotment of...debentures of ₹ ....each as per Board's Resolution No....dated....)

(d) On Allotment money being called

Debenture Allotment A/c Dr.

To % Debentures A/c

(Being Allotment Money Called)

(e) On Allotment money being received

Bank A/c Dr.

To Debenture Allotment A/c

(Being Allotment money received)

(f) On Debenture Call money being called

Debenture Calls A/c Dr.

To % Debentures A/c

(Being Call money made due)

(g) On Debenture Call money being called

Bank A/c Dr.

To Debenture Calls A/c

(Being Call money received)

ILLUSTRATION 6

Simmons Ltd. issued 1,00,000, 12% Debentures of ₹100 each at par payable in full on application by 1st April, Application were received for 1,10,000 Debentures. Debentures were allotted on 7th April. Excess money refunded on the same date.

You are required to pass necessary Journal Entries (including cash transactions) in the books of the company.

SOLUTION

In the books of Simmons Limited

Date	Particulars		₹ 000	₹ 000
April 1	Bank A/c	Dr.	11,000	
	To Debentures Application A/c			11,000
	(Being money received on 1,10,000 debentures)			
April 7	Debentures Application A/c	Dr.	1,000	

	To Bank A/c (Being money on 10,000 debentures refunded as per Board's Resolution No.....dated...)		1,000
April 7	Debentures Application A/c Dr. To Debentures A/c (Being the allotment of 1,00,000 debentures of ₹ 100 each at par, as per Board's Resolution No....dated...)	10,000	10,000

3.6.2.3 Debentures Issued at a Premium

A company issues debentures at a premium when the market rate of interest is lower than the debentures interest rate. The debentures, which are issued at a premium, are issued at a higher price than their nominal value; that is, if a debenture with a nominal value of ₹ 100 is issued at 10% premium, the company receives at ₹110 where the investor gets slightly less interest than stated in the debenture. For example, 12% Debentures of ₹100 issued at a premium of 10%. The investor will get ₹12 p.a. for his investment of 110. Therefore, the effective rate of interest on investment is (12/110x 100) = 10.91%.

The premium on debentures is credited to 'Securities Premium Account' as 'Debentures' are covered in the definition of 'securities' specified in the clause (h) of section 2 of the Securities Contracts (Regulation) Act. Therefore, restriction of utilization of debentures (securities) premium will also be governed by Section 52 of the Companies Act, 2013.

The accounting entries would be as follows:

(a) When cash is received

Bank A/c Dr. [Nominal value plus premium]

To Debentures Application A/c

(Being money received on....debentures @ ₹ .....

each including premium of ₹ .....)

(b) When excess money is refunded

Debentures Application A/c Dr.

To Bank A/c

(Being refund of money on....debentures @ ₹ ....

each, as per Board's Resolution No.....dated....)

(c) When the debentures are allotted

Debentures Application A/c Dr.

To % Debentures A/c

To Securities Premium A/c

(Being the allotment of....debentures, premium transferred to Securities Premium A/c, as per Board's Resolution No....dated....)

3.6.2.4 Debentures Issued at a Discount

The Companies Act does not impose any restriction on the price at which debentures can be issued. Unlike shares, there is no limit for discount on issue of debentures. This is why it is very common for debentures to be issued at a discount. The debentures which are issued at a discount are issued at a lower price than nominal value, that is, if a debenture with a nominal value of ₹100 is issued at 10% discount, the company receives ₹90 only. The issue of debentures at a discount slightly increases the true rate of interest payable. For example, 12% Debentures of ₹100 issued at a discount of 10%. The Company will have to pay ₹12 for a loan of ₹90. Therefore, the true rate of interest is (12/90 x 100) = 13.33%.

The company issues debentures at a discount when the market rate of interest is higher than the debenture interest rate. Like shares, Debentures Account is credited with the nominal value. The difference between the nominal value of debentures and cash received is transferred to "Discount on Issue of Debentures Account. In the subsequent years, Discount on Issue of Debentures is written-off proportionately by charging to the Statement of Profit and Loss. It is considered a normal practice to amortize discount on issue of debentures over the period of benefit, i.e., normally 3 to 5 years. However, this cannot go beyond tenure of debentures.

The accounting entries would be as follows :

(a) When Cash is received

Bank A/c	Dr.	[Actual cash received]
To Debentures Application A/c		
(Being money received on....debentures @₹ ......each)		

(b) When excess money is refunded

Debentures Application A/c	Dr.	
To Bank A/c		
(Being excess money on...debentures refunded as per Board's Resolution No.....dated....)		

(c) When the debentures are allotted

Debentures Application A/c	Dr.	[Actual cash received]

Discount on Issue of Debentures A/c Dr. [Discount on debentures]

To% Debentures A/c [Nominal value of debentures]

(Being the allotment of...debentures of ₹ ....each

@ ₹ .....each as per Board's Resolution No.....dated...)

In fact, the discount on issue of debentures is considered as incremental interest expense. The true expense (net borrowing cost) for a particular accounting period is, therefore, the total interest payment plus the discount amortised.

ILLUSTRATION 7

X Ltd. issued 1,00,000 12% Debentures of ₹100 each at a discount of 10% payable in full on application by 31st May, 2022. Applications were received for 1,20,000 debentures. Debentures were allotted on 9th June, 2022. Excess money was refunded on the same date. Pass necessary Journal Entries. Also show necessary ledger accounts.

SOLUTION

In the books of X Limited
Journal Entries

Date			
2022	**Particulars**	**₹ '000**	**₹ '000**
May 31	Bank A/c Dr.	10,800	
	To Debentures Application A/c		10,800
	(Being money received for 1,20,000 debentures @ ₹ 90 each)		
June 9	Debentures Application A/c Dr.	1,800	
	To Bank A/c		1,800
	(Being excess money on 20,000 debentures @ ₹ 90 refunded as per Board's Resolution No....dated....)		
June 9	Debentures Application A/c Dr.	9,000	
	Discount on Issue of Debentures A/c Dr.	1,000	
	To 12% Debentures A/c		10,000
	(Being the allotment of 1,00,000 debentures of ₹ 100 each at a discount of ₹ 10 per debenture as per Board's Resolution No.....dated...)		

Bank Account

Date	Particulars	₹	Date	Particulars	₹
31.5.2022	To 12% Debentures Application A/c	10,800	9.6.2022	By 12% Debentures Application A/c	1,800
			9.6.2022	By Balance c/d	9,000
		10,800			10,800

12% Debentures Account

Date	Particulars	₹	Date	Particulars	₹
30.6.2022	To Balance c/d	10,000	9.6.2022	By 12% Debentures Application A/c	9,000
			9.6.2022	By Discount on Issue of Debentures A/c	1,000
		10,000			10,000

Debentures Application Account

Date	Particulars	₹	Date	Particulars	₹
9.6.2022	To Bank A/c	1,800	31.5.2022	By Bank A/c	10,800
9.6.2022	To 12% Debentures A/c	9,000			
		10,800			10,800

Discount on Issue of Debentures Account

Date	Particulars	₹	Date	Particulars	₹
9.6.2022	To12% Debentures A/c	1,000	30.6.2022	By Balance c/d	1,000
		1,000			1,000

3.7 ISSUE OF DEBENTURES AS COLLATERAL SECURITY

Collateral security means secondary or supporting security for a loan, which can be realised by the lender in the event of the original loan not being repaid on the due date. Under this arrangement, the borrower agrees that a particular asset or a group of assets will be realized and the proceeds there from will be applied to repay the loan in the event that the amount due, cannot be paid.

Sometimes companies issue their own debentures as collateral security for a loan or a fluctuating overdraft. When the loan is repaid on the due date, these debentures are at once released with the main security. In case, the company cannot repay its loan and the interest thereon on the due date, the lender becomes the debenture holder who can exercise all the rights of a debenture holder.

In such cases, the holder of such debentures is entitled to interest only on the amount of loan, but not on the debentures.

Accounting Entries

There are two methods of showing these types of debentures in the accounts of a company.

Method 1

Under this method, no entry is made in the books of account of the company at the time of making issue of such debentures. In the 'Notes to Accounts' of Balance Sheet, the fact of the debentures being issued and outstanding is shown by a note under the liability secured.

ILLUSTRATION 8

X Ltd. obtains a loan from IDBI of ₹1,00,00,000, giving as collateral security of ₹1,50,00,000 (of ₹ 10 each), 14%, First Mortgage Debentures.

SOLUTION

In the Notes to Accounts of Balance Sheet of X Ltd., it is shown as follows:

Notes to Accounts of X Limited as at...(includes)

Long Term Borrowings	₹
Secured Loan	
IDBI Loan	1,00,00,000

(Collaterally secured by issue of ₹ 1,50,00,000 14% First Mortgage Debentures)

Method 2

Under this method, the following entry is made to record the issue of such debentures:

Debentures Suspense Account Dr.

To % Debentures Account

(Being the issue of...debentures collaterally as per

Board's Resolution No.....dated......)

The Debentures Suspense Account will appear on the assets side of the Balance Sheet under Other Non- Current Assets and Debentures on the liabilities side of the Balance Sheet. When the loan is repaid, the entry is reversed in order to cancel it.

ILLUSTRATION 9

Taking the same information of the illustration 8, the entry on issue will be as follows :

In the Books of X Ltd.

Journal

Date	Particulars		₹	₹
	Debentures Suspense A/c	Dr.	1,50,00,000	
	To 14% First Mortgage Debentures A/c			1,50,00,000
	(Being the issue of ₹ 15,00,000 debentures @ ₹10 collaterally as per Board's Resolution No...dated...)			

Balance Sheet of X Limited as at....(Extracts)

	Particulars	Notes No.	₹	
	EQUITY AND LIABILITIES			
1.	**Non-Current Liabilities**			
	Long Term Borrowings	1	2,50,00,000	
	Total		2,50,00,000	
	ASSETS			
2.	**Non-current Assets**			
	Other non-current asset	2	1,50,00,000	
3.	**Current Assets**			
	Cash and cash equivalent		1,00,00,000	
	Total		2,50,00,000	
Notes to accounts				
			₹	₹
1.	**Long Term Borrowings**			
	Secured Loan			
	IDBI Loan		1,00,00,000	
	14% First Mortgage Debentures		1,50,00,000	2,50,00,000

2.	**Other non-current asset** Debenture Suspense Account (issue of ₹ 15,00,000 14% First Debentures as collateral security as per contra)			1,50,00,000

Students should note that the Method 1 is much more logical from the accounting point of view. Therefore, it is advised to follow Method 1.

3.8 ISSUE OF DEBENTURES IN CONSIDERATION OTHER THAN FOR CASH

Just like shares, debentures can also be issued for consideration other than for cash, such as for purchase of land, machinery, etc. In this case, the following entries are passed:

(a)	Sundry Assets Account	Dr.	[Assets taken over]
	To Sundry Liabilities Account		[Liabilities assumed]
	To Vendors Account		[Purchase consideration]
	(Being the assets and liabilities taken over)		
(b)	Vendors Account	Dr.	
	To Debentures Account		
	(Being the issue of....debentures to satisfy purchase consideration)		

Further it should be noted that these debentures can be issued at par, premium and at discount. In each case the second entry for issue of debentures would be done accordingly. Number of debentures to be issued is calculated as follows:-

1. When debentures are issued at par

$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value}}$$

2. When debentures are issued at premium

$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value} + \text{Premium}}$$

3. When debentures are issued at discount

$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value - Discount}}$$

ILLUSTRATION 10

X Company Limited issued 10,000 14% Debentures of the nominal value of ₹50,00,000 as follows:

(a) To sundry persons for cash at 90% of nominal value of ₹ 25,00,000.

(b) To a vendor for purchase of fixed assets worth ₹10,00,000 – ₹ 12,50,000 nominal value.

(c) To the banker as collateral security for a loan of ₹ 10,00,000 – ₹ 12,50,000 nominal value.

Pass necessary Journal Entries.

SOLUTION

In the books of X Company Ltd.
Journal Entries

Date	Particulars		₹	₹
(a)	Bank A/c	Dr.	22,50,000	
	To Debentures Application A/c			22,50,000
	(Being the application money received on 5,000 debentures @ ₹ 450 each)			
	Debentures Application A/c	Dr.	22,50,000	
	Discount on issue of Debentures A/c	Dr.	2,50,000	
	To 14% Debentures A/c			25,00,000
	(Being the issue of 5,000 14% Debentures @ 90% as per Board's Resolution No....dated....)			
(b)	Fixed Assets A/c	Dr.	10,00,000	
	To Vendor A/c			10,00,000
	(Being the purchase of fixed assets from vendor)			
	Vendor A/c	Dr.	10,00,000	
	Discount on Issue of Debentures A/c	Dr.	2,50,000	
	To 14% Debentures A/c			12,50,000
	(Being the issue of debentures of ₹ 12,50,000 to vendor to satisfy his claim)			
(c)	Bank A/c	Dr.	10,00,000	

	To Bank Loan A/c (See Note) (Being a loan of ₹10,00,000 taken from bank by issuing debentures of ₹12,50,000 as collateral security)		10,00,000

Note : No entry is made in the books of account of the company at the time of making issue of such debentures. In the Balance Sheet due to the fact that the debentures being issued as collateral security and outstanding are shown under the respective liability.

3.9 TREATMENT OF DISCOUNT/LOSS ON ISSUE OF DEBENTURES

The discount on issue of debentures is amortised over a period between the issuance date and redemption date. It should be written-off in the following manner depending upon the terms of redemption:

(a) If the debentures are redeemable after a certain period of time, say at the end of 5 years, the total amount of discount should be written-off equally throughout the life of the debentures (applying the straight line method). The main advantage of this method is that it spreads the burden of discount equally over the years.

(b) If the debentures are redeemable at different dates, the total amount of discount should be written-off in the ratio of benefit derived from debenture loan in any particular year (applying the sum of the year's digit method). This method is suitable when debentures are redeemed by unequal instalments.

The accounting entries would be as follows :

Profit and Loss Account Dr.

To Discount on Issue of Debentures Account

(Being the amount of discount on issue of debentures written-off)

Loss on issue of debentures is also a capital loss and should be written off in a similar manner as discount on debentures issued. In the balance sheet both the items (Discount and Loss) are shown as Non-current/current assets depending upon the period for which it has to be written off.

ILLUSTRATION 11

HDC Ltd issues 1,00,000, 12% Debentures of ₹100 each at ₹94 on 1st January, 2022. Under the terms of issue, the debentures are redeemable at the end of 5 years from the date of the issue. Calculate the amount of discount to be written-off in each of the 5 years.

SOLUTION

Total amount of discount comes to ₹ 6,00,000 (₹6 X 1,00,000). The amount of discount to be written-off in each year is calculated as under :

Year end	Debentures outstanding	Ratio in which discount to be written-off	Amount of discount to be written-off
1st	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000
2nd	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000
3rd	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000
4th	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000
5th	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000= ₹ 1,20,000

ILLUSTRATION 12

HDC Ltd. issues 2,00,000, 12% Debentures of ₹10 each at ₹9.40 on 1st January, 2022. Under the terms of issue, 1/5th of the debentures are annually redeemable by drawings, the first redemption occurring on 31st December, 2022. Calculate the amount of discount to be written-off from 2022 to 2026.

SOLUTION

Calculation of amount of discount to be written-off

At the Year end	Debentures Outstanding before redemption	Ratio of benefit Derived	Amount of discount to be written-off
2022	₹ 20,00,000	5	5/15th of ₹ 1,20,000 = ₹ 40,000
2023	₹ 16,00,000	4	4/15th of ₹ 1,20,000 = ₹ 32,000
2024	₹ 12,00,000	3	3/15th of ₹ 1,20,000 = ₹ 24,000
2025	₹ 8,00,000	2	2/15th of ₹ 1,20,000 = ₹ 16,000
2026	₹ 4,00,000	1	1/15th of ₹ 1,20,000 = ₹ 8,000
	TOTAL	15	₹ 1,20,000

3.10 INTEREST ON DEBENTURES

Interest payable on coupon debenture is treated as a charge against the profits of the company. Interest on debenture is paid periodically and is calculated at coupon rate on the nominal value of debentures. The company will pay interest net of tax to the debenture holders because the company is under obligation to deduct tax at source at the rates applicable under tax rules from time to time. The companies will deposit the tax so deducted with income tax authorities. Following accounting entries are to be recorded in this regard:

1. *For making interest due*

   Interest A/c Dr.

   To Debenture holders' A/c

2. *For making payment of interest and deduction of tax at source (TDS)*

   Debenture holders A/c Dr.

   To TDS Payable A/c

   To Bank A/c

3. *For making payment of tax deducted at source*

   TDS payable A/c Dr.

   To Bank A/c

4. *For transferring interest to profit and loss account*

   Profit and Loss A/c Dr.

   To Interest A/c

ILLUSTRATION 13

A company issued 12% debentures of the face value of ₹10,00,000 at 10% discount on 1-1-2019. Debenture interest after deducting tax at source @ 10% was payable on 30th June and 31st of December every year. All the debentures were to be redeemed after the expiry of five year period at 5% premium.

Pass journal entries for the accounting year 2022.

SOLUTION

Journal Entries

			(₹)	(₹)
1-1-2022	Bank A/c	Dr.	9,00,000	
	Discount/Loss on Issue of Debentures A/c	Dr.	1,50,000	
	To 12% Debentures A/c	Dr.		10,00,000
	To Premium on Redemption of Debentures A/c			50,000
	(For issue of debentures at discount redeemable at premium)			

30-6-2022	Debenture Interest A/c	Dr.	60,000	
	To Debenture holders A/c			54,000
	To Tax Deducted at Source A/c			6,000
	(For interest payable)			
	Debenture holders A/c	Dr.	54,000	
	Tax Deducted at Source A/c	Dr.	6,000	
	To Bank A/c			60,000
	(For payment of interest and TDS)			
31-12-2022	Debenture Interest A/c	Dr.	60,000	
	To Debenture holders A/c			54,000
	To Tax Deducted at Source A/c			6,000
	(For interest payable)			
	Debenture holders A/c	Dr.	54,000	
	Tax Deducted at Source A/c	Dr.	6,000	
	To Bank A/c			60,000
	(For payment of interest and tax)			
	Profit and Loss A/c	Dr.	1,20,000	
	To Debenture Interest A/c			1,20,000
	(For transfer of debenture interest to profit and loss account at the end of the year)			
	Profit and Loss A/c	Dr.	30,000	
	To Discount/Loss on issue of debenture A/c			30,000
	(For proportionate debenture discount and premium on redemption written off, i.e., 1,50,000 x 1/5)			

SUMMARY

- Debenture is one of the most commonly used debt instrument issued by the company to raise funds for the business. A debenture is a bond issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest. Money payable on debentures may be paid either in full with application or in instalments.
- Debenture holders are the creditors of the company whereas shareholders are the owners of the company. Debenture holders have no voting rights and consequently do not pose any threat to the existing control of the company. Shareholders have voting rights and consequently control the total affairs of the company.
- Debentures can be classified on the basis of: (1) Security; (2) Convertibility; (3) Permanence; (4) Negotiability; and (5) Priority.
- Issue of redeemable debentures can be categorized into the following:
  1. Debenture issued at par and redeemable at par or at a discount;
  2. Debenture issued at a discount and redeemable at par or at discount;
  3. Debenture issued at premium and redeemable at par or at discount;
  4. Debenture issued at par and redeemable at premium;
  5. Debenture issued at a discount and redeemable at premium;
  6. Debenture issued at premium and redeemable at premium;

  Note: In practical life, redemption of debentures at a discount is a rare situation.
- Collateral security means secondary or supporting security for a loan, which can be realised by the lender in the event of the original loan not being repaid on the due date. Under this arrangement, the borrower agrees that a particular asset or a group of assets will be realized and the proceeds there from will be applied to repay the loan in the event that the amount due, cannot be paid. Sometimes companies issue their own debentures as collateral security for a loan or a fluctuating overdraft.
- Debentures can also be issued for consideration other than for cash, such as for purchase of land, machinery, etc.
- The discount on issue of debentures is amortised over a period between the issuance date and redemption date. Loss on issue of debentures is also a capital loss and should be written off in a similar manner as discount on debentures issued. In the balance sheet both the items (Discount and Loss) are shown as Non-current/current assets depending upon the period for which it has to be written off.
- Interest payable on debentures is treated as a charge against the profits of the company. Interest on debenture is paid periodically and is calculated at coupon rate on the nominal value of debentures.

TEST YOUR KNOWLEDGE

True and False

1. *Debenture holder are the owners of the company.*
2. *Perpetual debentures are payable at the time of liquidation of the company.*
3. *Registered debentures are transferable by delivery.*
4. *When companies issue their own debentures as collateral security for a loan, the holder of such debenture is entitled to interest only on the amount of loan and not on the debentures*
5. *Debentures suspense account appears on liability side of balance sheet.*
6. *If a company incurs loss, then it does not pay interest to the debenture holders.*
7. *At the time of liquidation, debenture holders are paid off after the shareholders.*
8. *Convertible debentures can be converted into equity shares.*
9. *Redeemable debentures are not payable during the life time of the company.*
10. *Debentures can be issued for a consideration other than for cash, such as for purchasing land, machinery etc.*

Multiple Choice Questions

1. *Premium on redemption of debentures account appearing in the balance sheet is _______.*

   (a) A nominal account – expenditure

   (b) A nominal account - income

   (c) A personal account ______.

2. *Debenture interest*

   (a) Is payable before the payment of any dividend on shares

   (b) Accumulates in case of losses or inadequate profits

   (c) Is payable after the payment of preference dividend but before the payment of equity dividend_______.

3. *F Ltd. purchased Machinery from G Company for a book value of ₹ 4,00,000. The consideration was paid by issue of 10% debentures of ₹ 100 each at a premium of 25%. The debenture account was credited with ______.*

   (a) ₹ 4,00,000

(b) ₹ 5,00,000

(c) ₹ 3,20,000

4. *Which of the following is not a characteristic of Bearer Debentures?*

   (a) *They are treated as negotiable instruments*

   (b) *Their transfer requires a deed of transfer*

   (c) *They are transferable by mere delivery*

5. *When debentures are issued as collateral security, the final entry for recording the collateral debentures in the books is __________.*

   (a) *Credit Debentures A/c and debit Cash A/c.*

   (b) *Debit Debenture suspense A/c and credit Cash A/c.*

   (c) *Debit Debenture suspense A/c and credit Debentures A/c.*

6. *When debentures are redeemable at different dates, the total amount of discount on issue of debentures should be written off*

   (a) *Every year by applying the sum of the year's digit method*

   (b) *Every year by applying the straight line method*

   (c) *To profit and loss account in full in the year of final or last redemption*

7. *Debentures are issued at discount when*

   (a) *Market interest rate is higher than debenture interest rate*

   (b) *Market interest rate is lower than debenture interest rate*

   (c) *Market interest rate is equal debenture interest rate*

8. *Interest payable on Debentures attract*

   (a) *Tax deducted at source*

   (b) *Goods and Service tax*

   (c) *Fringe benefit tax*

Theoretical questions

1. *Distinguish between debentures and shares.*

2. *Explain the purpose for raising of debenture by the company. Also give the main features of debentures.*

Practical questions

1. *Country Crafts Ltd. issued 1,00,000, 8% debentures of ₹ 100 each at premium of 5% payable fully on application and redeemable at premium of ₹ 10 Pass necessary journal entries at the time of issue.*

2. *Koinal Chemicals Ltd. issued 20,00,000, 10% debentures of ₹50 each at premium of 10%, payable as ₹ 20 on application and balance on allotment. Debentures are redeemable at par after 6 years. All the money due on allotment was called up and received. Record necessary entries when premium money is included in allotment money.*

3. *Kapil Ltd. issued 50,000, 12% Debentures of ₹100 each at a premium of 10% payable in full on application by 1st March, 2022. The issue was fully subscribed and debentures were allotted on 9th March, 2022.*

   Pass necessary Journal Entries (including cash transactions).

4. *On 1st April 2022 Sheru Ltd. issued 1,00,000 12% debentures of ₹100 each at a discount of 5%, redeemable on 31st March, 2027. Issue was oversubscribed by 20,000 debentures, who were refunded their money. Interest is paid annually on 31st March. You are required to prepare:*

   (i) Journal Entries at the time of issue of debentures.

   (ii) Discount on issue of Debenture Account

   (iii) Interest account and Debenture holder Account assuming TDS is deducted @ 10%.

5. *A Limited issued 14% Debentures of the nominal value of ₹ 10 each as follows:*

   (a) To sundry persons 1,00,000 Debentures for cash at 10% discount.

   (b) To a vendor for purchase of Inventory worth ₹ 1,00,000, 8,000 debentures at 25% premium.

   (c) To the banker as collateral security for a loan of ₹ 1,00,000 – ₹ 1,50,000 nominal value.

   Pass necessary Journal Entries.

ANSWERS/HINTS

True and False

1. False: Debenture holder are the creditors of the company.

2. True: Perpetual debentures, also known as irredeemable debentures are not repayable during the life time of the company.

3. False: Registered debentures are not easily transferable by delivery. Bearer debentures are transferrable by delivery.

4. True: In case the company cannot repay its loan & the interest thereon on the due date, the lender becomes debenture holder & then only he is entitled to interest on debentures.

5. False: Debentures suspense account appears on asset side of balance sheet under non-current asset.

6. False: Even if the company incurs loss or earns profit, it has to pay the interest on debentures.

7. False: At the time of liquidation, debenture holders are paid off before shareholders on priority basis.

8. True: Convertible debentures can be converted into equity share after a certain period of time from the date of its issue.

9. False: These debentures are repayable as per the terms of issue, for example, after 8 years from the date of issue.

10. True: Debentures can be issued for a consideration other than for cash, such as for purchasing land, machinery etc.

Multiple Choice Questions

1.	(c)	**2.**	(a)	**3.**	(c)	**4.**	(b)	**5.**	(c)	**6.**	(a)
7.	(b)	**8.**	(a)								

Theoretical Questions

1. Refer para 3.4 for the distinction between Shares and Debentures.

2. Debenture is one of the most commonly used debt instrument issued by the company to raise funds for the business. The most common method of supplementing the capital available to a company is to issue debentures which may either be simple or naked carrying no charge on assets, or mortgage debentures carrying either a fixed or a floating charge on some or all of the assets of the company.

For features of debentures refer para 3.3.

Practical Questions

1. Journal Entries in the Books of Country Crafts Ltd.

Date	Particulars	L.F.	Debit Amount (₹'000)	Credit Amount (₹'000)
(a)	Bank A/c	Dr.	10,500	
	To Debenture Application A/c			10,500
	(Debenture application money received)			
(b)	Debenture Application A/c	Dr.	10,500	
	Loss on Issue of Debenture A/c	Dr.	1,000	
	To Securities Premium A/c			500
	To 8% Debentures A/c			10,000
	To Premium on Redemption A/c			1,000
	(Debenture application money transferred to debenture account)			

2. Journal Entries in the Books of Koinal Chemicals Ltd.

Particulars		Debit Amount (₹ lakhs)	Credit Amount (₹ lakhs)
Bank A/c	Dr.	400	
To Debenture Application A/c			400
(Debenture application money received)			
Debentures Application A/c	Dr.	400	
To 10% Debentures A/c			400
(Debenture application money transferred to 10% debenture account consequent upon allotment)			

Debenture allotment A/c Dr.	700	
To 10% Debentures A/c		600
To Securities Premium A/c		100
(Call made on allotment of debenture including premium)		
Bank A/c Dr.	700	
To Debenture Allotment A/c		700
(Money received consequent upon allotment)		

3. Journal Entries in the books of Kapil Limited

Date	Particulars	₹	₹
2022			
March 1	Bank A/c Dr.	55,00,000	
	To Debentures Application A/c		55,00,000
	(Being the money received on 50,000 debentures @ ₹ 110 each including premium of ₹ 10 each)		
March 9	Debentures Application A/c Dr.	55,00,000	
	To 12% Debentures A/c		50,00,000
	To Securities Premium A/c		5,00,000
	(Being the allotment of 50,000 debentures of ₹ 100 each, premium @ ₹ 10 each transferred to Securities Premium Account as per Board's Resolution No....dated....)		

4. (i) Journal in the Books of Sheru Ltd.

Date	Particulars	LF	(₹ 00)	(₹ 00)
2022				
Apr 1	Bank A/c		1,14,000	
	To Debenture Application A/c			1,14,000
	(Being debenture application money received for 1,20,000 debentures)			
	Debenture Application A/c Dr.		1,14,000	
	Discount on Issue of Debenture A/c Dr.		5,000	

	To 12% Debenture A/c		1,00,000
	To Bank A/c		19,000
	(Being application money transferred to debenture account and excess refunded)		

(ii) **Discount on Issue of Debenture A/c**

Date	Particulars	₹'00	Date	Particulars	₹'00
1.4.22	To 12% Debentures A/c	5,000	31.3.23	By Profit & Loss A/c	1,000
			31.3.23	By Balance c/d	4,000
		5,000			5,000
1.4.23	To Balance b/d	4,000	31.3.24	By Profit & Loss A/c	1,000
			31.3.24	By Balance c/d	3,000
		4,000			4,000
1.4.24	To Balance b/d	3,000	31.3.25	By Profit & Loss A/c	1,000
			31.3.25	By Balance c/d	2,000
		3,000			3,000
1.4.25	To Balance b/d	2,000	31.3.26	By Profit & Loss A/c	1,000
			31.3.26	By Balance c/d	1,000
		2,000			2,000
1.4.26	To Balance b/d	1,000	31.3.27	By Profit & Loss A/c	1,000
		1,000			1,000

(iii) **Interest A/c**

Date	Particulars	₹'00	Date	Particulars	₹'00
31.3.23	To Debentureholder A/c	12,000	31.3.23	By Profit & Loss A/c	12,000
		12,000			12,000
31.3.24	To Debentureholder A/c	12,000	31.3.24	By Profit & Loss A/c	12,000
		12,000			12,000
31.3.25	To Debentureholder A/c	12,000	31.3.25	By Profit & Loss A/c	12,000
		12,000			12,000

31.3.26	To Debentureholder A/c	12,000	31.3.26	By Profit & Loss A/c	12,000
		12,000			12,000
31.3.27	To Debentureholder A/c	12,000	31.3.27	By Profit & Loss A/c	12,000
		12,000			12,000

Debentureholder A/c

Date	Particulars	₹'00	Date	Particulars	₹'00
31.3.23	To Bank A/c	10,800	31.3.23	By Interest A/c	12,000
31.3.23	To TDS A/c	1,200			
		12,000			12,000
31.3.24	To Bank A/c	10,800	31.3.24	By Interest A/c	12,000
31.3.24	To TDS A/c	1,200			
		12,000			12,000
31.3.25	To Bank A/c	10,800	31.3.25	By Interest A/c	12,000
31.3.25	To TDS A/c	1,200			
		12,000			12,000
31.3.26	To Bank A/c	10,800	31.3.26	By Interest A/c	12,000
31.3.26	To TDS A/c	1,200			
		12,000			12,000
31.3.27	To Bank A/c	10,800	31.3.27	By Interest A/c	12,000
31.3.27	To TDS A/c	1,200			
		12,000			12,000

5. **In the books of A Ltd.**

Journal Entries

Date	Particulars		₹	₹
(a)	Bank A/c	Dr.	9,00,000	
	To Debentures Application A/c			9,00,000
	(Being the application money received on 100,000 debentures @ ₹ 9 each)			
	Debentures Application A/c	Dr.	9,00,000	
	Discount on issue of Debentures A/c	Dr.	1,00,000	
	To 14% Debentures A/c			10,00,000
	(Being the issue of 100,000 14% Debentures @ 90% as per Board's Resolution No....dated....)			

(b)	Inventories A/c Dr. To Vendor A/c (Being the purchase of inventories from vendor)	1,00,000	 1,00,000
	Vendor A/c Dr. To 14% Debentures A/c To Securities Premium (Being the issue of 8,000 debentures of to vendor to satisfy his claim at premium of 25%)	1,00,000	 80,000 20,000
(c)	Bank A/c Dr. To Bank Loan A/c (See Note) (Being a loan of ₹1,00,000 taken from bank by issuing debentures of ₹1,50,000 as collateral security)	1,00,000	 1,00,000

Note : No entry is made in the books of account of the company at the time of making issue of such debentures. In the Balance Sheet due to the fact that the debentures being issued as collateral security and outstanding are shown under the respective liability.

UNIT – 4: ACCOUNTING FOR BONUS ISSUE AND RIGHT ISSUE

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the provisions relating to issue of bonus shares and right shares;
- Account for bonus shares and rights issue in the books of issuing company;
- Understand the meaning of renunciation of right;
- Differentiate between cum-right and ex-right value of share;
- Calculate value of rights.

UNIT OVERVIEW

BONUS SHARES	Bonus issue means an issue of additional shares to existing shareholders free of cost in proportion to their existing holding. A company may issue fully paid-up bonus shares to its shareholders out of— (i) its free reserves; (ii) securities premium account; or (iii) capital redemption reserve account: Bonus shares should not be issued out of revaluation reserves (i.e., reserves created by the revaluation of assets).
RIGHT ISSUE	Rights issue is an issue of rights to a company's existing shareholders that entitles them to buy additional shares directly from the company in proportion to their existing holdings, within a fixed time period. In a rights offering, the subscription price at which each share may be purchased is generally at a discount to the current market price. Rights are often transferable, allowing the holder to sell them in the open market. The difference between the cum-right and ex-right value of the share is the value of the right.

4.1 ISSUE OF BONUS SHARES

4.1.1 Introduction

A bonus share may be defined as issue of shares at no cost to current shareholders in a company, based upon the number of shares that the shareholder already owns. In other words, no new funds are raised with a bonus issue. While the issue of bonus shares increases the total number of shares issued and owned, it does not increase the net worth of the company. Although the total number of issued shares increases, the ratio of number of shares held by each shareholder remains constant.

Bonus issue is also known as 'capitalisation of profits'. Capitalisation of profits refers to the process of converting profits or reserves into paid up capital. A company may capitalise its profits or reserves which otherwise are available for distribution as dividends among the members by issuing fully paid bonus shares to the members.

If the subscribed and paid-up capital exceeds the authorised share capital as a result of bonus issue, a resolution shall be passed by the company at its general body meeting for increasing the authorised capital. A return of bonus issue along with a copy of resolution authorising the issue of bonus shares is also required to be filed with the Registrar of Companies.

Bonus shares are shares issued at no cost to current shareholders in a company → Based upon the number of shares → That the shareholder already owns.

Example 1

Alpha Company announced bonus issue to its shareholders in the ratio of 2:3 ie. 2 shares for every 3 shares held. Shareholder X has 6,000 shares before announcement of bonus issue. How much shares would he have after bonus issue?

Solution

Company announced bonus issue in ratio of 2:3

Shareholder X will be entitled to have 4,000 bonus shares (6,000 shares / 3 x 2)

Total number of shares X has after bonus issue 10,000 (6,000 + 4,000)

4.1.2 Provisions of the Companies Act, 2013

Section 63 of the Companies Act, 2013 deals with the issue of bonus shares. According to Sub-section (1) of Section 63, a company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of—

(i) its free reserves*;

(ii) the securities premium account; or

(iii) the capital redemption reserve account:

Provided that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

Sub-section (2) of Section 63 provides that no company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares under sub-section (1), unless—

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* *As per Section 2(43) of the Companies Act, 2013, "free reserves" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend. Provided that—*

(i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or

(ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves.

(a) it is authorised by its articles;

(b) it has, on the recommendation of the Board, been authorised in the general meeting of the company;

(c) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

(d) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;

(e) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up.

(f) it complies with such conditions as may be prescribed.

The company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same.

Sub-section (3) of the Section also provides that the bonus shares shall not be issued in lieu of dividend.

As per Para 39 (i) of Table F under Schedule I to the Companies Act, 2013, a company in general meeting may, upon the recommendation of the Board, resolve—

(i) (a) that it is desirable to capitalise any part of the amount for the time being standing to the credit of any of the company's reserve accounts, or to the credit of the profit and loss account, or otherwise available for distribution; and

(b) that such sum be accordingly set free for distribution in the specified manner amongst the members who would have been entitled thereto, if distributed by way of dividend and in the same proportions.

(ii) The sum aforesaid shall not be paid in cash but shall be applied, subject to the provision contained in clause (iii), either in or towards— (a) paying up any amounts for the time being unpaid on any shares held by such members respectively; (b) paying up in full, unissued shares of the company to be allotted and distributed, credited as fully paid-up, to and amongst such members in the proportions aforesaid; partly in the way specified in (a) and partly in that specified in (b) above;

A securities premium account and a capital redemption reserve account may only be applied in the paying up of unissued shares to be issued to members of the company as fully paid bonus shares. In other words, securities premium account and capital redemption reserve **cannot** be applied towards payment of unpaid amount on any shares held by existing shareholders.

As per Section 63(2) of the Companies Act, 2013, bonus shares cannot be issued unless party paid-up shares are made fully paid-up. Para 39(ii) of Table F under Schedule I to the Companies Act, 2013 allows use of free reserves for paying up amounts unpaid on shares held by existing shareholders.

On a combined reading of both the provisions, it can be said that free reserves may be used for paying up amounts unpaid on shares held by existing shareholders (though securities premium account and capital redemption reserve cannot be used).

4.1.3 Journal Entries

(A) (1) Upon the sanction of an issue of bonus shares

Capital Redemption Reserve Account	Dr.
Securities Premium Account[1]	Dr.
General Reserve Account	Dr.
Profit & Loss Account	Dr.
To Bonus to Shareholders Account.	

(2) Upon issue of bonus shares

Bonus to Shareholders Account	Dr.
To Share Capital Account.	

(B) (1) Upon the sanction of bonus by converting partly paid shares into fully paid shares

General Reserve Account	Dr.
Profit & Loss Account	Dr.
To Bonus to Shareholders Account	

(2) On making the final call due

Share Final Call Account	Dr.
To Share Capital Account.	

[1] *As per SEBI Regulations, such securities premium should be realized in cash, whereas under the Companies Act, 2013, there is no such requirement. In accordance with Section 52, securities premium may arise on account of issue of shares other than by way of cash. Thus, for unlisted companies, securities premium (not realized in cash) may be used for issue of bonus shares, whereas the same cannot be used in case of listed companies.*

(3) On adjustment of final call

Bonus to Shareholders Account Dr.

To Share Final Call Account

ILLUSTRATION 1

Following items appear in the trial balance of Bharat Ltd. (a listed company) as on 31st March, 2022:

	₹
40,000 Equity shares of ₹ 10 each	*4,00,000*
Capital Redemption Reserve	*55,000*
Securities Premium (collected in cash)	*30,000*
General Reserve	*1,05,000*
Surplus i.e. credit balance of Profit and Loss Account	*50,000*

The company decided to issue to equity shareholders bonus shares at the rate of 1 share for every 4 shares held and for this purpose, it decided that there should be the minimum reduction in free reserves. Pass necessary journal entries.

SOLUTION

Journal Entries in the books of Bharat Ltd.

		Dr.	Cr.
		₹	₹
Capital Redemption Reserve A/c	Dr.	55,000	
Securities Premium A/c	Dr.	30,000	
General Reserve A/c (b.f.)	Dr.	15,000	
To Bonus to Shareholders A/c			1,00,000
(Bonus issue of one share for every four shares held, by utilising various reserves as per Board's resolution dated.......)			
Bonus to Shareholders A/c	Dr.	1,00,000	
To Equity Share Capital A/c			1,00,000
(Capitalisation of profit)			

Working Note-

Number of Bonus shares to be issued- (40,000 shares / 4) X 1 = 10,000 shares

Value of Bonus shares- 10,000 shares of ₹ 10 each = ₹ 1,00,000

ILLUSTRATION 2

Pass Journal Entries in the following circumstances:

(i) *A Limited company with subscribed capital of ₹ 5,00,000 consisting of 50,000 Equity shares of ₹ 10 each; called up capital ₹ 7.50 per share. A bonus of ₹ 1,25,000 declared out of General Reserve to be applied in making the existing shares fully paid up.*

(ii) *A Limited company having fully paid up capital of ₹ 50,00,000 consisting of Equity shares of ₹ 10 each, had General Reserve of ₹ 9,00,000. It was resolved to capitalize ₹ 5,00,000 out of General Reserve by issuing 50,000 fully paid bonus shares of ₹ 10 each, each shareholder to get one such share for every ten shares held by him in the company.*

SOLUTION

Journal Entries

			₹	₹
(i)	General Reserve A/c	Dr.	1,25,000	
	To Bonus to shareholders A/c			1,25,000
	(For making provision of bonus issue)			
	Share Final Call A/c		1,25,000	
	To Equity share capital A/c			1,25,000
	(For final calls of ₹ 2.5 per share on 50,000 equity shares due as per Board's Resolution dated....)			
	Bonus to shareholders A/c	Dr.	1,25,000	
	To Share Final Call A/c			1,25,000
	(For bonus money applied for call)			
(ii)	General Reserve A/c	Dr.	5,00,000	
	To Bonus to shareholders A/c			5,00,000
	(For making provision of bonus issue)			
	Bonus to shareholders A/c	Dr.	5,00,000	
	To Equity share capital A/c			5,00,000
	(For issue of 50,000 bonus shares at ₹ 10)			

ILLUSTRATION 3

Following notes pertain to the Balance Sheet of Solid Ltd. as at 31st March, 2022:

	₹
Authorised capital :	
10,000 12% Preference shares of ₹ 10 each	*1,00,000*
1,00,000 Equity shares of ₹ 10 each	*10,00,000*
	11,00,000
Issued and Subscribed capital:	
8,000 12% Preference shares of ₹ 10 each fully paid	*80,000*
90,000 Equity shares of ₹ 10 each, ₹ 8 paid up	*7,20,000*
Reserves and Surplus :	
General reserve	*1,60,000*
Revaluation reserve	*35,000*
Securities premium (collected in cash)	*20,000*
Profit and Loss Account	*2,05,000*
Secured Loan:	
12% Debentures @ ₹ 100 each	*5,00,000*

On 1st April, 2022 the Company has made final call @ ₹ 2 each on 90,000 equity shares. The call money was received by 20th April, 2022. Thereafter the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held. Show necessary entries in the books of the company and prepare the extract of the Balance Sheet immediately after bonus issue assuming that the company has passed necessary resolution at its general body meeting for increasing the authorised capital.

SOLUTION

Journal Entries in books of Solid Ltd.

			Dr.	***Cr.***
2022			₹	₹
April 1	Equity Share Final Call A/c	Dr.	1,80,000	
	To Equity Share Capital A/c			1,80,000
	(Final call of ₹ 2 per share on 90,000 equity shares due as per Board's Resolution dated....)			

April 20	Bank A/c	Dr.	1,80,000	
	To Equity Share Final Call A/c			1,80,000
	(Final Call money on 90,000 equity shares received)			
	Securities Premium A/c	Dr.	20,000	
	General Reserve A/c	Dr.	1,60,000	
	Profit and Loss A/c (b.f.)	Dr.	45,000	
	To Bonus to Shareholders A/c			2,25,000
	(Bonus issue @ one share for every four shares held by utilising various reserves as per Board's Resolution dated...)			
April 20	Bonus to Shareholders A/c	Dr.	2,25,000	
	To Equity Share Capital A/c			2,25,000
	(Capitalization of profit)			

Balance Sheet (Extract) as at 30th April, 2022 (after bonus issue)

		Particulars	*Notes*	*Amount (₹)*
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	12,05,000
	b	Reserves and Surplus	2	1,95,000
2		**Non-current liabilities**		
	a	Long-term borrowings	3	5,00,000
		Total		**19,00,000**

Notes to Accounts

1	**Share Capital**	
	Equity share capital	
	Authorised share capital	
	10,000 12% Preference shares of ₹ 10 each	1,00,000
	1,12,500 Equity shares of ₹ 10 each	11,25,000

	Issued, subscribed and fully paid share capital			
	8,000 12% Preference shares of ₹ 10 each			80,000
	1,12,500 Equity shares of ₹ 10 each, fully paid (Out of above, 22,500 equity shares @ ₹ 10 each were issued by way of bonus)	(A)		11,25,000
		Total		**12,05,000**
2	**Reserves and Surplus**			
	Revaluation Reserve			35,000
	Securities Premium		20,000	
	Less: Utilised for bonus issue		(20,000)	Nil
	General reserve		1,60,000	
	Less: Utilised for bonus issue		(1,60,000)	Nil
	Profit & Loss Account		2,05,000	
	Less: Utilised for bonus issue		(45,000)	1,60,000
		Total		**1,95,000**
3	**Long-term borrowings**			
	Secured			
	12% Debentures @ ₹ 100 each			5,00,000

The authorised capital has been increased by sufficient number of shares. (11,25,000 – 10,00,000)

Working Note-

Number of Bonus shares to be issued (90,000 shares / 4) X 1 = 22,500 shares

Note: It has to be ensured that the authorized capital after bonus issue should not be less than the issued share capital (including bonus issue) in all the practical problems. The authorized capital may either be increased by the amount of bonus issue or the value of additional shares [value of bonus shares issued less unused authorized capital (excess of authorized capital in comparison to the issued shares before bonus issue)].

ILLUSTRATION 4

Following notes pertain to the Balance Sheet of Preet Ltd. as at 31st March, 2022

	₹
Share capital:	
Authorised capital:	
15,000 12% Preference shares of ₹ 10 each	*1,50,000*
1,50,000 Equity shares of ₹ 10 each	*15,00,000*
	16,50,000
Issued and Subscribed capital:	
12,000 12% Preference shares of ₹ 10 each fully paid	*1,20,000*
1,35,000 Equity shares of ₹ 10 each, ₹ 8 paid up	*10,80,000*
Reserves and surplus:	
General Reserve	*1,80,000*
Capital Redemption Reserve	*60,000*
Securities premium (collected in cash)	*37,500*
Profit and Loss Account	*3,00,000*

On 1st April, 2022, the Company has made final call @ ₹ 2 each on 1,35,000 equity shares. The call money was received by 20th April, 2022. Thereafter, the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held.

Show necessary journal entries in the books of the company and prepare the extract of the balance sheet as on 30th April, 2022 after bonus issue.

SOLUTION

Journal Entries in the books of Preet Ltd.

			₹	₹
1-4-2022	Equity share final call A/c	Dr.	2,70,000	
	To Equity share capital A/c			2,70,000
	(For final calls of ₹ 2 per share on 1,35,000 equity shares due as per Board's Resolution dated....)			
20-4-2022	Bank A/c	Dr.	2,70,000	

	To Equity share final call A/c		2,70,000
	(For final call money on 1,35,000 equity shares received)		
	Securities Premium A/c Dr.	37,500	
	Capital Redemption Reserve A/c Dr.	60,000	
	General Reserve A/c Dr.	1,80,000	
	Profit and Loss A/c (b.f.) Dr.	60,000	
	To Bonus to shareholders A/c		3,37,500
	(For making provision for bonus issue of one share for every four shares held)		
	Bonus to shareholders A/c Dr.	3,37,500	
	To Equity share capital A/c		3,37,500
	(For issue of bonus shares)		

Extract of Balance Sheet as at 30th April, 2022 (after bonus issue)

		₹
Share Capital		
Authorised Capital		
15,000 12% Preference shares of ₹10 each		1,50,000
1,68,750 Equity shares of ₹10 each (refer working note below)		16,87,500
Issued and subscribed capital		
12,000 12% Preference shares of ₹10 each, fully paid		1,20,000
1,68,750 Equity shares of ₹10 each, fully paid		16,87,500
(Out of above, 33,750 equity shares @ ₹10 each were issued by way of bonus)		
Reserves and surplus		
Securities Premium	37,500	
Less: Utilised for bonus issue	(37,500)	NIL
Capital Redemption Reserve	60,000	
Less: Utilised for bonus issue	(60,000)	NIL
General Reserve	1,80,000	

Less: Utilised for bonus issue	(1,80,000)	NIL
Profit and Loss Account	3,00,000	
Less: Utilised for bonus issue	(60,000)	2,40,000

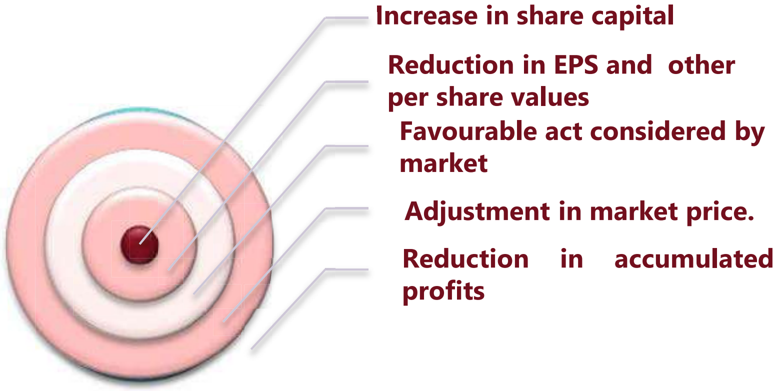
Working Notes:

1. Number of Bonus shares to be issued- ₹
   (1,35,000 shares / 4) X 1 = 33,750 shares
2. The authorised capital should be increased as per details given below:

Existing issued Equity share capital	13,50,000
Add: Issue of bonus shares to equity shareholders	3,37,500
	16,87,500

4.1.4 Effects of Bonus Issue

Bonus issue has following major effects:



4.2 RIGHT ISSUE

4.2.1 Introduction

Provisions of section 62(1)(a) of the Companies Act, 2013 govern any company, public or private, which is desirous of raising its subscribed share capital by issue of further shares. Whenever a company intends to issue new shares, the voting and governance rights of the existing shareholders may be diluted, if they are not allowed to preserve them. It may happen because new shareholders may subscribe to the issued share capital. Companies Act, 2013 allows existing shareholders to preserve their position by offering those newly issued shares at the first instance to them. The existing shareholders are given a right to subscribe these shares, if they like. However, if they do not desire to subscribe these shares, they are even given the right to renounce it in favour of someone else (unless the articles of the company prohibits such a right to renounce).

Value of right = Cum-right value of share − Ex-right value of share

In nutshell, the existing shareholders have a right to subscribe to any fresh issue of shares by the company in proportion to their existing holding for shares. They have an implicit right to renounce this right in favour of anyone else, or even reject it completely. In other words, the existing shareholders have right of first refusal, i.e., the existing shareholders enjoy a right to either subscribe for these shares or sell their rights or reject the offer.

Example 2

Assume a company makes a right issue of 10,000 shares when its existing issued and subscribed capital is 100,000 shares. This enables any shareholder having 10 shares to subscribe to 1 new share. Hence X, an existing shareholder holding 1,000 shares, may subscribe to 100 shares as a matter of right. The existing share percentage of X was 1% (1,000 / 100,000). If X subscribes these shares, his percentage holding in the company will be maintained at 1% (1,100 / 1,10,000). However, if X does not mind his share 0.91% diluting (1,000 / 1,10,000), he may renounce the right in favour of any one else, say Y. Hence, these 100 shares will be issued to Y, at the insistence of X. X may charge Y for this privilege, which is technically termed as the value of right.

A company desirous of issuing new shares has to offer, as per Section 62(1) (a) of Companies Act 2013, the shares to existing equity shareholders through a letter of offer subject to the following conditions, namely:

➢ The offer shall be made by notice specifying the number of shares offered and limiting a time not being less than fifteen days and not exceeding thirty days from the date of the offer within which the offer, if not accepted, shall be deemed to have been declined;

➢ Unless the articles of the company otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favour of any other person; and the notice (referred to in above bullet point) shall contain a statement of this right;

➢ After the expiry of the time specified in the notice aforesaid, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the Board of Directors may dispose of them in such manner which is not disadvantageous to the shareholders and the company.

Exceptions to the rights of existing equity shareholders

Section 62 recognises four situations under which the further shares are to be issued by a company, but they need not be offered to the existing shareholders.

The shares can be offered, without being offered to the existing shareholders, provided the company has passed a special resolution and shares are offered accordingly.

Situation 1

To employees under a scheme of employees' stock option subject to certain specified conditions

Situation 2

To any persons, either for cash or for a consideration other than cash, if the price of such shares is determined by the valuation report of a registered valuer subject to certain specified conditions.

Situation 3

Sometimes companies borrow money through debentures / loans and give their creditor an option to buy equity shares of a company. An option is a right, but not an obligation, to buy equity shares on a future date (expiry date) at a price agreed in advance (exercise price).

According to Section 62(3), nothing in this section shall apply to the increase of the subscribed capital of a company caused by the exercise of an option as a term attached to the debentures issued or loan raised by the company to convert such debentures or loans into shares in the company.

Provided that the terms of issue of such debentures or loan containing such an option have been approved before the issue of such debentures or the raising of loan by a special resolution passed by the company in general meeting.

Situation 4

It is a special situation where the loan has been obtained from the government, and government in public interest, directs the debentures / loan to be converted into equity shares.

According to Section 62(*4*), notwithstanding anything contained in sub-section (*3*), where any debentures have been issued, or loan has been obtained from any Government by a company, and if that Government considers it necessary in the public interest so to do, it may, by order, direct that such debentures or loans or any part thereof shall be converted into shares in the company on such terms and conditions as appear to the Government to be reasonable in the circumstances of the case even if terms of the issue of such debentures or the raising of such loans do not include a term for providing for an option for such conversion.

Financial effects of a further issue

The financial position of a business is contained in the balance sheet. Further issue of shares increase the amount of equity (net worth)[2] as well as the liquid resources (Bank). *The amount of equity is the product of further number of shares issued multiplied by issue price.* The issue price may be higher than the face value (issue at a premium). Companies Act does not allow issue of shares at a discount, except issue of sweat equity shares under Section 53.

Book Value of a share

Book value of a share = Net worth (as per books)/ Number of shares

if there are 10,000 shares with net worth of 1,25,000. The book value of one share is (₹ 125,000/ 10,000 shares) ₹ 12.50 per share. However, the market value may differ from the book value of shares. The market value of a company's shares represents the present value of future cash flows expected to be earned from the share in the form of dividends and capital gains from expected future share price appreciation.

The market price, which exists before the rights issue, is termed as Cum-right Market Price of the share. If the company decides to issue further shares, it may affect the market value of the share. 'Theoretically', the value of a company's shares after a rights issue must equal the sum of market capitalisation immediately prior to rights issue and the cash inflows generated from the rights issue.

Normally, the further public issue to the existing shareholders are offered at a discounted price from the market value, to evoke positive response as well as to reward the existing shareholders.

Assume a company having a net worth of ₹ 250,000. 1,000 shares are issued (making it a right issue of 1:10; or 1 new share for 10 existing shares held) at a price of ₹ 14 per share. The existing worth of tangible assets held by the business shall become 264,000 (Existing net worth ₹ 250,000 + Fresh Issue ₹ 14,000). Equity shares shall correspondingly command a valuation of ₹ 264,000.

The market price of the shares after further issue of shares (right issue) is termed as Ex-right Market Price of the shares. Theoretical Ex-Rights Price is a deemed value, which is attributed to a company's share immediately after a rights issue transaction occurs. This price is going to prevail after the further issue of shares is executed.

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[2] *As per Section 2(57) of Companies Act 2013, "net worth" means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation.*

Ex-right value of the shares = [Cum-right value of the existing shares + (Rights shares X Issue Price)] ÷ (Existing Number of shares + Number of right shares)

Right of Renunciation

Right of renunciation refers to the right of the shareholder to surrender his right to buy the securities and transfer such right to any other person. Shareholders that have received right shares have three choices of what to do with the rights. They can act on the rights and buy more shares as per the particulars of the rights issue; they can sell them in the market; or they can pass on taking advantage of their rights (i.e., reject the right offer).

The renunciation of the right is valuable and can be monetised by the existing shareholders in well-functioning capital market. The monetised value available to the existing shareholders due to right issue is known as 'value of right'. If a shareholder decides to renounce all or any of the right shares in favour of his nominee, the value of right is restricted to the sale price of the renouncement of a right in favour of the nominee. In case the right issue offer is availed by an existing shareholder, the value of right is determined as given below:

Value of right = Cum-right value of share – Ex-right value of share

Ex-right value of the shares = [Cum-right value of the existing shares + (Rights shares X Issue Price)] / (Existing Number of shares + Number of right shares)

In our previous example, Ex-right value of share = [₹ 250,000 + (₹ 14 X 1,000 shares)] / 10,000 + 1,000 shares = ₹ 24

Value of right = ₹ 25 – ₹ 24 = ₹ 1 per share.

Example 3

Continuing the previous case, consider an individual shareholder Mr. Narain holding 100 shares of Prosperous Company before rights issue.

Current worth of holding = No. of shares X Cum-right Market Price

= 100 X 25 = ₹ 2,500

(a) If Narain exercises his right, he will pay ₹ 14X10 shares = ₹ 140.

His total investment in the company including right is ₹ 2,640 (₹ 2,500+₹ 140).

On a per share basis, it is ₹ 2,640 /110 shares = ₹ 24, which is the Ex-right Market value of the share.

(b) If Narain does not exercise his right to further issue, his holding's worth will decline to ₹ 24 X 100 shares = ₹ 2400. The law allows him to compensate for this dilution of shareholding by renouncing this right in favour of, say, Mr. Murthy.

Narain can charge Murthy, in well-functioning capital markets, this dilution of ₹ 100 by renouncing his right to acquire 10 shares. Hence Murthy will be charged ₹ 10 per share (₹ 100 / 10 shares), in return for a confirmed allotment of 10 shares at ₹ 14 each.

For every share to be offered to Murthy, Narain must have ten shares at the back. Hence his holding of 10 shares fetches him right money of ₹ 10 or ₹ 1 per share held. This is exactly equal to the difference between Cum-right and Ex-right value of the share. It is termed as the Value of Right.

In a well-functioning capital market, this mechanism works in a fair manner to all the participants.

- Murthy's total investment will be ₹ 140 (payable to Company) + ₹ 100 (payable to Narain, by way of value of right), or ₹ 240. He will end up holding ten shares at an average cost of ₹ 24, which is the Ex-right Market Price of the share.
- Narain will have a final holding of ten shares worth ₹ 2400 + ₹ 100 by way of value of right received from Murthy. It matches with his cum-right holding valuation.

ILLUSTRATION 5

A company offers new shares of ₹ 100 each at 25% premium to existing shareholders on one for four bases. The cum-right market price of a share is ₹ 150. Calculate the value of a right. What should be the ex-right market price of a share?

SOLUTION

Ex-right value of the shares = (Cum-right value of the existing shares + Rights shares Issue Price) / (Existing Number of shares + No. of right shares)

= (₹ 150 X 4 Shares + ₹ 125 X 1 Share) / (4 + 1) Shares

= ₹ 725 / 5 shares = ₹ 145 per share.

Value of right = Cum-right value of the share – Ex-right value of the share

= ₹ 150 – ₹ 145 = ₹ 5 per share.

Hence, any one desirous of having a confirmed allotment of one share from the company at ₹ 125 will have to pay ₹ 20 (4 shares X ₹ 5) to an existing shareholder holding 4 shares and willing to renounce his right of buying one share in favour of that person.

4.2.2 Accounting for Right issue

The accounting treatment of rights share is the same as that of issue of ordinary shares and the following journal entry will be made:

Bank A/c Dr.

To Equity shares capital A/c

In case rights shares are being offered at a premium, the premium amount is credited to the securities premium account.

The accounting entry is usual and is

Bank A/c Dr.

To Equity Share Capital A/c

To Securities Premium A/c

Example 4

A Company having 70,000 shares of ₹10 each as its issued share capital and having market value of ₹21 issues rights shares in the ratio of 1:10 at an issue price of ₹10. Pass journal entry for issue of right shares.

The entry at the time of subscription of right shares by the existing shareholders will be:

Bank A/c	Dr.	70,000	
To Equity Share Capital A/c			70,000

(Being issue of 7,000 right shares at price of ₹ 10)

Working Note- Number of rights shares to be issued- 70,000/10X1= 7000 shares.

Example 5

A company having 1,00,000 shares of ₹10 each as its issued share capital, and having a market value of ₹46, issues rights shares in the ratio of 1:10 at an issue price of ₹31. Pass journal entry for issue of right shares.

The entry at the time of subscription of right shares by the existing shareholders will be:

Bank A/c	Dr.	3,10,000	
To Equity Share Capital A/c			1,00,000
To Securities Premium A/c			2,10,000

(Being issue of 10,000 right shares @ ₹ 31 offered)

4.2.3 Advantages and Disadvantages of Right Issue

Advantages of Right Issue

1. Right issue enables the existing shareholders to maintain their proportional holding in the company and retain their financial and governance rights. It works as a deterrent to the management, which may like to issue shares to known persons with a view to have a better control over the company's affairs.

2. In well-functioning capital markets, the right issue necessarily leads to dilution in the value of share. However, the existing shareholders are not affected by it because getting new shares at a discounted value from their cum-right value will compensate decrease in the value of shares. The cum-right value is maintained otherwise also, if the existing shareholders renounce their right in favour of a third party.

3. Right issue is a natural hedge against the issue expenses normally incurred by the company in relation to public issue.

4. Right issue has an image enhancement effect, as public and shareholders view it positively.

5. The chance of success of a right issue is better than that of a general public issue and is logistically much easier to handle.

Disadvantages of Right Issue

1. The right issue invariably leads to dilution in the market value of the share of the company.

2. The attractive price of the right issue should be objectively assessed against its true worth to ensure that you get a bargained deal.

Effects of Right Issue

Maintenance of existing shareholders' proportional holding in company and retain their financial and governance rights.

Dilution in the value of share.

Effects of Right Issue

Image enhancement

Convenience in handling issue

SUMMARY

- Bonus issue means an issue of additional shares free of cost to existing shareholders.
- Bonus Issue is also known as a "scrip issue" or "capitalization issue" or "capitalization of profits".
- Bonus issue has following major effects:
  - Share capital gets increased according to the bonus issue ratio
  - Effective Earnings per share, Book Value and other per share values stand reduced.
  - Markets take the action usually as a favourable act.
  - Market price gets adjusted on issue of bonus shares.
  - Accumulated profits get reduced.
- Bonus shares can be issued from following:
  - Free Reserves
  - Securities Premium collected in cash
  - Capital Redemption Reserve.
- Bonus issue cannot be made out of Revaluation Reserve created by revaluation of assets.
- A right issue is an offer of equity shares in a further issue of shares by a company to its existing shareholders, to enable them in maintaining their financial and governance interest in the company, if they so desire.
- The Right shares are normally offered at a price less than the cum-right value of the share, causing dilution in its value post-right issue. The value of share after right is termed as ex-right value (or average price) of the share. The difference between the cum-right and ex-right value (average price) of the share is called value of right.
- The accounting treatment of rights share is the same as that of issue of ordinary shares.
- The right issue offers considerable advantages to existing shareholders enabling them to maintain their rights in the company and is equally advantageous to the company for its relatively simple logistics and cost effectiveness as compared to a full blown pubic issue. However, the dilution in the value of the share is a dampener and a major limitation.

TEST YOUR KNOWLEDGE

True and false

1. *Earning per share gets increased after bonus issue.*
2. *Issued share capital including issue of rights shares and bonus shares may be more than the Authorised capital.*
3. *Rights issue of shares results in decrease of market value of per share in comparison to market price before rights issue.*
4. *Right shares are normally offered at a price more than the cum-right value of the share, causing dilution in its value post-right issue.*

Multiple Choice Questions

1. *Which of the following cannot be used for issue of bonus shares as per the Companies Act?*

   (a) Securities premium account

   (b) Revaluation reserve

   (c) Capital redemption reserve

2. *Which of the following statements is true with regard to declaring and issuing of Bonus Shares?*

   (a) Assets are transferred from the company to the shareholders.

   (b) A Bonus issue results in decrease in reserves and surplus.

   (c) A Bonus issue is same as declaration of dividends.

3. *Which of the following statement is true in case of bonus issue?*

   (a) Convertible debenture holders will get bonus shares in same proportion as to the existing shareholders.

   (b) Bonus shares may be issued to convertible debenture holders at the time of conversion of such debentures into shares.

   (c) Both (a) and (b).

4. *Bonus issue is also known as*

   (a) Scrip issue.

   (b) Capitalisation issue.

   (c) Both (a) and (b).

5. *The bonus issue is not made unless*

   (a) *Partly paid shares are made fully paid up.*

   (b) *It is provided in its articles of association*

   (c) *Both (a) and (b).*

6. *Bonus issue has the following effect*

   (a) *Market price gets adjusted on issue of bonus shares.*

   (b) *Effective Earnings per share, Book Value and other per share values stand increased.*

   (c) *Markets generally take the action as an unfavourable act.*

7. *ABC Co. Ltd resolved to issue bonus shares. Which of the following is not a pre-requisite for issuance of bonus shares?*

   (a) *Authorization in Articles of Association.*

   (b) *Timely Payment of statutory dues of employees such as PF, Gratuity etc.*

   (c) *Sufficient balance in bank account of company.*

8. *In case of further issue of shares, the right to renounce the shares in favour of a third party*

   (a) *Must include a right exercisable by the person concerned to renounce the shares;*

   (b) *Should include a right exercisable by the person concerned to renounce the shares;*

   (c) *Is deemed to include a right exercisable by the person concerned to renounce the shares (subject to the provisions under the articles of the company).*

9. *A company's share's face value is ₹ 10, book value is ₹ 20, Right issue price is ₹ 30 and Market price is ₹ 40, while recording the issue of right share, the securities premium will be credited with*

   (a) *₹ 10*

   (b) *₹ 20*

   (c) *₹ 30*

10. A. *Right shares enable existing shareholders to maintain their proportional holding in the company.*

    B. *Right share issue does not cause dilution in the market value of the share.*

Which of the option is correct?

(a) A-Correct; B Correct

(b) A – Incorrect; B Correct

(c) A - Correct; B – Incorrect

11. *Ex-Rights price can be calculated by which of these formulas?*

    (a) (Cum rights value of the existing shares + Rights share issue proceeds)/ (existing number of shares + No. of right shares).

    (b) (Cum rights value of the existing shares + Rights share issue proceeds) X (existing number of shares + No. of right shares).

    (c) (Cum rights value of the existing shares - Rights share issue proceeds)/ (existing number of shares – No. of right shares).

Theoretical Questions

1. *What is meant by Bonus issue? Explain its related provisions as per the Companies Act, 2013.*
2. *Explain the financial effects of a further issue of equity shares on the market value of the share.*
3. *What are the advantages and disadvantages of a rights issue?*
4. *What is meant by renunciation of rights shares by existing shareholder?*

Practical Questions

1. *Following items appear in the Trial Balance of Saral Ltd. as on 31st March, 2022:*

Particulars	***Amount***
4,500 Equity Shares of ₹ 100 each	*4,50,000*
Securities Premium (collected in cash)	*40,000*
Capital Redemption Reserve	*70,000*
General Reserve	*1,05,000*
Profit and Loss Account (Cr. Balance)	*65,000*

The company decided to issue to equity shareholders bonus shares at the rate of 1 share for every 3 shares held. Company decided that there should be the minimum reduction in free reserves. Pass necessary Journal Entries in the books Saral Ltd.

2. *The following notes pertain to Brite Ltd.'s Balance Sheet as at 31st March, 2022:*

Notes	**₹ in Lakhs**
(1) Share Capital	
Authorised :	
20 crore shares of ₹ 10 each	20,000
Issued and Subscribed :	
10 crore Equity Shares of ₹ 10 each	10,000
2 crore 11% Cumulative Preference Shares of ₹ 10 each	2,000
Total	12,000
Called and paid up:	
10 crore Equity Shares of ₹ 10 each, ₹ 8 per share called and paid up	8,000
2 crore 11% Cumulative Preference Shares of ₹ 10 each, fully called and paid up	2,000
Total	10,000
(2) Reserves and Surplus :	
Capital Redemption Reserve	1,485
Securities Premium (collected in cash)	2,000
General Reserve	1,040
Surplus i.e. credit balance of Profit & Loss Account	273
Total	4,798

On 2nd April 2022, the company made the final call on equity shares @ ₹ 2 per share. The entire money was received in the month of April, 2022.

On 1st June 2022, the company decided to issue to equity shareholders bonus shares at the rate of 2 shares for every 5 shares held . Pass journal entries for all the above mentioned transactions. Also prepare the notes on Share Capital and Reserves and Surplus relevant to the Balance Sheet of the company immediately after the issue of bonus shares.

3. *Following notes pertain to the Balance Sheet of Manoj Ltd. as at 31st March, 2022*

Authorised capital:	**₹**
30,000 12% Preference shares of ₹ 10 each	3,00,000
3,00,000 Equity shares of ₹ 10 each	30,00,000
	33,00,000

Issued and Subscribed capital:	
24,000 12% Preference shares of ₹ 10 each fully paid	*2,40,000*
2,70,000 Equity shares of ₹ 10 each, ₹ 8 paid up	*21,60,000*
Reserves and surplus:	
General Reserve	*3,60,000*
Capital Redemption Reserve	*1,20,000*
Securities premium (collected in cash)	*75,000*
Profit and Loss Account	*6,00,000*

On 1st April, 2022, the Company has made final call @ ₹ 2 each on 2,70,000 equity shares. The call money was received by 20th April, 2022. Thereafter, the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held.

Show necessary journal entries in the books of the company and prepare the extract of the balance sheet as on 30th April, 2022 after bonus issue.

4. *A company has decided to increase its existing share capital by making rights issue to its existing shareholders. The company is offering one new share for every two shares held by the shareholder. The market value of the share is ₹ 240 and the company is offering one share of ₹ 120 each. Calculate the value of a right. What should be the ex-right market price of a share?*

5. *A Ltd company having share capital of 25,000 equity shares of ₹10 each decides to issue rights share at the ratio of 1 for every 4 shares held at par value. Assuming all the share holders accepted the rights issue and all money was duly received, pass journal entries in the books of the company.*

6. *Following notes pertain to the Balance Sheet of Mars Company Limited as at 31st March 2022:*

	₹
Authorised capital:	
50,000 12% Preference shares of ₹ 10 each	*5,00,000*
5,00,000 Equity shares of ₹ 10 each	*50,00,000*
	55,00,000
Issued and Subscribed capital:	
50,000 12% Preference shares of ₹ 10 each fully paid	*5,00,000*

4,00,000 Equity shares of ₹ 10 each, ₹ 8 paid up	*32,00,000*
Reserves and surplus:	
General Reserve	*1,60,000*
Capital Redemption Reserve	*2,40,000*
Securities premium (collected in cash)	*2,75,000*
Revaluation Reserve	*1,00,000*
Profit and Loss Account	*16,00,000*

On 1st April, 2022, the Company has made final call @ ₹ 2 each on 4,00,000 equity shares. The call money was received by 25th April, 2022. Thereafter, on 1st May 2022 the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held, it decided that there should be minimum reduction in free reserves.

On 1st June 2022, the Company issued Rights shares at the rate of two shares for every five shares held on that date at issue price of ₹ 12 per share. All the rights shares were accepted by the existing shareholders and the money was duly received by 20th June 2022.

Show necessary journal entries in the books of the company for bonus issue and rights issue.

ANSWERS/ HINTS

True and False

1. False. Earnings per share gets decreased after bonus issue.

2. False. Issued share capital including issue of rights shares and bonus shares is always less than or equal to Authorised capital.

3. True. Rights issue of shares results in decrease of market value of per share in comparison to market price before rights issue.

4. False. Right shares are normally offered at a price less than the cum-right value of the share, causing dilution in its value post-right issue.

Multiple Choice Questions

1.	(b)	**2.**	(b)	**3.**	(c)	**4.**	(c)	**5.**	(c)	**6.**	(a)
7.	(c)	**8.**	(c)	**9.**	(b)	**10.**	(c)	**11.**	(a)		

Theoretical Questions

1. Bonus Issue means an offer of free additional shares to existing shareholders. A company may decide to distribute further shares as an alternative to increase the dividend pay-out. For details, refer para 4.1.1 & 4.1.2.

2. The financial position of a business is contained in the balance sheet. Further issue of shares increases the amount of share capital as well as the liquid resources (Bank). The amount of share capital issued is the product of further number of shares issued multiplied by issue price. The issue price may be higher than the face value (issue at a premium).

3. Rights issue is an issue of rights to a company's existing shareholders that entitles them to buy additional shares directly from the company in proportion to their existing holdings, within a fixed time period. For advantages and disadvantages of right issue, refer para 4.2.3.

4. In a situation where existing shareholder does not intend to subscribe to the rights issue of a company, he may give up his right in favour of another person for a consideration. Such giving up of rights is called renunciation of rights.

Practical Questions

1. **Journal Entries in the books of Saral Ltd.**

2022			Dr.	Cr.
	Capital Redemption Reserve A/c	Dr.	70,000	
	Securities Premium A/c	Dr.	40,000	
	General Reserve A/c (b.f.)	Dr.	40,000	
	To Bonus to Shareholders A/c			1,50,000
	(Bonus issue of one shares for every three shares held, by utilising various reserves as per Board's resolution dated.......)			
	Bonus to Shareholders A/c	Dr.	1,50,000	
	To Equity Share Capital A/c			1,50,000
	(Capitalisation of profit)			

Working Note- Number of bonus shares to be issued- 4500 / 3 X1= 1500 shares

2. **Journal Entries in the books of Brite Ltd.**

2022		Dr. ₹ in lakhs	Cr. ₹ in lakhs
April 2	Equity Share Final Call A/c Dr.	2,000	
	To Equity Share Capital A/c		2,000
	(Final call of ₹ 2 per share on 10 crore equity shares made due)		
	Bank A/c Dr.	2,000	
	To Equity Share Final Call A/c		2,000
	(Final call money on 10 crore equity shares received)		
June 1	Capital Redemption Reserve A/c Dr.	1,485	
	Securities Premium A/c Dr.	2,000	
	General Reserve A/c (b.f.) Dr.	515	
	To Bonus to Shareholders A/c		4,000
	(Bonus issue of two shares for every five shares held, by utilising various reserves as per Board's resolution dated.......)		
	Bonus to Shareholders A/c Dr.	4,000	
	To Equity Share Capital A/c		4,000
	(Capitalisation of profit)		

Notes to Accounts

			₹ in lakhs
1.	Share Capital		
	Authorised share capital:		
	20 crore shares of ₹ 10 each		20,000
	Issued, subscribed and fully paid up share capital:		
	14 crore Equity shares of ₹ 10 each, fully paid up		14,000
	(Out of the above, 4 crore equity shares @ ₹ 10 each were issued by way of bonus)		
	2 crore, 11% Cumulative Preference share capital of ₹ 10 each, fully paid up		2,000
			16,000

2.	Reserves and Surplus:		
	Capital Redemption reserve	1,485	
	Less: Utilised for bonus issue	(1,485)	-
	Securities Premium	2,000	
	Less: Utilised for bonus issue	(2,000)	-
	General Reserve	1,040	
	Less: Utilised for bonus issue	(515)	525
	Surplus (Profit and Loss Account)		273
	Total		798

3. Journal Entries in the books of Manoj Ltd.

			₹	₹
1-4-2022	Equity share final call A/c	Dr.	5,40,000	
	To Equity share capital A/c			5,40,000
	(For final calls of ₹ 2 per share on 2,70,000 equity shares due as per Board's Resolution dated....)			
20-4-2022	Bank A/c	Dr.	5,40,000	
	To Equity share final call A/c			5,40,000
	(For final call money on 2,70,000 equity shares received)			
	Securities Premium A/c	Dr.	75,000	
	Capital redemption Reserve A/c	Dr.	1,20,000	
	General Reserve A/c	Dr.	3,60,000	
	Profit and Loss A/c (b.f.)	Dr.	1,20,000	
	To Bonus to shareholders A/c			6,75,000
	(For making provision for bonus issue of one share for every four shares held)			
	Bonus to shareholders A/c	Dr.	6,75,000	
	To Equity share capital A/c			6,75,000
	(For issue of bonus shares)			

Extract of Balance Sheet as at 30th April, 2022 (after bonus issue)

		₹
Authorised Capital		
30,000 12% Preference shares of ₹10 each		3,00,000
3,37,500 Equity shares of ₹10 each (refer W.N.)		33,75,000
Issued and subscribed capital		
24,000 12% Preference shares of ₹10 each, fully paid		2,40,000
3,37,500 Equity shares of ₹10 each, fully paid		33,75,000
(Out of the above, 67,500 equity shares @ ₹10 each were issued by way of bonus shares)		
Reserves and surplus		
Capital Redemption Reserve	1,20,000	
Less: Utilised for bonus issue	(1,20,000)	NIL
Securities premium	75,000	
Less: Utilised for bonus issue	(75,000)	NIL
General Reserve	3,60,000	
Less: Utilised for bonus issue	(3,60,000)	NIL
Profit and Loss Account	6,00,000	
Less: Utilised for bonus issue	(1,20,000)	4,80,000

Working Note:

1. Number of bonus shares to be issued- 2,70,000/4 X1= 67,500 shares

2. The authorised capital should be increased as per details given below: ₹

Existing issued Equity share capital	27,00,000
Add: Issue of bonus shares to equity shareholders	6,75,000
	33,75,000

4. Ex-right value of the shares = (Cum-right value of the existing shares + Rights shares x Issue Price) / (Existing Number of shares + No. of right shares)

= (₹ 240 x 2 Shares + ₹ 120 x 1 Share) / (2 + 1) Shares

= ₹ 600 / 3 shares = ₹ 200 per share.

Value of right = Cum-right value of the share – Ex-right value of the share

= ₹ 240 – ₹ 200 = ₹ 40 per share.

Hence, any one desirous of having a confirmed allotment of one share from the company at ₹ 120 will have to pay ₹ 80 (2 shares x ₹ 40) to an existing shareholder holding 2 shares and willing to renounce his right of buying one share in favour of that person.

5. Journal Entry in the books of A Ltd.

		₹	₹
Bank A/c	Dr.	62,500	
To Equity share capital A/c			62,500
(For rights share issued at par value in the ratio of 1:4 equity shares due as per Board's Resolution dated....)			

Working Note:

Number of Rights shares to be issued- 25,000/4x1= 6,250 shares

6. Journal Entries in the books of Mars Ltd.

2022			Dr. ₹	Cr. ₹
April 1	Equity Share Final Call A/c	Dr.	8,00,000	
	To Equity Share Capital A/c			8,00,000
	(Final call of ₹ 2 per share on 4,00,000 equity shares made due)			
April 25	Bank A/c	Dr.	8,00,000	
	To Equity Share Final Call A/c			8,00,000
	(Final call money on equity shares received)			
May 1	Capital Redemption Reserve A/c	Dr.	2,40,000	
	Securities Premium A/c	Dr.	2,75,000	
	General Reserve A/c	Dr.	1,60,000	
	Profit and Loss A/c (b.f.)	Dr.	3,25,000	

	To Bonus to Shareholders A/c (Bonus issue of one shares for every four shares held, by utilising various reserves as per Board's resolution dated.......)		10,00,000
	Bonus to Shareholders A/c Dr. To Equity Share Capital A/c (Capitalisation of profit)	10,00,000	 10,00,000
June 20	Bank A/c Dr. To Securities Premium A/c To Equity Share Capital A/c (Being Rights issue of 2 shares for every 5 shares held as per board resolution dated ....)	24,00,000	 4,00,000 20,00,000

UNIT – 5: REDEMPTION OF PREFERENCE SHARES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- understand the meaning of redemption and the purpose of issuing redeemable preference shares;
- learn various provisions of the Companies Act, 2013 regarding preference shares and their redemption;
- familiarise yourself with various methods of redemption of fully paid-up preference shares by:
  - (i) Fresh issue of shares; Or
  - (ii) Capitalisation of divisible or undistributed profits; Or
  - (iii) Combination of (i) and (ii) above;
- understand the logic behind the creation of Capital Redemption Reserve;
- learn the accounting treatment for redemption of:
  - (i) fully paid-up preference shares;
  - (ii) partly called-up preference shares; and
  - (iii) fully called-up but partly paid-up preference shares.

UNIT OVERVIEW

Methods of redemption of Preference shares

- (a) By fresh issue of shares
- (b) By capitalisation of undistributed profits
- (c) By combination of (a) and (b)

Section 52 of the Companies Act, 2013 provides that the securities premium account may be applied by the company:

[NOTE: Certain class of Companies whose financial statements comply with the Accounting Standards as prescribed under Section 133 of the Companies Act, 2013, can't apply the securities premium account for the purposes (b) and (d)]

- (a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities
- (b) To write off preliminary expenses of the company
- (c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company
- (d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.
- (e) For the purchase of its own shares or other securities.

5.1 INTRODUCTION

Redemption is the process of repaying an obligation, at prearranged amounts and timings. It is a contract specifying the obligation to redeem preference shares within or at the end of a given time period at an agreed price. These shares are issued on the terms that shareholders will at a future date be repaid the amount which they invested in the company (apart from the frequent payments of a specified amount of dividend as return on investment during the tenure of the preference shares). The redemption date is the maturity date, which specifies when repayment is scheduled to take place and is usually printed on the preference share certificate. Through the process of redemption, a company can also adjust its financial structure, for example, by eliminating preference shares and replacing those with other securities if future growth of the company makes such change advantageous.

5.2 PURPOSE OF ISSUING REDEEMABLE PREFERENCE SHARES

A company may issue redeemable preference shares because of the following:

1. It is a proper way of raising finance in a dull primary market.
2. A company may face difficulty in raising share capital, as its shares are not traded on the stock exchange. Potential investors who may, hesitate in putting money into shares that cannot easily be sold may be encouraged to invest if the shares are redeemable by the company.
3. The preference shares may be redeemed when there is a surplus of capital and the surplus funds cannot be utilised in the business for profitable use.
4. No dividend is required to be paid, if there is loss or no profit, whereas interest is payable on debentures or loans even in case of loss. In other words, preference dividend declared / paid continues to be regarded as an appropriation of profits (similar treatment is given for equity shares), as against interest on debentures, which is a charge against profits.

In India, the issue and redemption of preference shares is governed by Section 55 of the Companies Act, 2013.

5.3 PROVISIONS OF THE COMPANIES ACT (SECTION 55)

A company limited by shares if so authorised by its Articles, may issue preference shares which at the option of the company, are liable to be redeemed within a period, normally not exceeding 20 years from the date of their issue. It should be noted that:

(a) no shares can be redeemed except out of divisible or distributable profit, (i.e. out of the profit of the company which would otherwise be available for dividend) or out of proceeds of fresh issue of shares made for the purpose of redemption;

(b) no such shares can be redeemed unless they are fully paid;

(c) (i) in case of such class of companies, as may be prescribed and whose financial statement comply with the accounting standards prescribed for such class of companies under Section 133, the premium, if any, payable on redemption shall be provided for out of the profits of the company, before the shares are redeemed:

Provided also that premium, if any, payable on redemption of any preference shares issued on or before the commencement of this Act by any such company shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.

(ii) in case of other companies (not falling under (i) above), the premium, if any payable on redemption shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.

(Refer to the Note given in para 5.4.1 for the basis applied in the Illustrations in this Chapter.)

(d) where any such shares are proposed to be redeemed out of the profits of the company, there shall, out of the divisible profits, i.e. the profits which would otherwise have been available for dividends, be transferred to a reserve account to be called Capital Redemption Reserve Account, a sum equal to the nominal amount of the shares redeemed; and the provisions of the Act relating to the reduction of the share capital of a company shall, except as provided in the Section, apply as if the Capital Redemption Reserve (CRR) Account were the paid-up share capital of the company. The utilisation of CRR Account is further restricted to issuance of fully paid-up bonus shares only.

From the legal provision outlined above, it is apparent that on the redemption of redeemable preference shares out of accumulated divisible profits, it will be necessary to transfer to the Capital Redemption Reserve Account an amount equal to the amount repaid on the redemption of preference shares on account of face value less proceeds of a fresh issue of shares made for the purpose of redemption. The object is that with the repayment of redeemable preference shares, the security for creditors/ bankers, etc. should not be reduced. At times, a part of the preference share capital may be redeemed out of accumulated divisible profits and the balance out of a fresh issue.

5.4 METHODS OF REDEMPTION OF FULLY PAID-UP SHARES

Redemption of preference shares means repayment by the company of the obligation on account of shares issued. According to the Companies Act, 2013, preference shares issued by a company must be redeemed within the maximum period (normally 20 years) allowed under the Act. Thus, a company cannot issue irredeemable preference shares.

Section 55 of the Companies Act, 2013, deals with provisions relating to redemption of preference shares. It ensures that there is no reduction in shareholders' funds due to redemption and, thus, the interest of outsiders is not affected. For this, it requires that either fresh issue of shares is made, or distributable profits are retained and transferred to 'Capital Redemption Reserve Account'.

The rationale behind these provisions is to protect the interest of outsiders to whom the amount is payable before redemption of preference share capital. The interest of outsiders is protected if the nominal value of capital redeemed is substituted, thus, ensuring the same amount of shareholders' fund.

- In case of redemption of preference shares out of proceeds of a fresh issue of shares, replacement of capital and tangible assets is obvious.
- If redemption is done out of distributable profits, replacement of capital is ensured in an indirect manner by retention of profit by transfer to Capital Redemption Reserve. In this case, the amount which would have otherwise gone to shareholders in the form of dividend is retained in the business and is used for settling the claim of preference shareholders. Thus, there is no additional drain from the net assets of the Company. The transfer of divisible profits to Capital Redemption Reserve makes them non-divisible profits. As Capital Redemption Reserve can be used only for issue of fully paid bonus shares, profits retained in the business ultimately get converted into share capital.

Security cover available to outside stakeholders depends upon called-up capital as well as uncalled capital to be demanded by the company as per its requirements. To ensure that the interests of outsiders are not reduced, Section 55 provides for redemption of only fully paid-up shares.

From the above paras, it can be concluded that the 'gap' created in the company's capital by the redemption of redeemable preference shares must be filled in by:

(a) the proceeds of a fresh issue of shares; or

(b) the capitalisation of undistributed profits (by creating Capital Redemption Reserve); or

(c) a combination of (a) and (b) above.

5.4.1 Redemption of Preference Shares by Fresh Issue of Shares

One of the methods for redemption of preference shares is to use the proceeds of a fresh issue of shares. A company can issue new shares (equity shares or preference shares) and the proceeds from such new shares can be used for redemption of preference shares.

The proceeds from issue of debentures cannot be utilised for the purpose.

A problem arises when a fresh issue is made for the purpose of redemption of preference shares, at a premium. The point to ponder is that whether the proceeds of a fresh issue of shares will include the amount of securities premium for the purpose of redemption of preference shares.

For securities premium account, Section 52 of the Companies Act, 2013 provides that the securities premium account may be applied by the company;

(a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities

(b) To write off preliminary expenses of the company

(c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company

(d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.

(e) For the purchase of its own shares or other securities.

Note: It may be noted that certain class of Companies whose financial statements comply with the Accounting Standards as prescribed under Section 133 of the Companies Act, 2013, can't apply the securities premium account for the purposes (b) and (d) mentioned above.

Note: All the questions in this chapter have been solved on the basis that the companies referred in the questions are governed by Section 133 of the Companies Act, 2013 and comply with the Accounting Standards prescribed for them. Accordingly the balance in securities premium account has not been utilized for the purpose of premium payable on redemption of preference shares.

Any other way, except the above prescribed ways, in which securities premium account is utilised will be in contravention of law.

Thus, the proceeds of a fresh issue of shares will not include the amount of securities premium for the purpose of redemption of preference shares.

Reasons for issue of New Equity Shares

A company may prefer issue of new equity shares for the following reasons:

(a) When the company has come to realise that the capital is needed permanently and it makes more sense to issue Equity Shares in place of Redeemable Preference Shares as Preference Shares carry a fixed rate of dividend.

(b) When the balance of profit, which would otherwise be available for dividend, is insufficient.

(c) When the liquidity position of the company is not good enough.

Advantages of redemption of preference shares by issue of fresh equity shares

Following are the advantages of redemption of preference shares by the issue of fresh equity shares:

(1) No cash outflow of money – now or later.

(2) New equity shares may be valued at a premium.

(3) Shareholders retain their equity interest.

Disadvantages of redemption of preference shares by issue of fresh equity shares

The disadvantages are:

(1) There will be dilution of future earnings;

(2) Share-holding in the company is changed if the fresh issue is made to outsiders. In case the fresh issue is made to existing shareholders in proportion to their shareholding (i.e., rights issue), the disadvantage of change in shareholding pattern can be mitigated.

5.4.2 Accounting Entries

1. When new shares are issued at par

   Bank Account Dr.

   To Share Capital Account

   (Being the issue of ....shares of ₹......each for the purpose of redemption of preference shares, as per Board's Resolution No...... dated.......)

2. When new shares are issued at a premium

   Bank Account Dr.

   To Share Capital Account

   To Securities Premium Account

   (Being the issue of ....shares of ₹......each at a premium of ₹......each for the purpose of redemption of preference shares as per Board's

   Resolution No..... dated......)

3. When preference shares are redeemed at par

Redeemable Preference Share Capital Account Dr.

To Preference Shareholders Account

4. When preference shares are redeemed at a premium

Redeemable Preference Share Capital Account Dr.

Premium on Redemption of Preference Shares Account Dr.

To Preference Shareholders Account

5. When payment is made to preference shareholders

Preference Shareholders Account Dr.

To Bank Account

6. For adjustment of premium on redemption

Profit and Loss Account Dr.

To Premium on Redemption of Preference Shares Account

ILLUSTRATION 1

Hinduja Company Ltd. had 5,000, 8% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of ₹ 10 each fully paid up at par. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

SOLUTION

In the books of Hinduja Company Ltd.

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr. (₹)*
	Bank A/c	Dr.	5,00,000	
	To Equity Share Capital A/c			5,00,000
	(Being the issue of 50,000 Equity Shares of ₹10 each at par for the purpose of redemption of preference shares, as per Board Resolution No. ....dated........)			

	8% Redeemable Preference Share Capital A/c	Dr.	5,00,000	
	To Preference Shareholders A/c			5,00,000
	(Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)			
	Preference Shareholders A/c	Dr.	5,00,000	
	To Bank A/c			5,00,000
	(Being the amount paid on redemption of preference shares)			

ILLUSTRATION 2

C Ltd. had 10,000, 10% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company decided to redeem these preference shares at par, by issue of sufficient number of equity shares of ₹ 10 each at a premium of ₹ 2 per share as fully paid up. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

SOLUTION

In the books of C Ltd.

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr. (₹)*
	Bank A/c	Dr.	12,00,000	
	To Equity Share Capital A/c			10,00,000
	To Securities Premium A/c			2,00,000
	(Being the issue of 1,00,000 Equity Shares of ₹10 each at a premium of ₹2 per share as per Board's Resolution No..... dated.........)			
	10% Redeemable Preference Share Capital A/c	Dr.	10,00,000	
	To Preference Shareholders A/c			10,00,000
	(Being the amount payable on redemption of preference shares transferred to Preference Shareholders A/c)			
	Preference Shareholders A/c	Dr.	10,00,000	
	To Bank A/c			10,00,000
	(Being the amount paid on redemption of preference shares)			

Note: Amount required for redemption is ₹ 10,00,000. Therefore, face value of equity shares to be issued for this purpose must be equal to ₹ 10,00,000. Premium received on new issue cannot be used to finance the redemption.

ILLUSTRATION 3

G India Ltd. had 9,000 10% redeemable Preference Shares of ₹ 10 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of ₹ 9 each fully paid up.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

SOLUTION

In the books of G India Limited

Journal

Date	*Particulars*		*Dr. (₹)*	*Cr. (₹)*
	Bank A/c	Dr.	90,000	
	To Equity Share Capital A/c			90,000
	(Being the issue of 10,000 Equity Shares of ₹9 each at par, as per Board's Resolution No.......Dated.....)			
	10% Redeemable Preference Shares Capital A/c	Dr.	90,000	
	To Preference Shareholders A/c			90,000
	(Being the amount payable on redemption of preference shares transferred to Preference Shareholders A/c)			
	Preference Shareholders A/c	Dr.	90,000	
	To Bank A/c			90,000
	(Being the amount paid on redemption of preference shares)			

5.4.3 Calculation of Minimum Fresh Issue of Shares

Sometimes, examination problem does not specify the number of shares to be issued for the purpose of redemption of preference shares and requires that the minimum number of shares should be issued to ensure that provisions of Section 55 of the Companies Act, 2013, are not violated. This is done in four steps as given below:

(1) In such cases, the maximum amount of reserves and surplus available for redemption is ascertained taking into account the balances appearing in the balance sheet before

redemption and the additional information provided in the problem. For example, if balance of general reserve in the balance sheet is ₹1,00,000 and additional information provides that the Board of Directors have decided that the balance of general reserve should not be less than ₹40,000 under any circumstances, then, the maximum amount of general reserve available for redemption is ₹ 60,000.

(2) After ascertaining the maximum amount of reserves and surplus available for redemption, adjustment for premium on redemption payable out of profits is made and then it is compared with the nominal value of shares to be redeemed. By comparison, one gets the minimum proceeds of fresh issue as Section 55 permits redemption either out of proceeds of fresh issue or out of divisible profits. Thus,

Minimum Proceeds of Fresh Issue of shares :

Nominal value of preference shares to be redeemed – Maximum amount of reserve and surplus available for redemption.

(3) After computation of minimum proceeds, the minimum number of shares to be issued are determined by dividing minimum proceeds by the proceeds of one share. This is done as follows:

Minimum Number of Shares = Minimum proceeds to comply with Section 55/ face value of one share

Proceeds of one share mean the par value of a share issued, if it is issued at par or premium. However, in case of issue of share at a discount, it refers to the discounted value.

(4) Minimum number of shares calculated as per (3) above, needs to be adjusted due to various reasons. Firstly, shares fractions cannot be issued. Thus, if minimum number of shares as per (3) above includes a fraction, it must be approximated to the next higher figure to ensure that provisions of Section 55 are not violated. Secondly, if the examination problem states that the proceeds/number of shares should be a multiple of say, 10 or 50 or 100, then again the next higher multiple should be considered.

ILLUSTRATION 4

The Board of Directors of a Company decided to issue minimum number of equity shares of ₹ 9 to redeem ₹ 5,00,000 preference shares. The maximum amount of divisible profits available for redemption is ₹ 3,00,000. Calculate the number of shares to be issued by the company to ensure that the provisions of Section 55 are not violated. Also determine the number of shares if the company decides to issue shares in multiples of ₹ 50 only.

SOLUTION

Nominal value of preference shares	₹ 5,00,000
Maximum possible redemption out of profits	₹ 3,00,000
Minimum proceeds of fresh issue	₹ 5,00,000 – 3,00,000 = ₹ 2,00,000
Proceed of one share	= ₹ 9
Minimum number of shares	$= \frac{2,00,000}{9}$ = 22,222.22 shares

As fractional shares are not permitted, the minimum number of shares to be issued is 22,223 shares.

If shares are to be issued in multiples of 50, then the next higher figure which is a multiple of 50 is 22,250. Hence, minimum number of shares to be issued in such a case is 22,250 shares.

5.4.4 Fresh Issue at a Premium and Minimum Fresh Issue

The calculation of minimum number of shares, when fresh issue is at a premium should be handled very carefully Minimum fresh issue cannot be calculated unless one knows the profits available for replacement of preference shares and profit available for replacement cannot be determined unless one knows the portion of profit available for redemption which is required for paying premium on redemption. To tackle this, assume that profits available for redemption is not required for paying premium on redemption of preference shares. In other words, it means that securities premium including premium on fresh issue is comparatively more than premium on redemption.

If the above assumption holds good, minimum number of shares can be calculated in a simple manner without use of equation. But, if above condition does not hold good, then an equation is used to determine the minimum number of shares.

5.4.5 Minimum Fresh Issue to Provide Funds for Redemption

Besides, ensuring compliance with Section 55, the fresh issue of shares is made to provide funds for making payment to preference shareholders. To calculate minimum number of fresh shares to be issued to provide funds, amount payable to preference shareholders is compared with funds available for redemption and the balance of funds to be raised by fresh issue of shares are calculated. The amount to be raised is divided by the issue price of a share (amount payable by shareholder including premium, if any, on fresh issue) to compute the minimum number of shares to be issued.

ILLUSTRATION 5

X Ltd. gives you the following information as at 31st March, 2023:

	Particulars	₹
	EQUITY AND LIABILITIES	
1.	***Shareholders' funds***	
	a Share capital	*2,90,000*
	b Reserves and Surplus	*48,000*
2.	***Current liabilities***	
	Trade Payables	*56,500*
	ASSETS	
1.	***Property, Plant and Equipment***	*3,45,000*
2.	***Non-current investments***	*18,500*
3.	***Current Assets***	
	Cash and cash equivalents (bank)	*31,000*

The share capital of the company consists of ₹ 50 each equity shares of ₹ 2,25,000 and ₹ 100 each Preference shares of ₹ 65,000(issued on 1.4.2021). Reserves and Surplus comprises Profit and Loss Account only.

In order to facilitate the redemption of preference shares at a premium of 10%, the Company decided:

(a) to sell all the investments for ₹ 15,000.

(b) to finance part of redemption from company funds, subject to, leaving a bank balance of ₹ 12,000.

(c) to issue minimum equity share of ₹ 50 each share to raise the balance of funds required.

You are required to pass the necessary Journal Entries to record the above transactions.

SOLUTION

Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	37,500	
	To Share Application A/c			37,500
	(For application money received on 750 shares @ ₹ 50 per share)			

	Share Application A/c Dr. To Equity Share Capital A/c (For disposition of application money received)		37,500	37,500
	Preference Share Capital A/c Dr. Premium on Redemption of Preference Shares A/c Dr. To Preference Shareholders A/c (For amount payable on redemption of preference shares)		65,000 6,500	71,500
	Bank A/c Dr. Profit and Loss A/c (loss on sale) A/c Dr. To Investment A/c (For sale of investments at a loss of ₹ 3,500)		15,000 3,500	18,500
	Profit and Loss A/c Dr. To Capital Redemption Reserve A/c (For transfer to CRR out of divisible profits an amount equivalent to excess of nominal value of preference shares over proceeds (face value of equity shares) i.e., ₹ 65,000 - ₹ 37,500)		27,500	27,500
	Preference Shareholders A/c Dr. To Bank A/c (For payment of preference shareholders)		71,500	71,500
	Profit and Loss A/c Dr. To Premium on Redemption of Preference Shares A/c (For writing off premium on redemption out of profits)		6,500	6,500

Working Note:

Calculation of Number of Shares:

	₹
Amount payable on redemption (₹ 65,000 + 10% of ₹ 65,000)	71,500
Less: Sale price of investment	(15,000)
	56,500
Less: Available bank balance (31,000 - 12,000)	(19,000)
Funds from fresh issue	37,500

∴ No. of shares = 37,500/50=750 shares

5.5 REDEMPTION OF PREFERENCE SHARES BY CAPITALISATION OF UNDISTRIBUTED DIVISIBLE PROFITS

Another method for redemption of preference shares, as per the Companies Act, is to use the distributable profits in place of issuing new shares. When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve Account by debiting the distributable profit. In other words, some of the distributable profits are kept aside to ensure that it can never be distributed to shareholders as dividend.

Profit or a portion of profit that can be otherwise legally distributed as dividend to the shareholders is known as Divisible or Distributable Profit.

In this connection, the provisions of the Companies Act state that 'When any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise have been available for dividend (i.e. out of divisible profits), be transferred to a reserve to be called the Capital Redemption Reserve Account sum equal to the nominal amount of the shares redeemed'.

Note: Only Divisible Profits can be used to create Capital Redemption Reserve, Non-Divisible Profits cannot be used for this purpose.

5.5.1 Advantages of redemption of preference shares by capitalisation of undistributed divisible profits

The advantages of redemption of preference shares by capitalisation of undistributed divisible profits are:

(1) No change in the percentage of equity share-holding of the company;

(2) Surplus funds can be used.

5.5.2 Disadvantages of redemption of preference shares by capitalisation of undistributed divisible profits

The disadvantage of redemption of preference shares by capitalisation of undistributed profits is that there will be a reduction in liquidity or assets may need to be sold such as investments.

Accounting Entries

1. **For transferring nominal amount of shares redeemed to Capital Redemption Reserve Account**

   General Reserve Account Dr.

   Profit and Loss Account Dr.

   any other Divisible Profits Dr.

   To Capital Redemption Reserve Account

   (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act).

2. **When shares are redeemed at par**

   Redeemable Preference Share Capital Account Dr.

   To Preference Shareholders Account

   (Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)

3. **When shares are redeemed at a premium**

   Redeemable Preference Share Capital Account Dr.

   Premium on Redemption of Preference Shares Account Dr.

   To Preference Shareholders Account

   (Being the amount payable on redemption transferred to Preference Shareholders Account)

4. **When payment is made to preference shareholders**

   Preference Shareholders Account Dr.

   To Bank Account

   (Being the payment to preference shareholders as per terms)

5. **For adjustment of premium of redemption**

   Divisible Profit Account Dr.

   To Premium on Redemption of Preference Shares Account

   (Being the premium on redemption adjusted against Profit and Loss Account)

ILLUSTRATION 6

The following are the extracts from the Balance Sheet of ABC Ltd. as on 31st December, 2022.

Share capital: 40,000 Equity shares of ₹ 10 each fully paid – ₹ 4,00,000; 1,000 10% Redeemable preference shares of ₹ 100 each fully paid – ₹ 1,00,000.

Reserve & Surplus: Capital reserve – ₹ 50,000; Securities premium – ₹ 50,000; General reserve – ₹ 75,000; Profit and Loss Account – ₹ 35,000

On 1st January 2023, the Board of Directors decided to redeem the preference shares at par by utilisation of reserve.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

SOLUTION

In the books of ABC Limited
Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
2023				
Jan 1	10% Redeemable Preference Share Capital A/c	Dr.	1,00,000	
	To Preference Shareholders A/c			1,00,000
	(Being the amount payable on redemption transferred to Preference Shareholders Account)			
	Preference Shareholders A/c	Dr.	1,00,000	
	To Bank A/c			1,00,000
	(Being the amount paid on redemption of preference shares)			
	General Reserve A/c	Dr.	75,000	
	Profit & Loss A/c	Dr.	25,000	
	To Capital Redemption Reserve A/c			1,00,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			

Note: Securities premium and capital reserve (not being distributable profits) cannot be utilised for transfer to Capital Redemption Reserve.

5.5.3 Redemption of Preference Shares by combination of Fresh Issue and Capitalisation of Undistributed divisible Profits

A company can redeem the preference shares partly from the proceeds from new issue and partly out of profits. In order to fill in the 'gap' between the face value of shares redeemed and the proceeds of new issue, a transfer should be made from distributable profits (Profit & Loss Account, General Reserve and other Free Reserves) to Capital Redemption Reserve Account.

Formula:

		₹
(i)	Amount to be Transferred to Capital Redemption Reserve	₹
	Face value of shares redeemed	***
	Less: Proceeds from new issue	***
		***
(ii)	Proceeds to be collected from New Issue	₹
	Face value of shares redeemed	***
	Less: Profits available for distribution as dividend	***
		***

The term 'proceeds from fresh/new issue' shall be interpreted as:

(a) Amount credited to Share Capital, in case of issue at par

(b) Amount credited to Share Capital, in case of issue at premium. Though premium is received which is credited to the Securities Premium A/c, the same shall not be regarded as 'proceeds', because if it were to be treated as such, the transfer of distributable profits to the Capital Redemption Reserve would be lower by the amount of the premium received.

(c) Amount received (i.e., debited to Cash/Bank), in case of issue at a discount.

Note: Section 53 of the Companies Act, 2013 prohibits issue of shares at a discount, except in case of issue of Sweat Equity Shares as outlined in Section 54.

ILLUSTRATION 7

C Limited had 3,000, 12% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company had to redeem these shares at a premium of 10%.

It was decided by the company to issue the following:

(i) 25,000 Equity Shares of ₹ 10 each at par,

(ii) 1,000 14% Debentures of ₹ 100 each.

The issue was fully subscribed and all amounts were received in full. The payment was duly made. The company had sufficient profits. Show Journal Entries in the books of the company.

SOLUTION

In the books of C Limited
Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	2,50,000	
	To Equity Share Capital A/c			2,50,000
	(Being the issue of 25,000 equity shares of ₹ 10 each at par as per Board's resolution No……dated…..)			
	Bank A/c	Dr.	1,00,000	
	To 14% Debenture A/c			1,00,000
	(Being the issue of 1,000 Debentures of ₹ 100 each as per Board's Resolution No…..dated……)			
	Profit & Loss A/c	Dr.	50,000	
	To Capital Redemption Reserve A/c			50,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			
	12% Redeemable Preference Share Capital A/c	Dr.	3,00,000	
	Premium on Redemption of Preference Shares A/c	Dr.	30,000	
	To Preference Shareholders A/c			3,30,000
	(Being the amount payable on redemption transferred to Preference Shareholders Account)			
	Preference Shareholders A/c	Dr.	3,30,000	
	To Bank A/c			3,30,000
	(Being the amount paid on redemption of preference shares)			
	Profit & Loss A/c	Dr.	30,000	
	To Premium on Redemption of Preference Shares A/c			30,000
	(Being the adjustment of premium on redemption against Profits & Loss Account)			

Working Note:

Amount to be transferred to Capital Redemption Reserve Account

Face value of shares to be redeemed	3,00,000
Less: Proceeds from new issue	(2,50,000)
Total Balance	50,000

ILLUSTRATION 8

The capital structure of a company consists of 20,000 Equity Shares of ₹ 10 each fully paid up and 1,000 8% Redeemable Preference Shares of ₹ 100 each fully paid up (issued on 1.4.2021).

Undistributed reserve and surplus stood as: General Reserve ₹ 80,000; Profit and Loss Account ₹ 20,000; Investment Allowance Reserve out of which ₹ 5,000, (not free for distribution as dividend) ₹ 10,000; Securities Premium ₹ 2,000, Cash at bank amounted to ₹ 98,000. Preference shares are to be redeemed at a Premium of 10% and for the purpose of redemption, the directors are empowered to make fresh issue of Equity Shares at par after utilising the undistributed reserve and surplus, subject to the conditions that a sum of ₹ 20,000 shall be retained in general reserve and which should not be utilised.

Pass Journal Entries to give effect to the above arrangements.

SOLUTION

In the books of ....
Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	25,000	
	To Equity Share Capital A/c			25,000
	(Being the issue of 2,500 Equity Shares of ₹ 10 each at a premium of Re. 1 per share as per Board's Resolution No.....dated.......)			
	General Reserve A/c	Dr.	60,000	
	Profit & Loss A/c	Dr.	10,000	
	Investment Allowance Reserve A/c	Dr.	5,000	
	To Capital Redemption Reserve A/c			75,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			
	8% Redeemable Preference Share Capital A/c	Dr.	1,00,000	

	Premium on Redemption of Preference Shares A/c To Preference Shareholders A/c (Being the amount paid on redemption transferred to Preference Shareholders Account)	Dr.	10,000	1,10,000
	Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of preference shares)	Dr.	1,10,000	1,10,000
	Profit & Loss A/c To Premium on Redemption of Preference Shares A/c (Being the premium payable on redemption is adjusted against Profit & Loss Account)	Dr.	10,000	10,000

Working Note:

No of Shares to be issued for redemption of Preference Shares:

Face value of shares redeemed			₹ 1,00,000
Less:	Profit available for distribution as dividend:		
	General Reserve : ₹(80,000-20,000)	₹ 60,000	
	Profit and Loss (20,000 – 10,000 set aside for adjusting premium payable on redemption of preference shares)	₹10,000	
	Investment Allowance Reserve: (₹ 10,000-5,000)	₹ 5,000	(₹ 75,000)
			₹ 25,000

Therefore, No. of shares to be issued = ₹ 25,000/₹10 = 2,500 shares.

5.5.4 Sale of Investments to Provide Sufficient Funds for Redemption

Companies may have sufficient investments, which can be sold, in the market to arrange funds for redemption of preference shares.

5.6 REDEMPTION OF PARTLY CALLED-UP PREFERENCE SHARES

One of the conditions of redemption is that only fully paid up preference shares can be redeemed by a company. Hence:

1) If the problem states that it is decided to redeem preference shares which are partly called up, then it is assumed that the final call on these shares is demanded and received before proceeding with redemption of these shares.

2) If information about both fully paid and partly paid preference shares is provided, then, it is presumed that only fully paid shares are to be redeemed and partly paid shares are left intact.

3) The company can forfeit the shares, if the call money is not received by the company in spite of giving opportunity to pay the same via reminders.

ILLUSTRATION 9

The Balance Sheet of XYZ Ltd. as at 31st December, 2021 inter alia includes the following information:

	₹
50,000, 8% Preference Shares of ₹100 each, ₹70 paid up	*35,00,000*
1,00,000 Equity Shares of ₹100 each fully paid up	*1,00,00,000*
Securities Premium	*5,00,000*
Capital Redemption Reserve	*20,00,000*
General Reserve	*50,00,000*
Bank	*15,00,000*

Under the terms of their issue, the preference shares are redeemable on 31st March, 2022 at 5% premium. In order to finance the redemption, the company makes a rights issue of 50,000 equity shares of ₹ 100 each at ₹ 110 per share, ₹ 20 being payable on application, ₹ 35 (including premium) on allotment and the balance on 1st January, 2023. The issue was fully subscribed and allotment made on 1st March, 2022. The money due on allotment were duly received by 31st March, 2022. The preference shares were redeemed after fulfilling the necessary conditions of Section 55 of the Companies Act, 2013.

You are asked to pass the necessary Journal Entries. (Ignore date column)

SOLUTION

Journal Entries

		₹	₹
8% Preference Share Final Call A/c	Dr.	15,00,000	
To 8% Preference Share Capital A/c			15,00,000
(For final call made on preference shares @ ₹ 30 each to make them fully paid up)			
Bank A/c	Dr.	15,00,000	
To 8% Preference Share Final Call A/c			15,00,000
(For receipt of final call money on preference shares)			
Bank A/c	Dr.	10,00,000	
To Equity Share Application A/c			10,00,000
(For receipt of application money on 50,000 equity shares @ ₹ 20 per share)			
Equity Share Application A/c	Dr.	10,00,000	
To Equity Share Capital A/c			10,00,000
(For capitalisation of application money received)			
Equity Share Allotment A/c	Dr.	17,50,000	
To Equity Share Capital A/c			12,50,000
To Securities Premium A/c			5,00,000
(For allotment money due on 50,000 equity shares @ ₹ 35 per share including a premium of ₹ 10 per share)			
Bank A/c	Dr.	17,50,000	
To Equity Share Allotment A/c			17,50,000
(For receipt of allotment money on equity shares)			
General Reserve A/c	Dr.	27,50,000	
To Capital Redemption Reserve A/c			27,50,000
(For transfer of CRR the amount not covered by the proceeds of fresh issue of equity shares i.e., 50,00,000 - 10,00,000 - 12,50,000)			
8% Preference Share Capital A/c	Dr.	50,00,000	

Premium on Redemption of Preference Shares A/c	Dr.	2,50,000	
To Preference Shareholders A/c			52,50,000
(For amount payable to preference shareholders on redemption at 5% premium)			
Preference Shareholders A/c	Dr.	52,50,000	
To Bank A/c			52,50,000
(For amount paid to preference shareholders)			
General Reserve A/c	Dr.	2,50,000	
To Premium on Redemption A/c			2,50,000
(For writing off premium on redemption of preference shares)			

Note: Amount received (excluding premium) on fresh issue of shares till the date of redemption should be considered for calculation of proceeds of fresh issue of shares. Thus, proceeds of fresh issue of shares ₹ 22,50,000 (₹ 10,00,000 application money plus ₹ 12,50,000 received on allotment towards share capital) will be considered.

5.6 REDEMPTION OF FULLY CALLED BUT PARTLY PAID-UP PREFERENCE SHARES

The problem of unpaid calls on fully called up shares may be studied under following categories:

5.6.1 When the amount of calls-in-arrears is received by the company

If the amount of unpaid calls is received by the Company before redemption, the entry passed is as under:

Bank A/c Dr.

To Calls-in-Arrears A/c

After receipt of calls in arrears, the shares become fully paid up and then, company can proceed with redemption in the normal course.

5.6.2 In case of Forfeited Shares

If in spite of receiving a proper notice from the company, the shareholders fail to pay the unpaid calls, the Board of Directors may decide to forfeit the shares and cancel these shares instead of reissuing the forfeited shares because redemption of these shares is due immediately or in near future. In this case, the journal entry for forfeiture is passed as usual, which will be as follows:

Preference Share Capital A/c # Dr

(#Called up share capital only relating to the shares to be forfeited)

To Calls In Arrears A/c

To Shares Forfeited A/c *

(*Amount actually collected on shares forfeited. This will be equal to the balancing amount)

NOTE: But it should be noted, in this case, that the number of shares to be redeemed will be reduced by the number of shares so forfeited. Further, since the preference shares are getting redeemed, the forfeited shares will not be reissued and hence the balance in the Shares Forfeited A/c should be transferred to Capital Reserve by passing the following journal entry:

Shares Forfeited A/c Dr.

To Capital Reserve A/c

ILLUSTRATION 10

With the help of the details in Illustration 9 above and further assuming that the Preference Shareholders holding 2,000 shares fail to make the payment for the Final Call made under Section 55, you are asked to pass the necessary Journal Entries and show the relevant extracts from the balance sheet as on 31st March, 2022 with the corresponding figures as on 31st December, 2021 assuming that the shares in default are forfeited after giving proper notices. (Ignore date column)

SOLUTION

Journal Entries

			₹	₹
	8% Preference Share Final Call A/c	Dr.	15,00,000	
	To 8% Preference Share Capital A/c			15,00,000
	(For final call made on preference shares @ ₹ 30 each to make them fully paid up)			
	Bank A/c (48,000 x ₹30)	Dr.	14,40,000	
	Calls in arrears A/c (2,000x ₹30)		60,000	
	To 8% Preference Share Final Call A/c			15,00,000
	(For receipt of final call money on preference shares)			

	Preference Share Capital A/c (2000 X ₹100) To Calls in Arrears A/c (2000 X ₹30) To Shares Forefeited A/c (2000 X ₹70) (For Shares Forefeited after shareholders fail to pay the Final Call)	Dr.	2,00,000	 60,000 1,40,000
	Bank A/c To Equity Share Application A/c (For receipt of application money on 50,000 equity shares @ ₹ 20 per share)	Dr.	10,00,000	 10,00,000
	Equity Share Application A/c To Equity Share Capital A/c (For capitalisation of application money received)	Dr.	10,00,000	 10,00,000
	Equity Share Allotment A/c To Equity Share Capital A/c To Securities Premium A/c (For allotment money due on 50,000 equity shares @ ₹ 35 per share including a premium of ₹ 10 per share)	Dr.	17,50,000	 12,50,000 5,00,000
	Bank A/c To Equity Share Allotment A/c (For receipt of allotment money on equity shares)	Dr.	17,50,000	 17,50,000
	General Reserve A/c To Capital Redemption Reserve A/c (For transfer of CRR the amount not covered by the proceeds of fresh issue of equity shares i.e., 48,00,000 – 10,00,000 – 12,50,000)	Dr.	25,50,000	 25,50,000
	8% Preference Share Capital A/c Premium on Redemption of Preference Shares A/c To Preference Shareholders A/c (For amount payable to preference shareholders on redemption at 5% premium)	Dr. Dr.	48,00,000 2,40,000	 50,40,000
	Preference Shareholders A/c To Bank A/c (For amount paid to preference shareholders)	Dr.	50,40,000	 50,40,000

	General Reserve A/c	Dr.	2,40,000	
	To Premium on Redemption A/c			2,40,000
	(For writing off premium on redemption of preference shares)			
	Shares Forfeited A/c	Dr.	1,40,000	
	To Capital Reserve A/c			1,40,000
	(For transferring balance to Capital Reserve A/c after redemption of preference shares)			

Note: Amount received (excluding premium) on fresh issue of shares till the date of redemption should be considered for calculation of proceeds of fresh issue of shares. Thus, proceeds of fresh issue of shares ₹ 22,50,000 (₹10,00,000 application money plus ₹ 12,50,000 received on allotment towards share capital) will be considered.

SUMMARY

- Redemption is the process of repaying an obligation, at prearranged amount and timing.
- In India, the issue and redemption of preference shares is governed by Section 55 of the Companies Act, 2013.
- A company limited by shares if so authorised by its Articles, may issue preference shares which at the option of the company*, are liable to be redeemed. It should be noted that:

  (a) no shares can be redeemed except out of profit of the company which would otherwise be available for dividend or out of proceeds of fresh issue of shares made for the purpose of redemption;

  (b) no such shares can be redeemed unless they are fully paid;

  * A company cannot issue irredeemable preference shares.
- Methods of redemption of fully paid-up preference shares: (i) by Fresh issue of shares; (ii) by Capitalisation of undistributed profits; (iii) Combination of (i) and (ii),

TEST YOUR KNOWLEDGE

True and False

1. *When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Reserve account by debiting the distributable profit.*
2. *A company who prepares financial statements in compliance with Accounting Standards under Section 133 of the Companies Act, 2013, it cannot utilize securities premium for the purpose of providing for premium on the redemption of Redeemable Preference shares of the Company.*
3. *The balance in forfeited shares account can be used for transfer to capital redemption reserve account.*
4. *Capital redemption reserve cannot be used for writing off miscellaneous expenses and losses*

Multiple Choice Questions

1. *Securities premium cannot be used to ______.*

   (a) Issue bonus shares

   (b) Redeem preference shares

   (c) Write-off preliminary expenses

2. *S Ltd. issued 2,000, 10% Preference shares of ₹ 100 each at par on 1.4.2021, which are redeemable at a premium of 10%. For the purpose of redemption, the company issued 1,500 Equity Shares of ₹ 100 each at a premium of 20% per share. At the time of redemption of Preference Shares, the amount to be transferred by the company to the Capital Redemption Reserve Account = ?*

   (a) ₹ 50,000

   (b) ₹ 40,000

   (c) ₹ 2,00,000

3. *Which of the following cannot be used for the purpose of creation of capital redemption reserve account?*

   (a) Profit and loss account (credit balance)

(b) *General reserve account*

(c) *Unclaimed dividend account*

4 *According to Section 52 of the Companies Act, 2013, the amount in the Securities Premium A/c cannot be used for the purpose of*

(a) *Issue of fully paid bonus shares*

(b) *Writing off losses of the company*

(c) *For purchase of own securities*

5. *Which of the following can be utilized for redemption of preference shares?*

(a) *The proceeds of fresh issue of equity shares*

(b) *The proceeds of issue of debentures*

(c) *The proceeds of issue of fixed deposit*

6. *Preference shares amounting to ₹ 2,00,000 (already issued on 1.4.2021) are redeemed at a premium of 5%, by issue of shares amounting to ₹ 1,00,000 at a premium of 10%. The amount to be transferred to capital redemption reserve = ?*

(a) *₹ 1,05,000*

(b) *₹ 1,00,000*

(c) *₹ 2,00,000*

Theoretical Questions

1. *What is the purpose of issuing redeemable preference shares?*

2. *What are the provisions of the Companies Act, 2013 related with redemption of preference shares? Explain in brief.*

Practical Questions

1. *The books of B Ltd. showed the following balance on 31st December, 2023:*

30,000 Equity Shares of ₹10 each fully paid; 18,000 12% Redeemable Preference Shares of ₹10 each fully paid; 4,000 10% Redeemable Preference Shares of ₹ 10 each, ₹ 8 paid up (all shares issued on 1st April, 2022).

Undistributed Reserve and Surplus stood as: Profit and Loss Account ₹ 80,000; General Reserve ₹ 1,20,000; Securities Premium Account ₹ 15,000 and Capital Reserve ₹ 21,000.

For redemption, 3,000 equity shares of ₹10 each are issued at 10% premium. At the same time, Preference shares are redeemed on 1st January, 2024 at a premium of ₹2 per share. The whereabouts of the holders of 100 shares of ₹10 each fully paid are not known.

A bonus issue of equity share was made at par, two shares being issued for every five held on that date out of the Capital Redemption Reserve Account. However, equity shares, issued for redemption are not eligible for bonus.

Show the necessary Journal Entries to record the transactions. (Ignore date column)

ANSWERS/ HINTS

True and false

1. False: When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve account by debiting the distributable profit.

2. True: A company who prepares financial statements in compliance with Accounting Standards under Section 133 of the Companies Act, 2013, it cannot utilize securities premium for the purpose of providing the premium on the redemption of redeemable preference shares.

3. False: The balance in Forfeited shares account cannot be used for transfer to capital redemption reserve account.

4. True: Capital redemption reserve cannot be used for writing off miscellaneous expenses and losses.

Multiple Choice Questions

1.	(b)	**2.**	(a)[1]	**3.**	(c)	**4.**	(b)	**5.**	(a)	**6.**	(b)[2]

Theoretical Questions

1. A company may issue redeemable preference shares to raise finance in a dull primary market. Preference shares may be redeemed when there is a surplus of capital and the surplus funds cannot be utilised in the business for profitable use. For details, refer para 5.2 of the chapter.

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[1] 2,00,000 – 1,50,000
[2] 2,00,000 – 1,00,000

2. Section 55 of the Companies Act, 2013, deals with provisions relating to redemption of preference shares. It ensures that there is no reduction in shareholders' funds due to redemption and, thus, the interest of outsiders is not affected. For details, refer para 5.3 of the chapter.

Practical Questions

1. **In the books of B Limited**

Journal Entries

Particulars		*Dr. (₹)*	*Cr. (₹)*
12% Redeemable Preference Share Capital A/c	Dr.	1,80,000	
Premium on Redemption of Preference Shares A/c	Dr.	36,000	
To Preference Shareholders A/c			2,16,000
(Being the amount payable on redemption of 18,000 12% Redeemable Preference Shares transferred to Shareholders Account)			
Preference Shareholders A/c	Dr.	2,14,800	
To Bank A/c			2,14,800
(Being the amount paid on redemption of 17,900 preference shares)			
Bank A/c	Dr.	33,000	
To Equity Shares Capital A/c			30,000
To Securities Premium A/c			3,000
(Being the issue of 3,000 Equity Shares of ₹ 10 each at a premium of 10% as per Board's Resolution No....... Dated......)			
General Reserve A/c	Dr.	1,20,000	
Profit & Loss A/c	Dr.	30,000	
To Capital Redemption Reserve A/c			1,50,000
(Being the amount transferred to Capital Redemption Reserve A/c as per the requirement of the Act.)			
Capital Redemption Reserve A/c	Dr.	1,20,000	
To Bonus to Shareholders A/c			1,20,000
(Being the amount appropriated for issue of bonus share in the ratio of 5:2 as per shareholders Resolution No...... dated...)			

Bonus to Shareholders A/c Dr. To Equity Share Capital A/c (Being the utilisation of bonus dividend for issue of 12,000 equity shares of ₹ 10 each fully paid)		1,20,000	1,20,000
Profit & Loss A/c Dr. To Premium on Redemption of Preference Shares A/c (Being premium on redemption of preference shares adjusted against to Profit & Loss Account)		36,000	36,000

Working Note:

(1) Partly paid-up preference shares cannot be redeemed.

(2) Amount to be Transferred to Capital Redemption Reserve Account

Face value of share to be redeemed	₹ 1,80,000
Less: Proceeds from fresh issue (excluding premium)	(₹ 30,000)
	₹ 1,50,000

(3) No bonus shares on 3,000 equity shares issued for redemption.

Note: Bonus shares does not result in receipt of cash, and hence the increase in share capital on account of bonus issue cannot be considered in determination of amount to be transferred to Capital Redemption Reserve.

UNIT – 6: REDEMPTION OF DEBENTURES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand about the redemption of debentures;
- Understand the requirement of creation of a Debenture Redemption Reserve and creation of Debenture Redemption Fund (i.e. making investments for purpose of redemption of debentures);
- Understand various methods of redemption of debentures;
- Understand the accounting treatment of redemption of debentures;
- Solve problems based on redemption of debentures.

UNIT OVERVIEW

Methods of Redemption of Debentures

- By payment in Lumpsum
- By payment in instalments
- By purchase in open market
- By conversion into shares

Provisions under the Companies Act, 2013 for Issue of Debentures

- Section 71 (1)
  - A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption.
    - Provided that the issue of such debentures with an option to convert into shares, wholly or partly, should be approved by a special resolution passed at a duly convened general meeting.
- Section 71 (2)
  - No company can issue any debentures which carry any voting rights.
- Section 71 (4)
  - Where debentures are issued by a company, then the company should create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account should not be utilised for any purpose other than the redemption of debentures.

6.1 INTRODUCTION

A debenture is an instrument issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest.

Under Section 71 (1) of the Companies Act, 2013, a company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption.

Provided that the issue of debentures with an option to convert such debentures into shares, wholly or partly, should be approved by a special resolution passed at a duly convened general meeting.

Section 71 (2) further provides that no company can issue any debentures which carry any voting rights.

Section 71 (4) provides that where debentures are issued by a company, the company should create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account should not be utilized by the company for any purpose other than the redemption of debentures.

Basic provisions

If a charge has been created on any asset or the entire assets of the company,

- the nature of the charge
- the asset(s) charged

are described therein.

- Since the charge is not valid unless registered with the Registrar, his certificate registering the charge is printed on the bond.
- It is also customary to create a trusteeship in favour of one or more persons in the case of mortgage debentures. The trustees of debenture holders have all powers of a mortgage of a property and can act in whatever manner they think necessary to safeguard the interest of debenture holders.

Note: Issue of debentures has already been discussed in detail in unit 3 of Chapter 11.

6.2 REDEMPTION OF DEBENTURES

Debentures are usually redeemable i.e. either redeemed in cash or convertible to equity shares after a time period.

Redeemable debentures may be **redeemed**:

- after a **fixed number** of years; or
- any time after a **certain number of years** has elapsed since their issue; or
- on giving a **specified notice**; or
- by **annual drawing**.

A company may also purchase its debentures, as and when convenient, in the open market. When the debentures are quoted at a discount on the Stock Exchange, it may be profitable for the company to purchase and cancel them.

6.3 DEBENTURE REDEMPTION RESERVE

A company issuing debentures may be required to create a debenture redemption reserve account out of the profits available for distribution of dividend and amounts credited to such account cannot be utilised by the company for any other purpose except for redemption of debentures. Such an arrangement would ensure that the company will have sufficient liquid funds for the redemption of debentures at the time they fall due for payment.

An appropriate amount is transferred from profits every year to Debenture Redemption Reserve and its investment is termed as Debenture Redemption Reserve Investment (or Debenture Redemption Fund). In the last year or at the time of redemption of debentures, Debenture Redemption Reserve Investments are encashed and the amount so obtained is used for the redemption of debentures.

6.3.1 Requirement to create Debenture Redemption Reserve

Section 71 of the Companies Act 2013 covers the requirement of creating a debenture redemption reserve account. Section 71 states as follows:

(1) Where a company issues debentures under this section, it should create a debenture redemption reserve account out of its profits which are available for distribution of dividend every year until such debentures are redeemed.

(2) The amounts credited to the debenture redemption reserve should not be utilised by the company for any purpose except for the purpose aforesaid.

(3) The company should pay interest and redeem the debentures in accordance with the terms and conditions of their issue.

(4) Where a company fails to redeem the debentures on the date of maturity or fails to pay the interest on debentures when they fall due, the Tribunal may, on the application of any or all the holders of debentures or debenture trustee and, after hearing the parties concerned, direct, by order, the company to redeem the debentures forthwith by the payment of principal and interest due thereon.

6.3.2 Balance in Debenture Redemption Reserve (DRR)

When the company decides to establish the Debenture Redemption Reserve Account, the amount indicated by the Debenture Redemption Reserves tables is credited to the Debenture Redemption Reserve account and debited to profit and loss account. That shows the intention of the company to set aside sum of money to build up a fund for redeeming debentures. Immediately, the company should also purchase outside investments. The entry for the purpose naturally will be to debit Debenture Redemption Reserve Investments and credit Bank.

If the debentures are purchased within the interest period, the price would be inclusive of interest provided these are purchased "Cum-interest"; but if purchased "Ex-interest", the interest to the date of purchase would be payable to the seller additionally. In order to adjust the effect thereof the amount of interest accrued till the date of purchase, if paid, is debited to the Interest Account against which the interest for the whole period will be credited. As a result, the balance in the account would be left equal to the interest for the period for which the debentures were held by the company.

6.3.3 Adequacy of Debenture Redemption Reserve (DRR)

As per Rule 18 (7) of the Companies (Share Capital and Debentures) Amendment Rules, 2019, the company shall comply with the requirements with regard to Debenture Redemption Reserve (DRR) and investment or deposit of sum in respect of debentures maturing during the year ending on the 31st day of March of next year (*refer para 6.4 below*), in accordance with the conditions given below—

the Debenture Redemption Reserve shall be created out of the profits of the company available for payment of dividend; the limits with respect to adequacy of DRR and investment or deposits, as the case may be, shall be as under:

S. No	Debentures issued by	Adequacy of Debenture Redemption Reserve (DRR)
1	All India Financial Institutions (**AIFIs**) regulated by Reserve Bank of India **and Banking**	**No DRR** is required

	Companies for both public as well as **privately placed debentures**		
2	**Other Financial Institutions (FIs)** within the meaning of clause (72) of section 2 of the Companies Act, 2013		**DRR** will be **as applicable to NBFCs** registered with RBI (**as per (3) below**)
3	**For listed companies** (other than AIFIs and Banking Companies as specified in Sr. No. 1 above):		
	a.	All **listed NBFCs** (registered with RBI under section 45-IA of the RBI Act,) and **listed HFCs** (Housing Finance Companies registered with National Housing Bank) **for both public** as well as **privately placed debentures**	**No DRR** is required
	b.	**Other listed companies for both public** as well as **privately placed debentures**	**No DRR** is required
4	**For unlisted companies** (other than AIFIs and Banking Companies as specified in Sr. No. 1 above		
	a.	All **unlisted NBFCs** (registered with RBI under section 45-IA of the RBI (Amendment) Act, 1997) and **unlisted HFCs** (Housing Finance Companies registered with National Housing Bank) **for privately placed debentures**	**No DRR** is required
	b.	**Other unlisted companies**	**DRR** shall be **10% of** the **value of** the **outstanding debentures** issued

6.3.4 Investment of Debenture Redemption Reserve (DRR) Amount

Further, as per Rule 18 (7) of the Companies (Share Capital and Debentures) Amendment Rules, 2019, following companies

(a) All listed NBFCs

(b) All listed HFCs

(c) All other listed companies (other than AIFIs, Banking Companies and Other FIs); and

(d) All unlisted companies which are not NBFCs and HFCs

shall on or before the 30th day of April in each year, in respect of debentures issued, deposit or invest, as the case may be, a sum which should not be less than 15% of the amount of its debentures maturing during the year ending on the 31st day of March of next year, in any one or more of the following methods, namely:

(a) in deposits with any scheduled bank, free from charge or lien;

(b) in unencumbered securities of the Central Government or of any State Government;

(c) in unencumbered securities mentioned in clauses (a) to (d) and (ee) of Section 20 of the Indian Trusts Act, 1882;

(d) in unencumbered bonds issued by any other company which is notified under clause (f) of Section 20 of the Indian Trusts Act, 1882.

The amount deposited or invested, as the case may be, above should not be utilised for any purpose other than for the redemption of debentures maturing during the year referred to above.

Provided that the amount remaining deposited or invested, as the case may be, shall not at any time fall below 15% of the amount of debentures maturing during the 31st day of March of that year.

In case of partly convertible debentures, DRR shall be created in respect of non-convertible portion of debenture issue.

The amount credited to DRR shall not be utilised by the company except for the purpose of redemption of debentures.

Note: It should be noted that appropriation to DRR can be made any time before redemption and Investments in specified securities as mentioned above can be done before 30th April for the debentures maturing that year, however, for the sake of simplicity and ease, it is advisable to make the appropriation and investment immediately after the debentures are allotted assuming that the company has sufficient amount of profits (issued if allotment date is not given in the question). Also, in some cases, the date of allotment could be missing, in such cases the appropriation and investments should be done on the first day of that year for which ledgers accounts are to be drafted.

6.3.5 Journal Entries

The necessary journal entries passed in the books of a company are given below:

1. After allotment of debentures

   (a) For setting aside the fixed amount of profit for redemption

   Profit and Loss A/c Dr.

   To Debenture Redemption Reserve A/c

(b) For investing the amount set aside for redemption

Debenture Redemption Reserve Investment A/c Dr.

To Bank A/c

(c) For receipt of interest on Debenture Redemption Reserve Investments

Bank A/c Dr.

To Interest on Debenture Redemption Reserve Investment A/c

(d) For transfer of interest on Debenture Redemption Reserve Investments (DRRI)

Interest on Debenture Redemption Reserve Investment A/c Dr.

To Profit and loss A/c*

** Considering the fact that interest is received each year through cash/bank account and it is not re-invested. In the illustrations given in the chapter, the same has been considered and hence interest on DRR investment is not credited to DRR A/c but taken to P&L A/c.*

2. At the time of redemption of debentures

(a) For encashment of Debenture Redemption Reserve Investments

Bank A/c Dr.

To Debenture Redemption Reserve Investment A/c

(b) For amount due to debentureholders on redemption

Debentures A/c Dr.

To Debentureholders A/c

(c) For payment to debentureholders

Debentureholders A/c Dr.

To Bank A/c

(d) After redemption of debentures, DRR should be transferred to general reserve

DRR A/c Dr.

To General Reserve

6.4 METHODS OF REDEMPTION OF DEBENTURES

Redemption of debentures must be done according to the terms of issue of debentures and any deviation therefrom will be treated as a default by the company.

Redemption by paying off the debt on account of debentures issued can be done in any one of the three methods viz:

6.4.1 By payment in lumpsum

Under payment in lumpsum method, at maturity or at the expiry of a specified period of debenture the payment of entire debenture is made in one lot or even before the expiry of the specified period.

6.4.2 By payment in Instalments

Under payment in instalments method, the payment of specified portion of debenture is made in instalments at specified intervals.

6.4.3 Purchase of Debentures in Open Market

Debentures sometimes are purchased in open market. This is not covered in the chapter as it has been specifically excluded from the syllabus at Foundation level.

ILLUSTRATION 1

The following balances appeared in the books of a company (unlisted company other than AIFI, Banking company, NBFC and HFC) as on December 31, 2021: 6% Mortgage 10,000 debentures of ₹ 100 each; Debenture Redemption Reserve (for redemption of debentures) ₹ 50,000; Investments in deposits with a scheduled bank, free from any charge or lien ₹ 1,50,000 at interest 4% p.a. receivable on 31st December every year. Bank balance with the company is ₹ 9,00,000.

The Interest on debentures had been paid up to December 31, 2021.

On February 28, 2022, the investments were realised at par and the debentures were paid off at 101, together with accrued interest.

Write up the concerned ledger accounts (excluding bank transactions). Ignore taxation.

SOLUTION

6% Mortgage Debentures Account

2022			₹	2022			₹
Feb. 28	To	Debenture-holders A/c	10,00,000	Jan. 1	By	Balance b/d	10,00,000

Premium on Redemption of Debentures Account

2022			₹	2022			₹
Feb. 28	To	Debenture-holders A/c	10,000	Feb. 28	By	Profit and loss A/c	10,000

Debentures Redemption Reserve Investment Account

2022			₹	2022			₹
Jan. 1	To	Balance b/d	1,50,000	Feb. 28	By	Bank	1,50,000

Debenture Interest Account

2022			₹	2022			₹
Feb. 28	To	Bank (10,000 x 100 x 6% x 2/12)	10,000	Feb. 28	By	Profit & Loss A/c	10,000

Bank A/c

2022			₹	2022			₹
Jan 01	To	Balance b/d	9,00,000	Feb. 28	By	Debenture-holders (10,000 x 101)	10,10,000
Feb 28	To	Interest on Debentures Redemption Investments (1,50,000 x 4% x 2/12)	1,000				
	To	Debentures Redemption Reserve investment A/c	1,50,000		By	Debenture Interest A/c	10,000
					By	Balance c/d	31,000
			10,51,000				10,51,000

Debenture Redemption Reserve Account

2022			₹	2022			₹
Feb 28	To	General Reserve-note	1,00,000	Jan.1	By	Balance b/d	50,000
				Jan.1	By	Profit & Loss (b/f)	50,000
			1,00,000				1,00,000

Note

Amount to be transferred to DRR before the redemption = ₹ 1,00,000 [i.e. 10% of (10,000 X 100)].

ILLUSTRATION 2

The following balances appeared in the books of Paradise Ltd (unlisted company other than AIFI, Banking company, NBFC and HFC) as on 1-4-2021:

(i) *12 % Debentures ₹ 7,50,000*

(ii) *Balance of DRR ₹ 25,000*

(iii) *DRR Investment 1,12,500 represented by 10% ₹ 1,125 Secured Bonds of the Government of India of ₹ 100 each.*

Annual contribution to the DRR was made on 31st March every year. On 31-3-2022, balance at bank was ₹ 7,50,000 before receipt of interest. The investment were realised at par for redemption of debentures at a premium of 10% on the above date.

You are required to prepare the following accounts for the year ended 31st March, 2022:

(1) *Debentures Account*

(2) *DRR Account*

(3) *DRR Investment Account*

(4) *Bank Account*

(5) *Debenture Holders Account.*

SOLUTION

1. **12% Debentures Account**

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31st March, 2022	To Debenture holders A/c	7,50,000	1st April, 2021	By Balance b/d	7,50,000
		7,50,000			7,50,000

2. **DRR Account**

Date	*Particulars*	₹	*Date*	*Particulars*	₹
			1st April, 2021	By Balance b/d	25,000
31st March, 2022	To General reserve A/c (Refer Note)	75,000	1st April, 2021	By Profit and loss A/c (Refer Note)	50,000
		75,000			75,000

3. 10% Secured Bonds of Govt. (DRR Investment) A/c

		₹			₹
1st April, 2021	To Balance b/d	1,12,500	31st March, 2022	By Bank A/c	1,12,500
		1,12,500			1,12,500

4. Bank A/c

		₹			₹
31st March, 2022	To Balance b/d	7,50,000	31st March, 2022	By Debenture holders A/c	8,25,000
	To Interest on DRR Investment (1,12,500 x 10%)	11,250			
	To DRR Investment A/c	1,12,500		By Balance c/d	48,750
		8,73,750			8,73,750

5. Debenture holders A/c

		₹			₹
31st March, 2022	To Bank A/c	8,25,000	31st March, 2022	By 12% Debentures	7,50,000
				By Premium on redemption of debentures (7,50,000 X 10%)	75,000
		8,25,000			8,25,000

Note–

Calculation of DRR before redemption = 10% of ₹ 7,50,000 = 75,000

Available balance = ₹ 25,000

DRR required = 75,000 – 25,000 = ₹ 50,000.

ILLUSTRATION 3

XYZ Ltd. has issued 1,000, 12% convertible debentures ₹100 each redeemable after a period of five years. According to the terms & conditions of the issue, these debentures were redeemable at a premium of 5%. The debenture holders also had the option at the time of redemption to convert 20% of their holdings into equity shares of ₹ 10 each at a price of ₹ 20 per share and balance in cash. Debenture holders amounting ₹ 20,000 opted to get their debentures converted into equity shares as per terms of the issue. You are required to calculate the number of shares issued and cash paid for redemption of ₹ 20,000 debenture holders.

SOLUTION

	Number of debentures
Debenture holders opted for conversion (20,000 /100)	200
Option for conversion	20%
Number of debentures to be converted (20% of 200)	40
Redemption value of 40 debentures at a premium of 5% [40 x (100+5)]	₹ 4,200
Equity shares of ₹ 10 each issued on conversion	
[₹ 4,200/ ₹ 20]	210 shares

Calculation of cash to be paid :

	₹
Number of debentures	200
Less: number of debentures to be converted into equity shares	(40)
	160

Redemption value of 160 debentures (160 × ₹ 105) ie. ₹ 16,800.

ILLUSTRATION 4

The Balance Sheet of BEE Co. Ltd. (unlisted company other than AIFI, Banking company, NBFC and HFC) as at 31st March, 2021 is as under:

Particulars	Note No	₹
I. Equity and liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	2,00,000
(b) Reserves and Surplus	2	1,20,000
(2) Non-current liabilities		
(a) Long term borrowings	3	1,20,000
(3) Current Liabilities		
(a) Trade payables		1,15,000
Total		5,55,000
II. Assets		
(1) Non-current assets		
(a) Property, Plant and Equipment	4	1,15,000

(2)	**Current assets**		
	(a) Inventories		1,35,000
	(b) Trade receivables		75,000
	(c) Cash and bank balances	5	2,30,000
	Total		5,55,000

Notes to Accounts

			₹
1.	**Share Capital**		
	Authorised share capital		
	30,000 shares of ₹ 10 each fully paid		3,00,000
	Issued and subscribed share capital		
	20,000 shares of ₹ 10 each fully paid		2,00,000
2.	**Reserve and Surplus**		
	Profit & Loss Account		1,20,000
3.	**Long term borrowings**		
	12% Debentures		1,20,000
4.	**Property, Plant and Equipment**		
	Freehold property		1,15,000
5.	**Cash and bank balances**		
	Cash at bank	2,00,000	
	Cash in hand	30,000	2,30,000

At the Annual General Meeting, it was resolved:

(a) To give existing shareholders the option to purchase one ₹ 10 share at ₹ 15 for every four shares (held prior to the bonus distribution). This option was taken up by all the shareholders.

(b) To issue one bonus share for every five shares held.

(c) To repay the debentures at a premium of 3%.

Give the necessary journal entries for these transactions.

SOLUTION

Journal of BEE Co. Ltd.

		Dr. ₹	Cr. ₹
Bank A/c	Dr.	75,000	
To Equity Shareholders A/c			75,000
(Application money received on 5,000 shares @ ₹ 15 per share to be issued as rights shares in the ratio of 1:4)			
Equity Shareholders A/c	Dr.	75,000	
To Equity Share Capital A/c			50,000
To Securities Premium A/c			25,000
(Share application money on 5,000 shares @ ₹ 10 per share transferred to Share Capital Account, and ₹ 5 per share to Securities Premium Account vide Board's Resolution dated...)			
Securities Premium A/c	Dr.	25,000	
Profit & Loss A/c	Dr.	25,000	
To Bonus to Shareholders A/c			50,000
(Amount transferred for issue of bonus shares to existing shareholders in the ratio of 1:5 *vide* General Body's resolution dated...)			
Bonus to Shareholders A/c	Dr.	50,000	
To Equity Share Capital A/c			50,000
(Issue of bonus shares in the ratio of 1 for 5 *vide* Board's resolution dated....)			
Profit and Loss A/c	Dr.	12,000	
To Debenture Redemption Reserve			12,000
(for DRR created 10% x 1,20,000)			
Debenture Redemption Reserve Investment A/c	Dr.	18,000	
To Bank A/c			18,000
(for DRR Investment created 15% x 1,20,000)			
12% Debentures A/c	Dr.	1,20,000	
Premium Payable on Redemption A/c @ 3%	Dr.	3,600	

To Debenture holders A/c (Amount payable to debentures holders)			1,23,600
Profit and loss A/c To Premium Payable on Redemption A/c (Premium payable on redemption of debentures charged to Profit & Loss A/c)	Dr.	3,600	3,600
Debenture Redemption Reserve A/c To General Reserve (for DRR transferred to general reserve)	Dr.	12,000	12,000
Bank A/c To Debenture Redemption Reserve Investment (for DRR Investment realised)	Dr.	18,000	18,000
Debenture holders A/c To Bank A/c (Amount paid to debenture holders on redemption)	Dr.	1,23,600	1,23,600

SUMMARY

- Debentures may create a charge against some or all the assets of the company.
- Charge may be fixed or floating, depends upon the condition of issue.
- Debentures may be redeemed after a fixed number of years or after a certain period has elapsed.
- For redemption of debentures, certain companies are required to create Debenture Redemption Reserve.
- Methods of redemption: lumpsum payment and payment in instalments.

TEST YOUR KNOWLEDGE

True and False

1. *Amounts credited to the debenture redemption reserve may be utilised by the company for any purpose.*
2. *All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures need not create any Debenture Redemption Reserve (DRR).*

3. *Under payment in instalments method, the payment of entire debenture is made in one lot.*
4. *At redemption of debentures, DRR should be transferred to general reserve.*

Multiple Choice Questions

1. *Which of the following statements is true?*
   - (a) *A debenture holder is an owner of the company.*
   - (b) *A debenture holder can get his money back only on the liquidation of the company.*
   - (c) *A debenture issued at a discount can be redeemed at a premium.*
2. *Which of the following statements is false?*
   - (a) *Debentures can be redeemed by payment in lump sum at the end of a specified period.*
   - (b) *Debentures cannot be redeemed during the life time of the company.*
   - (c) *Debentures can be redeemed by payments in annual instalments.*
3. *For debentures issued by unlisted companies (other than AIFIs, Banking companies, NBFCs and HFCs), Debentures Redemption reserve will be considered adequate if it is:*
   - (a) *25% of the value of debentures issued through public issue.*
   - (b) *10% of the value of debentures issued through public issue.*
   - (c) *5% of the value of debentures issued through public issue.*
4. *A company has issued 6% debentures for ₹ 10,00,000, interest being payable on 31st March and 30th September. The company redeems ₹ 10,000 debentures at ₹ 96 (ex-interest) on 1st August 2021. The amount of Profit/loss on cancellation of debentures will be*
   - (a) *Profit of ₹ 600.*
   - (b) *Profit of ₹ 400.*
   - (c) *Loss of ₹ 400*

Theoretical Questions

1. *What is meant by redemption of debentures? Explain.*
2. *Write short note on Debenture Redemption Reserve.*

Practical Questions

1. *A company had issued 20,000, 13% debentures of ₹ 100 each on 1st April, 2021. The debentures are due for redemption on 1st July, 2022. The terms of issue of debentures provided that they were redeemable at a premium of 5% and also conferred option to the debenture holders to convert 20% of their holding into equity shares (Nominal value ₹ 10) at a price of ₹ 15 per share. Debenture holders holding 2,500 debentures did not exercise the option. Calculate the number of equity shares to be allotted to the debenture holders exercising the option to the maximum.*

2. *Libra Limited (a listed company) recently made a public issue in respect of which the following information is available:*

   (a) *No. of partly convertible debentures issued- 2,00,000; face value and issue price- ₹ 100 per debenture.*

   (b) *Convertible portion per debenture- 60%, date of conversion- on expiry of 6 months from the date of closing of issue.*

   (c) *Date of closure of subscription lists- 1.5.2021, date of allotment- 1.6.2021, rate of interest on debenture- 15% payable from the date of allotment, value of equity share for the purpose of conversion- ₹ 60 (Face Value ₹ 10).*

   (d) *No. of debentures applied for- 2,00,000.*

   (e) *Interest payable on debentures half-yearly on 30th September and 31st March.*

   Write relevant journal entries for all transactions arising out of the above during the year ended 31st March, 2022 (including cash and bank entries).

3. *Case Ltd. (unlisted company other than AIFI, Banking company, NBFC and HFC) provides the following information as at 31st March, 2022:*

Particulars	**₹**
Shareholder's Funds	
(a) Share Capital	
Authorized share capital:	
45,000 equity shares of ₹ 10 each fully paid	4,50,000
Issued and subscribed share capital:	
30,000 equity shares of ₹ 10 each fully paid	3,00,000
(b) Reserves and Surplus	
Profit & Loss Account	1,62,000

	Debenture Redemption Reserve	*18,000*
Non-current liabilities		
(a)	*Long term borrowings*	
	12% Debentures	*1,80,000*
Current Liabilities		
(a)	*Trade payables*	*1,72,500*
Non-current assets		
(a)	*Property, Plant and Equipment (Freehold property)*	*1,72,500*
(b)	*Non-current Investment: DRR Investment*	*27,000*
Current assets		
(a)	*Inventories*	*2,02,500*
(b)	*Trade receivables*	*1,12,500*
(c)	*Cash and bank balances:*	
	Cash at bank	*2,73,000*
	Cash in hand	*45,000*

At the Annual General Meeting on 1.4.2022, it was resolved:

(a) *To give existing shareholders the option to purchase one ₹ 10 share at ₹ 15 for every four shares (held prior to the bonus distribution). This option was taken up by all the shareholders.*

(b) *To issue one bonus share for every five shares held.*

(c) *To repay the debentures at a premium of 3%.*

Give the necessary journal entries for these transactions.

ANSWERS/ HINTS

True and False

1. False: Amounts credited to the debenture redemption reserve should not be utilised by the company for any purpose except for the purpose other than for redemption of debentures.

2. True: All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures need not create any DRR.

3. False: under payment in instalments method, the payment of specified portion of debentures are made in instalments at specified intervals.

4 True: DRR is transferred to general reserve at the time of redemption of debentures.

Multiple Choice Questions

1.	(c)	**2.**	(b)	**3.**	(b)	**4.**	(b)				

Theoretical Questions

1. Debentures are usually redeemable i.e. either redeemed in cash or convertible after a time period.

Redeemable debentures may be **redeemed**:

- after a **fixed number** of years; or
- any time after a **certain number of years** has elapsed since their issue; or
- on giving a **specified notice**; or
- by **annual drawing**.

For details, refer para 6.2 of the chapter.

2. A company issuing debentures may be required to create a debenture redemption reserve account out of the profits available for distribution of dividend and amounts credited to such account cannot be utilised by the company except for redemption of debentures. Such an arrangement would ensure that the company will have sufficient liquid funds for the redemption of debentures at the time they fall due for payment. For details, refer para 6.3.

Practical Questions

1. **Calculation of number of equity shares to be allotted**

	Number of debentures
Total number of debentures	20,000
Less: Debenture holders not opted for conversion	(2,500)
Debenture holders opted for conversion	17,500
Option for conversion	20%
Number of debentures to be converted (20% of 17,500)	3,500
Redemption value of 3,500 debentures at a premium of	

5% [3,500 x (100+5)]	₹ 3,67,500
Equity shares of ₹ 10 each issued on conversion [₹ 3,67,500/ ₹ 15]	24,500 shares

2. **Journal Entries in the books of Libra Ltd.**

Journal Entries

Date	***Particulars***		***Amount ₹ Dr.***	***Amount ₹ Cr.***
1.5.2021	Bank A/c	Dr.	2,00,00,000	
	To Debenture Application A/c			2,00,00,000
	(Application money received on 1,50,000 debentures @ ₹ 100 each)			
1.6.2021	Debenture Application A/c	Dr.	2,00,00,000	
	To 15% Debentures A/c			2,00,00,000
	(Allotment of 1,50,000 debentures to applicants and 50,000 debentures to underwriters)			
1.6.2021	Debenture Redemption Investment A/c	Dr.	12,00,000	
	To Bank A/c			12,00,000
	(2,00,000 X 100 x 15% X 40%)			
	(Being Investments made for redemption purpose)			
30.9.2021	Debenture Interest A/c	Dr.	10,00,000	
	To Bank A/c			10,00,000
	(Interest paid on debentures for 4 months @ 15% on ₹ 2,00,00,000)			
31.10.2021	15% Debentures A/c	Dr.	1,20,00,000	
	To Equity Share Capital A/c			20,00,000
	To Securities Premium A/c			1,00,00,000
	(Conversion of 60% of debentures into shares of ₹ 60 each with a face value of ₹ 10)			

31.3.2022	Debenture Interest A/c	Dr.	7,50,000	
	To Bank A/c			7,50,000
	(Interest paid on debentures for the half year) ***(Refer working note)***			

Working Note:

Calculation of Debenture Interest for the half year ended 31st March, 2022

On ₹ 80,00,000 for 6 months @ 15% = ₹6,00,000

On ₹ 1,20,00,000 for 1 months @ 15% = ₹ 1,50,000

₹7,50,000

3. Journal Entries in the Books of Case Ltd.

		Dr.₹	**Cr.₹**
Bank A/c	Dr.	1,12,500	
To Equity Shareholders A/c			1,12,500
(Application money received on 7,500 shares @ ₹ 15 per share to be issued as rights shares in the ratio of 1:4)			
Equity Shareholders A/c	Dr.	1,12,500	
To Equity Share Capital A/c			75,000
To Securities Premium A/c			37,500
(Share application money on 7,500 shares @ ₹ 10 per share transferred to Share Capital Account, and ₹ 5 per share to Securities Premium Account vide Board's Resolution dated…)			
Securities Premium A/c	Dr.	37,500	
Profit & Loss A/c	Dr.	37,500	
To Bonus to Shareholders A/c			75,000
(Amount transferred for issue of bonus shares to existing shareholders in the ratio of 1:5 *vide* General Body's resolution dated…)			
Bonus to Shareholders A/c	Dr.	75,000	
To Equity Share Capital A/c			75,000
(Issue of bonus shares in the ratio of 1 for 5 vide Board's resolution dated….)			

12% Debentures A/c	Dr.	1,80,000	
Premium Payable on Redemption A/c (@ 3%)	Dr.	5,400	
To Debenture holders A/c			1,85,400
(Amount payable to debentures holders)			
Profit and loss A/c	Dr.	5,400	
To Premium Payable on Redemption A/c			5,400
(Premium payable on redemption of debentures charged to Profit & Loss A/c)			
Debenture Redemption Reserve A/c	Dr.	18,000	
To General Reserve			18,000
(For DRR transferred to general reserve)			
Bank A/c	Dr.	27,000	
To Debenture Redemption Reserve Investment			27,000
(for DRR Investment realised)			
Debenture holders A/c	Dr.	1,85,400	
To Bank A/c			1,85,400
(Amount paid to debenture holders on redemption)			

NOTES

ACCOUNTING TERMINOLOGY GLOSSARY

Acceptance

The drawee's signed assent on bill of exchange, to the order of the drawer. This term is also used to describe a bill of exchange that has been accepted.

Accounting policies

Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

Accrual

Recognition of revenues and costs as they are earned or incurred (and not as money is received or paid). It includes recognition of transactions relating to assets and liabilities as they occur irrespective of the actual receipts or payments.

Accrual/Mercantile Basis of Accounting

The method of recording transactions by which *revenues, costs, assets* and *liabilities* are reflected in the accounts in the period in which they accrue. The 'accrual basis of accounting' includes considerations relating to *deferrals, allocations, depreciation* and *amortisation*. This basis is also referred to as *mercantile basis of accounting*.

Accrued Asset

A developing but not yet enforceable claim against another person which accumulates with the passage of time or the rendering of service or otherwise. It may arise from the rendering of services (including the use of money) which at the date of accounting have been partly performed, and are not yet billable.

Accrued Expense

An expense which has been incurred in an accounting period but for which no enforceable claim has become due in that period against the enterprise. It may arise from the purchase of services (including the use of money) which at the date of accounting have been only partly performed, and are not yet billable.

Accrued Liability

A developing but not yet enforceable claim by another person which accumulates with the passage of time or the receipt of service or otherwise. It may arise from the purchase of services (including the use of money) which at the date of accounting have.

Accrued Revenue

Revenue which has been earned in an accounting period but in respect of which no enforceable claim has become due in that period by the enterprise. It may arise from the rendering of services (including the use of money) which at the date of accounting have been partly performed, and are not yet billable.

Accumulated Depletion

The total to date of the periodic depletion charges on wasting assets.

Accumulated Depreciation

The total to date of the periodic depreciation charges on depreciable assets.

Advance

Payment made on account of, but before completion of, a contract, or before acquisition of goods or receipt of services.

Amortised Value

The *amortizable* amount less any portion already provided by way of *amortization*.

Annual Report

The information provided annually by the management of an enterprise to the owners and other interested persons concerning its operations and financial position. It includes the information statutorily required, e.g., in the case of a company, the *balance sheet, profit and loss statement* and notes on accounts, the *auditor's report* thereon, and the report of the Board of Directors. It also includes other information voluntarily provided e.g., *value added statement*, graphs, charts, etc.

Appropriation Account

An account sometimes included as a separate section of the *profit and loss statement* showing application of *profits* towards *dividends, reserves*, etc.

Assets

Tangible objects or intangible rights owned by an enterprise and carrying probable future benefits.

Authorised Share Capital

The number and par value, of each class of shares that an enterprise may issue in accordance with its instrument of incorporation. This is sometimes referred to as **nominal share capital**.

Average Cost

The cost of an item at a point of time as determined by applying an average of the cost of all items of the same nature over a period. When weightages are also applied in the computation, it is termed as **weighted average cost**.

Bad Debts

Debts owed to an enterprise which are considered to be irrecoverable.

Balance Sheet

A statement of the financial position of an enterprise as at a given date, which exhibits its *assets, liabilities, capital, reserves* and other account balances at their respective *book values*.

Bill of Exchange

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.

Bonus Shares

Shares allotted by capitalization of the reserves or surplus of a corporate enterprise.

Book Value

The amount at which an item appears in the books of account or financial statements. It does not refer to any particular basis on which the amount is determined e.g., cost, replacement value, etc.

Borrowing costs

Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

Bond/Debenture

A formal document constituting acknowledgment of a debt by an enterprise usually given under its common seal and normally containing provisions regarding payment of interest, repayment of principal and security, if any. It is transferable in the appropriate manner.

Call

A demand pursuant to terms of issue to pay a part or whole of the balance remaining payable on shares or *debentures* after allotment.

Called-up Share Capital

That part of the subscribed share capital which shareholders have been required to pay.

Capital

Generally refers to the amount invested in an enterprise by its owners e.g. *paid-up share capital* in a corporate enterprise. It is also used to refer to the interest of owners in the assets of an enterprise.

Capital Assets

Assets, including *investments* not held for sale, conversion or consumption in the ordinary course of business.

Capital Commitment

Future *liability* for capital expenditure in respect of which contracts have been made.

Capital Employed

The finances deployed by an enterprise in its *net fixed assets*, *investments* and *working capital*. Capital employed in an operation may, however, exclude *investments* made outside that operation.

Capital Profit/Capital Loss

Excess of the proceeds realised from the sale, transfer, or exchange of the whole or a part of a capital asset over its cost. When the result of this computation is negative, it is referred to as **capital loss**.

Capital Reserve

A *reserve* of a corporate enterprise which is not available for distribution as *dividend*.

Capital Work-in-progress

Expenditure on *capital assets* which are in the process of construction or completion.

Cash

Cash comprises cash on hand and demand deposits with banks

Cash equivalents

Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash Basis of Accounting

The method of recording transactions by which *revenues* and *costs* and *assets* and *liabilities* are reflected in the accounts in the period in which actual receipts or actual payments are made.

Cash Discount

A reduction granted by a supplier from the invoiced price in consideration of immediate payment or payment within a stipulated period.

Cash Profit

The *net profit* as increased by non-cash costs, such as *depreciation, amortization*, etc. When the result of the computation is negative, it is termed as **cash loss**.

Carrying amount

Carrying amount is the amount at which an asset is recognized in the balance sheet, net of any accumulated amortization and accumulated impairment losses thereon.

Charge

An encumbrance on an asset to secure an indebtedness or other obligations. It may be fixed or floating.

Cheque

A *bill* of exchange drawn upon a specified banker and not expressed to be payable otherwise than on demand.

Collateral Security

Security which is given in addition to the principal security against the same *liability* or obligation.

Costs of disposal

Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.

Contingency

A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

Contingent Asset

An *asset* the existence, ownership or value of which may be known or determined only on the occurrence or non-occurrence of one or more uncertain future events.

Contingent Liability

An obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

Contra Account

One or two or more accounts which partially or wholly off-set another or other accounts.

Cost

The amount of *expenditure* incurred on or attributable to a specified article, product or activity.

Cost of Purchase

The purchase price including duties and taxes, freight inwards and other *expenditure* directly attributable to acquisition, less *trade discounts*, rebates, duty drawbacks, and subsidies in respect of such purchase.

Cost of Goods Sold

The cost of goods sold during an accounting period. In manufacturing operations, it includes (i) cost of materials; (ii) labour and factory overheads; selling and administrative expenses are normally excluded.

Conversion Cost

Cost incurred to convert raw materials or components into finished or semi-finished products. This normally includes costs which are specifically attributable to units of production, i.e., direct labour, direct expenses and subcontracted work, and production overheads as applicable in accordance with either the *direct cost* or *absorption costing method*. Production overheads exclude expenses which relate to general administration, finance, selling and distribution.

Convertible Debenture

A *debenture* which gives the holder a right to its conversion, wholly or partly, in shares in accordance with the terms of issue.

Cumulative Dividend

A *dividend* payable on *cumulative preference shares* which, if unpaid, accumulates as a claim against the earnings of a corporate enterprise, before any distribution is made to the other shareholders.

Cumulative Preference Shares

A class of preference shares entitled to payment of *cumulative dividends*. Preference shares are always deemed to be cumulative, unless they are expressly made non-cumulative.

Current Assets

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 Liability

Liability including loans, deposits and bank overdraft which falls due for payment in a relatively short period, normally not more than twelve months.

Deferral

Postponement of recognition of a revenue or expense after its related receipt or payment (or incurrence of a *liability*) to a subsequent period to which it applies. Common examples of deferrals include prepaid rent and taxes, unearned subscriptions received in advance by newspapers and magazine selling companies, etc.

Deficiency

The excess of *liabilities* over *assets* of an enterprise at a given date. The debit balance in the *profit and loss statement*.

Deficit

The debit balance in the profit and loss statement.

Depletion

A measure of exhaustion of a wasting asset represented by periodic write off of cost or other substituted value.

Depreciation

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

Depreciable amount

Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

Depreciable assets

Depreciable assets are assets which

(i) are expected to be used during more than one accounting period; and

(ii) have a limited useful life; and

(iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

Depreciation Method

Any method of calculating depreciation for an accounting period.

Depreciation Rate

A percentage applied to the historical cost or the substituted amount of a *depreciable asset* (or in case of *diminishing balance method*, the historical cost or the substituted amount less *accumulated depreciation*).

Diminishing Balance Method

A method under which the periodic charge for *depreciation* of an *asset* is computed by applying a fixed percentage to its historical cost or substituted amount less *accumulated depreciation* (net book value). This is also referred to as **written down value method**.

Discount

A reduction from a list price, quoted price or invoiced price. It also refers to the price for obtaining payment on a bill before its maturity.

Dividend

A distribution to shareholders out of profits or reserves available for this purpose.

Entity Concept

The view of the relationship between the accounting entity and its owners which regards the entity as a separate person, distinct and apart from its owners.

Equity Share

A share which is not a preference share. Also sometimes called **ordinary share**.

Exchange difference

Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

Expenditure

Incurring a *liability*, disbursement of cash or transfer of property for the purpose of obtaining *assets*, goods or services.

Expense

A cost relating to the operations of an accounting period or to the *revenue* earned during the period or the benefits of which do not extend beyond that period.

Expired Cost

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

Extraordinary items

Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

Fair value

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

Fair Market Value

The price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

First Charge

A *charge* having priority over other charges.

First In, First Out (FIFO)

Computation of the cost of items sold or consumed during a period as though they were sold or consumed in order of their acquisition.

Fixed asset

Asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

Fixed Cost

That cost of production which by its very nature remains relatively unaffected in a defined period of time by variations in the volume of production.

Fixed Deposit

Deposit for a specified period and at specified rate of interest.

Fixed or Specific Charge

A *charge* which attaches to a particular *asset* which is identified when the charge is created, and the identity of the *asset* does not change during the subsistence of the *charge*.

Floating Charge

A general *charge* on some or all *assets* of an enterprise which are not attached to specific *assets* and are given as security against a debt.

Financial Instrument

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

Foreign currency

Foreign currency is a currency other than the reporting currency of an enterprise.

Forfeited Share

A share to which title is lost by a member for non-payment of call money or default in fulfilling any engagement between members or expulsion of members where the articles specifically provide therefor.

Free Reserve

A *reserve* the utilization of which is not restricted in any manner.

Functional Classification

A system of classification of *expenses* and *revenues* and the corresponding *assets* and *liabilities* to each function or activity, rather than by reference to their nature.

Fund

An account usually of the nature of a *reserve* or a *provision* which is represented by specifically earmarked *assets*.

Fundamental Accounting Assumptions

Basic accounting assumptions which underlie the preparation and presentation of financial statements. They are *going concern*, consistency and *accrual*. Usually, they are not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

Gain

A monetary benefit, *profit* or advantage resulting from a transaction or group of transactions.

General Reserve

A *revenue reserve* which is not earmarked for a specific purpose.

Going Concern Assumption

An accounting assumption according to which an enterprise is viewed as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.

Goodwill

An *intangible asset* arising from business connections or trade name or reputation of an enterprise.

Gross Margin or Gross Profit

The excess of the proceeds of goods sold and services rendered during a period over their *cost*, before taking into account administration, selling, distribution and financing expenses. When the result of this computation is negative it is referred to as **gross loss**.

Government

Government refers to government, government agencies and similar bodies whether local, national or international.

Government grants

Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Gross book value

Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value.

Income and Expenditure Statement

A financial statement, often prepared by non-profit making enterprises like clubs, associations etc. to present their *revenues* and *expenses* for an accounting period and to show the excess of *revenues* over *expenses* (or vice versa) for that period. It is similar to profit and loss statement and is also called **revenue and expense statement**.

Intangible Asset

Asset which does not have a physical identity e.g. *goodwill*, patents, copyright etc.

Inventories are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Investment

Expenditure on assets held to earn interest, income, profit or other benefits.

Investments

Assets held not for operational purposes or for rendering services i.e. assets other than *fixed assets* or *current assets* (e.g. securities, shares, *debentures*, immovable properties).

Issued Share Capital

That portion of the *authorized share capital* which has actually been offered for subscription. This includes any *bonus shares* allotted by the corporate enterprise.

Joint venture

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

Last In, First Out (LIFO)

Computation of the cost of items sold or consumed during a period on the basis that the items last acquired were sold or consumed first.

Liability

The financial obligation of an enterprise other than owners' funds.

Lien

Right of one person to satisfy a claim against another by holding or retaining possession of that other's *assets*/property.

Long-term Liability

Liability which does not fall due for payment in a relatively short period, i.e., normally a period not more than twelve months.

Lease

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

Materiality

An accounting concept according to which all relatively important and relevant items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements are disclosed in the financial statements.

Mortgage

A transfer of interest in specific immovable property for the purpose of securing a loan advanced, or to be advanced, an existing or future debt or the performance of an engagement which may give rise to a pecuniary *liability*. The security is redeemed when the loan is repaid or the debt discharged or the obligations performed.

Net Assets/Shareholders' funds/Net Worth

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**.

Net Fixed Assets

Fixed assets less accumulated depreciation thereon up-to-date.

Net Profit/Net loss

The excess of *revenue* over *expenses* during a particular accounting period. When the result of this computation is negative, it is referred to as **net loss**. The net profit may be shown before or after tax.

Net realizable value

Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Obsolescence

Diminution in the value of an asset by reason of its becoming out-of date or less useful due to technological changes, improvement in production methods, change in market demand for the product or service output of the asset, or legal or other restrictions.

Operating Profit

The *net profit* arising from the normal operations and activities of an enterprise without taking account of extraneous transactions and expenses of a purely financial nature.

Paid-up Share Capital

That part of the *subscribed share capital* for which consideration in cash or otherwise has been received. This includes *bonus shares* allotted by the corporate enterprise.

Preference Share Capital

That part of the *share capital* of a corporate enterprise which enjoys preferential rights in respect of payments of fixed *dividend* and repayment of *capital*. Preference shares may also have full or partial participating rights in surplus profits or surplus capital.

Preliminary Expenses

Expenses relating to the formation of an enterprise. These include legal, accounting and share issue expenses incurred for formation of the enterprise.

Prepaid Expense

Payment for expense in an accounting period, the benefit for which will accrue in the subsequent accounting period(s).

Prime Cost

The total *cost* of direct materials, direct wages and other direct production expenses.

Prior Period Item

Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

Profit/Loss

A general term for the excess of *revenue* over related *cost*. When the result of this computation is negative it is referred to as **loss**.

Profit and Loss Account

A financial statement which presents the *revenues* and *expenses* of an enterprise for an accounting period and shows the excess of *revenues* over *expenses* (or vice versa). It is also known as **profit and loss account**.

Promissory Note

An instrument in writing (not being a bank note or 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.

Provision

An amount written off or retained by way of providing for *depreciation* or diminution in value of assets or retained by way of providing for any known *liability* the amount of which cannot be determined with substantial accuracy.

Provision for Doubtful Debts

A *provision* made for debts considered doubtful of recovery.

Prudence

A concept of care and caution used in accounting according to which (in view of the uncertainty attached to future events) *profits* are not anticipated, but recognised only when realised, though not necessarily in cash. Under this concept, *provision* is made for all known *liabilities* and losses, even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

Redeemable Preference Share

The preference share that is repayable either after a fixed or determinable period or at any time decided by the management (by giving due notice), under certain conditions prescribed by the instrument of incorporation or the terms of issue.

Redemption

Repayment as per given terms normally used in connection with preference shares and debentures.

Reserve

The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a *provision* for *depreciation* or diminution in the value of assets or for a known *liability*. The reserves are primarily of two types: *capital reserves* and *revenue reserves*.

Revaluation Reserve

A *reserve* created on the revaluation of *assets* or *net assets* of an enterprise represented by the surplus of the estimated replacement cost or estimated market values over the *book values* thereof.

Residual value

Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

Revenue/Income

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

Revenue Reserve

Any reserve other than a capital reserve.

Right Share

An allotment of shares on the issue of fresh *capital* by a corporate enterprise to which a shareholder is entitled on payment, by virtue of his holding certain shares in the enterprise in proportion to the number of shares already held by him. (Shares allotted to certain categories of *debenture* holders pursuant to the rights enjoyed by them are sometimes called right shares)

Sales Turnover/Gross Turnover/Gross Sales

The aggregate amount for which sales are effected or services rendered by an enterprise. The terms **gross turnover** and **net turnover** (or **gross sales** and **net sales**) are sometimes used to distinguish the sales aggregate before and after deduction of returns and trade discounts.

Secured Loan

Loan secured wholly or partly against an asset.

Share Capital

Aggregate amount of money paid or credited as paid on the shares and/ or stocks of a corporate enterprise.

Share Discount

The excess of the face value of shares over their issue price.

Shareholders' Equity

The interest of the shareholders in the *net assets* of a corporate enterprise. However, in the case of liquidation it is represented by the residual assets after meeting prior claims.

Share Issue Expenses

Costs incurred in connection with the issue and allotment of shares. These include legal and professional fees, advertising expenses, printing costs, underwriting commission, brokerage, and also expenses in connection with the issue of prospectus and allotment of shares.

Share warrants

Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

Securities Premium

The excess of the issue price of shares over their face value.

Sinking Fund

A *fund* created for the repayment of a *liability* or for the replacement of an asset.

Straight Line Method

The method under which the periodic charge for *depreciation* is computed by dividing the *depreciable amount* of a *depreciable asset* by the estimated number of years of its useful life.

Subscribed Share Capital

That portion of the *issued share capital* which has actually been subscribed and allotted. This includes any *bonus shares* allotted by the corporate enterprise.

Substance over Form

An accounting concept according to which the substance and not merely the legal form of transactions and events governs their accounting treatment and presentation in financial statements.

Sundry Creditors / Trade Creditors/Trade payables

Amount owed by an enterprise on account of goods purchased or services received or in respect of contractual obligations. Also termed as **trade creditors** or **account payables** or **Trade payables**.

Sundry Debtors / Trade Debtors/ Trade Receivables

Person from whom amounts are due for goods sold or services rendered or in respect of contractual obligations. Also termed as **debtors, trade debtors, account receivables, trade receivables**.

Surplus

Credit balance in the *profit and loss statement* after providing for proposed appropriations, e.g., *dividend* or *reserves.*

Trade Discount

A reduction granted by a supplier from the list price of goods or services on business considerations other than for prompt payment.

Unexpired Cost

That portion of an *expenditure* whose benefit has not yet been exhausted.

Unissued Share Capital

That portion of the *authorised share capital* for which shares have not been offered for subscription.

Unpaid Dividend

Dividend which has been declared by a corporate enterprise but has not been paid, or the warrant or *cheque* in respect whereof has not been dispatched within the prescribed period.

Useful life

Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise