DCAM-02

VARDHAMAN MAHAVEER OPEN UNIVERSITY, KOTA

FUNDAMENTALS OF ACCOUNTING

DCAM-02

Vardhaman Mahaveer Open University, Kota

Fundamentals of Accounting

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Fundamentals of Accounting

Unit - 1 Introduction to Accounting

Structure of Unit:

1.0 Objectives

After completing this unit, you will be able to:

- Define and understand the meaning of accounting
- Explain the objectives of accounting
- Explain the scope of accounting
- Explain the need of accounting
- Make distinction between book-keeping and accounting
- Explain the accounting process
- Identify and explain the basics of accounting
- Use the general terms used in accounting

1.1 Introduction

Accounting discipline deals with measurement of economic activities affecting inflow and outflow of economic resources to develop useful information for decision making. At household level, information about inflow and outflow of cash resources helps to assess financial position and plan household activities.

At government level, information about inflow from taxes (direct as well as indirect) and expenditure on various activities (developmental and non-developmental) is needed for planning and budgeting. Although accounting can be thought of as a discipline having universal applicability, its growth is closely associated with the developments in 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 thereby creating economic information about business enterprises to facilitate decision making.

1.2 Meaning of Accounting

The main purpose of accounting is to ascertain profit or loss during a specified period, to show financial condition of the business on a particular date and to have control over the business organization's property. Such accounting records are required to be maintained to measure the income of the business and communicate the information so that it may be used by managers, owners and other parties. Accounting is a discipline which records, classifies, summarises and interprets financial information about the activities of a business concern so that intelligent decisions can be made about the business concern.

The American Institute of Certified Public Accountants has defined Accounting as - “Accounting is an art of recording, classifying, and summarising in a significant manner and in terms of money transactions and events which in part, at least of a financial character, and interpreting the results thereof”.

American Accounting Association defines accounting as “the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information.”

Of late accounting is being regarded as a service activity. The Accounting Principles Board (APB) or AICPA in its statement No. 4 (1970) has given the following definition of accounting: “Accounting is a service activity. Its function is to provide quantitative information primarily of financial nature about economic entities that is intended to be useful in making economic decisions, in making reasoned choices among alternative courses of action. Accounting includes several branches, e.g. financial accounting, cost accounting, managerial accounting, government accounting etc.”

Thus, accounting is not merely concerned with recording, classifying or summarising the transactions but also an important tool for providing appropriate information to the management for decision making.

The analysis of the above definitions brings out the following as attributes of accounting:

(i) It is the art of recording and classifying business transactions and events.

(ii) The events and transactions of a financial nature must be recorded in monetary terms, while the events and transactions of a non-financial nature cannot be recorded.

(iii) The record should reflect the importance of the transactions so recorded both individually and collectively, which includes summarization, thereby making it amenable to analysis.

(iv) The users of the financial statements should be able to obtain the message encompassed in such financial statements, and it is the knowledge of accounting, which enables the user to understand the contents of the financial statements.

(v) It is an art of making summarisation, analysis, and interpretation of the events and transactions.

(vi) The results of such analysis must be communicated to the persons who are to make decisions or form judgments.

Activity A:

Define accounting and explain its attributes.

1.3 Objectives of Accounting

The starting point for any area of study is to set forth its boundaries and determine its objectives. Developments in the field of science and mathematics have brought about a significant change in the field of accounting. The whole concept of accounting has changed. Accounting has to be versatile system serving a large number of goals of modern business and industry simultaneously. The type of accounting information useful to management in taking decisions is not necessarily the same as is needed by shareholders, prospective investors, creditors and others. Different accounting principles may be required to meet the several objectives of accounting.

The main objectives of accounting are as follows:

(i) **Accounting is required to keep and maintain systematic records of a business:** Accounting is a means of recording the monetary transactions and events. Accounting is done to keep and maintain a systematic record of financial transactions and events. In the absence of accounting there would have been terrific burden on human memory which, inmost cases would have been impossible to bear. In accounting, systematic record of monetary aspects of business transactions and events are maintained, the first step in preparation of financial statements. This is referred to as book-keeping. After recording daily business transactions and events in an orderly manner, recorded information is classified and then, summaries are prepared. Thus, accounting is a wider term and includes, besides book-keeping, preparation of financial statements and their analysis and interpretation.

(ii) **To protect business properties:** Accounting provides protection to business properties from unjustified and unwarranted use. This is possible on account of accounting supplying the following information to the manager or the proprietor:

- The amount of the proprietor's fund invested in the business.
- How much the business have to pay to others?
- How much the business has to recover from others?
- How much the business has in the form of (a) fixed-assets, (b) cash in hand, (c) cash at bank, (d) stock of raw-materials, work-in-progress and finished goods?

Information about the above matters helps the proprietor in assuring that the funds of the business are not unnecessarily kept idle or underutilised.

(iii) **To ascertain the operational profit or loss:** Accounting is required to ascertain the earning of the business concerns, which is achieved by preparation of profit and loss account. To ascertain profit earned or losses suffered during a period of time, a business organization prepares an income statement. It is also referred to as trading and profit & loss account. To calculate operational profit or loss for a period of time, revenues and other incomes are aggregated and expenses incurred during that period are subtracted from the aggregate of revenue and other incomes. Revenue refers to the value of goods sold or services rendered. Other incomes include rent, interest, dividend and/ or royalty received from the parties who use business properties, fund, rights etc.

Expenses mean the amount of resources used or lost to earn revenue and other incomes. Excess of revenue and other incomes over expenses is termed as profit. However, if expenses are more than the aggregate of revenues and other incomes then the loss is suffered by the business organization. Hence, it essentially involves recognising revenues and expenses and matching them to establish the results of the business.

Thus, Profit (or Loss) = Revenues and other incomes - Expenses

(iv) Accounting is required to identify the obligations (Liabilities) and resources (asset) of the business organization. In addition to profit (or loss), sound decision-making requires information about the financial position of a business organization. To depict financial position of a business, financial position statement is prepared. On one hand, it gives details of resources owned by the business organization. Resources owned are termed as assets. On the other hand, it contains information about obligations of business. Obligations of the business towards outsiders and the owner are referred to as liabilities and capital respectively. Financial position statement is also termed as balance sheet which provides information about sources of finance (e.g. outside liabilities and owner's equity) and the resources (e.g. assets) of the business.

(v) Accounting records are required to portray the liquidity position. Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, cash dividends and other distributions of resources by the organization to owners, and about other factors that may affect an enterprise's liquidity and solvency.

(vi) Accounting records are required to control over the property and assets of the firm. Accounting provides up-to-date information about the various assets that the firm possesses and the liabilities the firm owes so that nobody can claim a payment which is not due to him.

(vii) Accounting records are required to file tax returns. This is the objective which hardly needs emphasis. The credible accounting records provide the best bases for filing returns of both, direct as well as indirect taxes.

(viii) Accounting records are required to be maintained statutorily by central government and regulatory bodies.

(ix) Accounting records are required to make financial information available to various groups and users. Accounting is called the language of business. It aims to communicate information about financial results and financial position of a business enterprise to decision-makers. Various groups like owners, investors, management, creditors, financial institutions, employees, government, researchers, customers, public etc. need this information for sound decision-making. Thus, accounting aims to meet the information needs of the decision-makers and helps them in rational decision-making. This is done through financial statements, namely, "Income Statements" and "Position Statement". It must be understood properly that there are general purpose statement designed to cater primarily to external user groups.

Activity B:

Define accounting and explain its objectives.

1.4 Scope of Accounting

Accounting is as old as money itself. However, the act of accounting was not as developed as it is today because in the early stages of civilisation, the numbers of transactions to be recorded were so small that each businessman was able to record and check for himself all his transactions. Accounting was practiced in India twenty five centuries ago as it is clear from the "Kautilyia Arthashastra". The Arthashastra of Kautilyia not only relates to politics and economics, but also explains the art of proper keeping of accounts. However, the modern system of accounting based on the principles of Double Entry System owes its origin to *Lucas Pacioli* who first published the principles of Double Entry System in 1494 at *Venice* in Italy. Thus, the art of accounting has been practiced for centuries but it is only in the late nineteen thirties that the study of the subject "Accounting" has been taken up seriously.

In the recent years large scale production, cut throat competition, widening of the market and changes in the technology have brought remarkable changes in the field of accounting. In the words of *Gordon and Gordon Shilling Law*: "It has come to be recognised as a tool for mastering the various economic problems which a business organisation may have to face. It systematically writes the economic history of the organisation. It provides information that can be drawn upon by those responsible for decision affecting the organisation's future. This history is written mostly in quantitative terms. It consists partly of files of data, partly of reports summarising various portions of these data, and partly of the plan established by management, to guide its operations."

Accounting plays a key role in serving a systematic and up-to-date record of varied and numerous business transactions. Its target is to analyse the financial transactions as they take place, to record them in orderly fashion, to group and arrange the information in terms of useful and understandable financial report (Balance Sheet, Income Statement) and to assist in the process of interpretation.

Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is useful in making economic decisions, in making reasoned choices among alternative course of action.

To be more useful, accounting should provide various information in an integral information system. The primary objective of accounting is to take decision on various matters based on accounting data provided through different financial statements. Accounting is thus not an end itself but a means to an end. It is mainly a service function. In broad perspective an accounting system should concern itself with the following information:

- Analysis of past financial data to find out the reasons for bad condition of the concern and corrective measures for improvement of the business.
- Accounting is an art, on the other hand, it is the application of knowledge comprising of some accepted theories, rules, concepts and conventions. It helps us to achieve our goals and tells us the manner in which we may attain our objectives in the best possible way. The more we practice an art the more expert we become in it.
- Accounting is a science because recording, classifying and summarising of business transactions is done on the basis of certain principles of double entry system which are universally applicable.
- Accounting seems to be very important in financial forecasting and financial forecasting helps in estimating the profitable projects and out of these profitable projects accountant chooses the one which is more profitable for the concern.
- For decision-making accounting is useful. Accounting helps the accountants to take decision about capital structures, cost of capital, an ideal capital gearing ratio, capital budgeting, working capital, cash, budget, cost control, inventory management etc.
- Accounting is a technique which compares the cost of various departments and thus find out which department is efficient than the other.
- As is common with physicians, engineers, lawyers, and architects, accountants (including CPAs) commonly are engaged in professional practice or are employed by business, government entities, non-profit organisations and so on.
- Accounting can be classified into the following categories : (i) Financial accounting (ii) Management accounting (including Cost accounting), (iii) Auditing (iv) Others like Price level changes accounting, Social cost accounting, Social auditing, Human resource accounting, Forensic accounting, Creative accounting, Value added accounting etc.

Activity C:

What is accounting? Explain its Scope.

1.5 Need of Accounting

Accounting, being a man-made system, has evolved over a period of time to provide financial information of a business enterprise to users of accounting information. A large number of groups with varied interests in affairs of business enterprise have emerged over a period of time, especially after emergence of corporate form of organisation involving separation of ownership and management.

The main points of need of accounting are as follows:

(i) Accounting information needs of shareholders have assumed great significance in the corporate business world because of separation of ownership and management in case of joint stock companies. Owners are interested in the financial information, to know about safety of amount invested and return on amount invested.

(ii) For managing business profitably, information about financial results and financial position is needed by management. By providing this information accounting helps managers in efficient and smooth running of a business organization.

(iii) Prospective investors would like to know about the past performance of the business organization before making investment in that concern. By analysing historical information provided by accounting records, they can arrive at a decision about the return and the risk involved in investing in a particular business organization.

(iv) Creditors and Financial institutions, whosoever is extending credit or loan to a business organization would like to have information about its repaying capacity, credit worthiness etc. The required information can be obtained by analysing and interpreting the financial statements of the business organization.

(v) Employees are concerned about job security and future prospects. Both of these are intimately related with the performance of the business concern. Thus, by analysing financial statements they can draw conclusions about their job-security and future prospects.

(vi) Government policies relating to taxation, providing subsidies etc. are guided by relevance of the industry in the economic development of the country and the past performance of the industry. Information about past performance is provided by the accounting system. Collection of taxes is also based on accounting records.

(vii) Researchers need financial information for testing hypothesis and development of theories and models. The financial statements provide the required information.

(viii) Customers who have developed loyalties to a business are certainly interested in the continuance of the business. They certainly want to know about the future directions of the organization with which they are associating themselves. The way to information about the organization is through their financial statements.

(ix) An enterprise affects the public at large in many ways, such as a provider of employment to a number of persons, being a customer to many suppliers, a provider of amenities in the locality, a cause of concern to the public due to pollution etc. Hence, public at large is interested in knowing the future directions of organization and the only window to peep inside the organization is their financial statements.

(x) Members of non-profit organizations such as schools, colleges, hospitals, clubs, charitable institution to know how their contributed funds are being utilised and to ascertain if the organization deserves continued support or support should be withdrawn keeping in view the bad performance depicted by the accounting information and diverted to another organization. In knowing the performance of such organizations, criterion will not be the profit made but the chief criterion will be the service provided to the society.

Above mentioned points of need of accounting and accounting information are not exhaustive. Anyone having an interest in the business enterprise can use information for decision-making.

Activity D:

Explain need of accounting.

1.6 Book-keeping and Accounting

Book-keeping is the science and art of correctly recording in books of accounts all those business transactions that result in the transfer of money or money's worth. Book-keeping is recording of the financial transactions of a business in a methodical manner so that information on any point in relation to them may be quickly obtained.

A book-keeper may be responsible for keeping all the financial records of a business or only a minor segment such as maintenance of the customer's accounts in a department store. Much of the work of a book-keeper is clerical in nature and can be accomplished through the use of mechanical and electronic equipment. Thus, book-keeping is more of a routine work. Book-keeping is a part of accounting. Recording of business transactions in original books and posting into ledger is book-keeping. It is thus, the first stage of accounting. It is also said that accounting starts where book-keeping ends.

On the other hand, Accounting is primarily concerned with the design of the system of records, the preparation of reports based on the recorded data, the interpretation of the reports and finally communicating the results of the interpretation to persons who are interested in such results. Accountants often direct and review the work of book-keepers. The work of accountants at the beginning may include some book-keeping but accountants must possess a much higher level of knowledge, conceptual understanding and analytical skill than is required of the book-keepers.

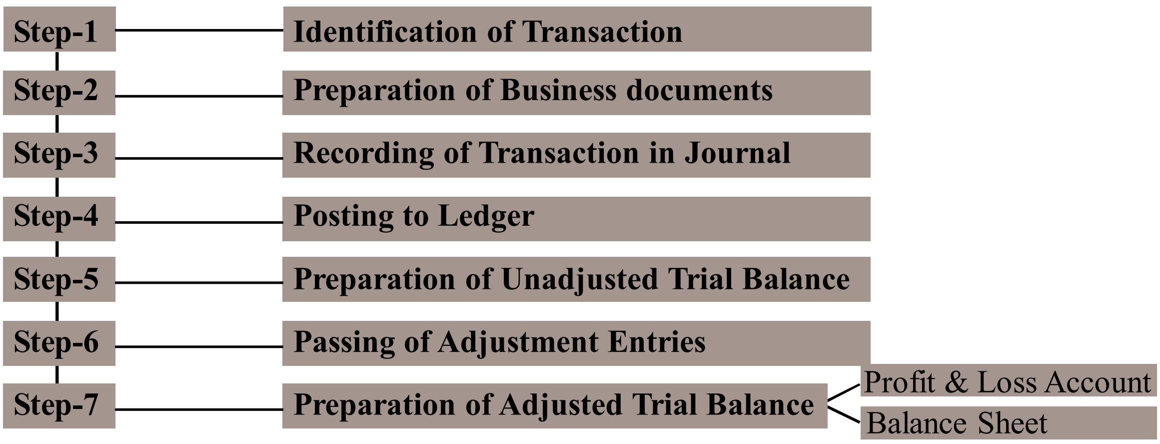
Welsch and Anthony have beautifully given the distinction between book-keeping and accounting as follows:

“Some people naively confuse a book-keeper with an accountant and book-keeping with accounting. In effect they confuse one of the minor parts with the whole of accounting. It is tantamount to comparing the simple administration of first aid with the complex practice of medicine by the physician. Book-keeping is the routine and clerical side of accounting and requires only minimal knowledge of the accounting model. A book-keeper records the repetitive and uncomplicated transactions in most businesses and may maintain the simple records of a very small business. In contrast, the accountant is a professional competent in the design of information system, analysis of complex economic events, interpretative and analytical processes, reporting, financial advising, and management consulting.

Activity E:

Differentiate between Book-keeping and Accounting.

1.7 Accounting Process



Accounting is best known as the language of business and it communicates the results of the business. As the accepted *lingua franca* in addition to being the medium of communication it also satisfies the role of understanding the existing as well as potential additions to the available literature. As with every credible language, Accounting also has its own rules and syntax which comprises the principles on which the system is based - known as the Generally Accepted Accounting Principles, Accounting Standards, US GAAP, etc. The Indian Accounting Standards, International Accounting Standards, forming the theoretical base of Accountancy, and the Double Entry Book-keeping for recording the transactions provides the practical base of the system.

To communicate the necessary, vital and relevant information, the requirements of the prospective users are identified and a systematic process is adhered to resulting in the formation of 'Financial Statements'. They are primarily the Income Statement and the Position Statement more commonly known as the 'Trading & Profit and Loss Account' and the 'Balance Sheet' respectively. The major purposes of these statements basically are :

- providing information which in turn becomes the basis for exercising decisions and actions by the potential users.
- reflecting the financial progress and present health of the business.
- aiding in the formulation of policies and procedures for the smooth and efficient conduct of the business.
- enabling the management to discharge their obligations and stewardship functions effectively.

In earlier times there used to be no distinction between the ownership and the management and was concerned only with providing information to the owners. But with their separation and the increasing emphasis on the business being managed by qualified and competent professionals, the role and purpose of financial accounting has undergone a paradigm shift to that of stewardship thereby highlighting the accountability aspect of managing the enterprise.

The cause of the new orientation is the increasing reliance by the interested entities such as shareholders, investors, trade creditors, employees, customers, statutory authorities like Income tax and Excise departments, the government and other agencies. They do not have any participation in the management of the affairs of the organisation and as such collect the required information from the financial statements. Such interest displayed by a varied group of constituents necessitates the presentation of a true and fair portrayal of the financial conduct of the business.

This has underscored the need for developing accounting concepts, principles and standards to ensure that accounting information serves the needs of various users. Also, to impart credibility to the reported financial statements, these are required to be attested by professional accountants who perform the task of auditing (which involves examination and verification) before expressing their opinions on the financial statements.

Accounting consists of creation of financial information and the subsequent use of such information. Creation entails three steps namely Recording, Classifying and Summarizing which are described below:

(A) Recording:

a. What to record: All the events and transactions which affect the business have to be recorded in accordance with the principles of accounting. As money is the common unit of measurement all such events are to be expressed in monetary terms, and thus those which do not facilitate such transaction will not be recorded. Distinction is to be maintained between the owner's transactions and that of the entity engaged in commercial activities.

b. When to record: Accounting is historical in nature because of which the recording is to be effected only after the occurrence of the subject transaction. Therefore, sale of goods cannot be recorded in the Books of Account when the goods are merely intended to be sold out only after such sale is complete and the property in the goods has been transferred to the buyer. There are a few exceptions to this rule like the Provision for income tax, etc.

c. How to record: As mentioned above, the Double Entry Book-keeping system is the practical base of accounting. Entries are passed in the Journal and the entries are called Journal Entries. Suffice to state for the present that a journal entry is based on the premise of every transaction affecting the business in two ways. Kindly note that the perfection of the concept of Journal Entry is at the core of the entire Accounting system.

d. Value at which it is to be recorded: All the ingredients of the financial statements are to be assigned appropriate values. Money is the scale of measurement in accounting and we can measure only those which can be translated into monetary terms. However, it ought to be kept in mind that money changes and does not remain stable over time. Hence money as a unit of measurement is not stable in dimension for comparison over time. Value refers to the benefits to be derived from objects and different valuation bases are used in accounting, of which, the frequently used are Historical cost, Current cost, Realizable value and Present value.

Historical cost is the amount paid or payable to acquire a benefit. This is also the most commonly used measurement. Assets are recorded at the cash paid or the fair value of the consideration given at the time of acquisition. Liabilities are recorded at the amount of value received in exchange for the obligation or, in certain cases like taxes, at the expected amount to be paid to discharge the amount due. Please note that there are exceptions to this rule and your attention shall be drawn at the relevant places.

Current cost is the amount that needs to be paid if the asset is to be acquired currently.

Realisable value is the net amount collectable in the event of the asset's disposal.

Present value is the present discounted value of the future inflows that an item is expected to generate in the normal course of business.

(B) Classifying:

Refers to the rational segregation of the recorded information into related groups so as to make the record useful. The book containing such classified information is called the Ledger Book consisting of a number of accounts each complete in its own way. For example, all the receipts forming inflows and the payments forming outflows are grouped to ascertain the net cash position of the firm. The arrangement in this case is better known as the Cash Book. The mechanism for classification is to open accounts called ledger accounts.

(C) Summarizing:

After the Recording and Classification phases are complete the accounts containing relevant information in the Ledger Book are to be balanced and the balances listed. The Statement giving names of these accounts and their respective balances is called the Trial Balance. On the basis of the Trial Balance the summaries are generated to provide information about the Profit/Loss and the Position of the firm. The reporting of these summaries is done through Financial Statements.

Financial Statements can be said to include the Balance Sheet, the Profit and Loss Account, Notes to the Accounts and other incidental statements and explanatory material which are identified as part of financial statements.

Activity F:

What is an Accounting process?

1.8 Basics of Accounting

For recording business transactions of business organization, there are three approaches of accounting which are widely accepted: (a) Cash basis of accounting (b) Accrual basis of accounting (c) hybrid or Mixed basis of accounting. As you know, all business transactions ultimately result into realisation of revenue or incurring of expense. Truely speaking, the approaches to accounting which are to be discussed here tell how revenues and expenses are to be recognised.

(a) Cash Basis of Accounting

Under the cash basis of accounting actual cash receipts and actual cash payments are recorded. Credit transactions are not recorded at all and are ignored till the cash is actually received or paid.

Income is merely the difference between the cash receipts and cash payments. The Receipts and Payments Account prepared in case of non-trading concerns such as a charitable institution, a club, a school, a college etc. and professional men like lawyer, doctor, a chartered accountant etc. can be cited as the best example of cash basic of accounting.

Advantages of cash basis of accounting:

The main advantages of cash basis of accounting are as follows:

1. Cash basis of accounting has considerable appeal to many people because it is so simple, appears to be so realistic, is verifiable and satisfies the conservative instinct.

2. Cash basis of accounting approach is more objective as very few estimates and judgments are required.

3. Cash basis of accounting is suitable for those enterprises where most of the transactions are on cash basis.

Disadvantages of cash basis of accounting:

The main disadvantages of cash basis of accounting are as follows:

1. Cash basis of accounting does not give a true and fair view of profit and loss and financial position of the organization because it ignores outstanding and prepaid expenses and accrued income and income received in advance.

2. Cash basis of accounting does not follow matching principle of accounting.

3. Cash basis of accounting does not distinguish between capital and revenue items and as a result there is no consistency in the profits of the two years.

4. In cash basis of accounting actual cash inflows and outflows are considered, there is great possibility of profit manipulation e.g., payments may be delayed or proposed, similarly incomes may be postponed or collected early.

Illustration 1

During the financial year 2009-10 Shyam had cash sales of Rs. 2,70,000 and credit sales of Rs. 1,80,000. His expenses for the year were Rs. 2,10,000 out of which 90,000 is still to be paid. Find out Shyam's income for 2009-10 following cash basis of accounting.

Solution

	Rs.
Revenues (Inflows of cash)	2,70,000
Less: Expenses (outflows of cash)	1,20,000
Profit 150,000	

Working Notes :

1. Credit sales and expenses outstanding will not be considered in cash basic of accounting.
2. Expenses or outflow of cash = Total expenses of the year - outstanding expenses

(b) Accrual Basis of Accounting

Due to disadvantages of the cash basis of accounting, the accrual basis of accounting has been developed by accountants. In this accounting approach every cash receipt cannot be treated income for determining the true profit of the accounting entity of the period. Accrual basis of accounting rejects the circumstances of receipt or payment of cash as criteria for associating either income or expense with a period. Rather this basic of accounting is based on concept of realisation and expiration and follows two basic accounting principles viz. the revenue recognition and the matching principle. On the accrual basis of accounting, the income whether received or not but has been earned or accrued during the period forms past of the total income of that period e.g., sales made on credit will be included in the total sales of the period irrespective of the fact when cash is actually realised. Similarly, if the firm has taken benefit of a particular service, but has not paid within that period, the expense will relate to the period in which the service has been utilised and not to the period in which the payment for it is made, e.g., rent due to the landlord but not paid will be taken as an expense for the period when it is due and not in the period when it is paid.

Thus, under accrual basis of accounting net income for a period is the result of matching of revenue realised in the period and costs expired during the period.

Advantages of Accrual basis of accounting:

The main advantages of accrual basis of accounting are as follows:

1. Accrual basis of accounting is preferred by accountants as it is more scientific as compared to cash basis of accounting.
2. The accrual basis of accounting gives a complete picture of the financial transactions of the business as it makes a record of all transactions relating to a period and takes into account adjustments like outstanding expenses, prepaid expenses, income received in advance and income earned but not received etc.
3. The accrual basis of accounting discloses correct profit or loss for a particular period and also exhibit true financial position of the business on a particular day.
4. Accrual basis of accounting has wide acceptability as the Companies Act, 1988 has amended section 209 of the companies Act, 1956 with effect from 15th June 1988 requiring companies to maintain their accounts on accrual basic of accounting so that fairest possible periodic net income and the financial position may be reported to the public.

Disadvantages of accrual basis of accounting:

The main disadvantages of accrual basic of accounting are as follows :

1. Accrual basis of accounting is not as simple as cash basis of accounting.
2. In accrual basis of accounting a quick appraisal of the profit or loss is not possible as a lot of adjustments are required for finding the true financial position of the business.
3. The accrual basis of accounting is too elaborative.

Illustration 2

During the financial year 2009-10 Shyam had cash sales of Rs. 2,70,000 and credit sales of Rs. 1,80,000. His expenses for the year were Rs. 2,10,000 out of which 90,000 is still to be paid. Find out the net income according to accrual basis of accounting.

Solution

Total Sales = Cash Sales (Rs. 2,70,000) + Credit Sales (Rs. 1,80,000)

Revenues = Rs. 2,70,000 + Rs. 1,80,000	= Rs. 4,50,000
Less: Total Expenses for the year	= Rs. 2,10,000
Profit	= Rs. 2,40,000

Working Notes :

1. Rs. 90,000 expenses still to be paid belongs to this year and hence are to be charged to the revenue of this year.
2. Credit sales of Rs. 1,80,000 are taken in the year in which sale transaction is effected.

Difference between Accrual Basis of Accounting and Cash Basis of Accounting

	Accrual Basic of Accounting		Cash Basic of Accounting
1	Under accrual basic of accounting there may be outstanding expenses, prepaid expenses, accrued income and income received in advance in he Balance Sheet.	1	Under cash basic of accounting there is no outstanding or prepaid expenses and income accrued or received in advance in the Balance Sheet.
2	In this system Income statement will show relatively higher income if there are items of prepaid expenses and accrual income.	2	In this system Income statement will show lower income in case there are items of prepaid expenses and accrued income.
3	In this system Income statement will show relatively lower income if there are items of outstanding expenses and income received in advance.	3	In this system Income statement will show relatively higher income if there are items of outstanding expenses and income received in advance.
4	Accrual basic of accounting is recognised under the Companies Act, 1956.	4	This basic of accounting is not recognised under the Companies Act, 1956.
5	Under accrual basic of accounting the accountant has the option of following alternative method of depreciation (i.e. SLM or DBM) or method of valuation of inventory (i.e. LIFO or FIFO etc.)	5	Under this basic of accounting the accountant has no such option to follow alternative method of depreciation or valuation of inventory.
6	Enterprises with cash and credit transactions prefer this accrual basic of accounting.	6	Enterprises with mostly cash transactions prefer this cash basic of accounting.
7	Business enterprises with profit motive ascertain their profit or loss under accrual basic of accounting.	7	Professional people like doctors, lawyers, etc. and small non-trading concerns ascertain their profit or loss under cash basic of accounting.
8	Accrual basic of accounting is a reliable system because it makes a complete record of all cash and credit transactions. It ascertains correct profit or loss.	8	It is not a reliable basic of accounting because accurate profit or loss can not be ascertained under this cash basic of accounting.
9	This accrual basic of accounting is technical because it involves the adjustments of accounts for preparing the final accounts.	9	Cash basic of accounting is simple because it does not require any technical knowledge.
10	This accrual basic of accounting being based on a complete record of the financial transactions gives a true and fair view of profit or loss for particular period and also exhibits true financial position of the business on a particular day.	10	Cash basic does not give true and fair view of profit or loss and the financial position of the business because it does not take in to consideration outstanding transactions.

(c) Mixed or Hybrid Basis of Accounting

Cash basis of accounting is by far the simplest system whereas the accrual basis of accounting is scientific and reliable. So accountants have tried to club these advantages of the two systems and have come up mixed or hybrid basis of accounting. Under mixed basis of accounting both cash basis and accrual basis are followed. Incomes are recorded on cash basis whereas expenses are taken on accrual basis. The net income is ascertained by matching expenses on accrual basis with income on cash basis. This is the most conservative basis of ascertaining income because all possible expenses relating to the period whether actually paid or not are considered whereas income only received in cash is taken into consideration. When all the expenses are taken into account, there is reduction in taxable income and hence this system is popular among professionals like advocates, doctors, lawyers, chartered accountants etc.

Illustration 3

Gopal supplies you the following information about his income and expenses for the financial year 2009-10.

	Rs.
Expenses paid	1,60,000
Expenses paid in advance	40,000
Expenses not paid yet	20,000
Income received	2,40,000
Income received in advance	30,000
Income not yet received	24,000

Find out the net income or profit of Gopal if he adopts (a) Cash basic of accounting (b) Accrual basic of accounting (c) Hybrid basic of accounting.

Solution

(a) Cash Basis

	Rs.
Revenues :	
Income received	2,40,000
Less: Expenses :	
Expenses paid	1,60,000
Profit	80,000

(b) Accrual Basis

	Rs.
Revenues :	
Income received	2,40,000
+Income not received yet	24,000
- Income received in advance	30,000
	(A) 2,34,000
Expenses :	
Expenses paid	1,60,000
+ Expenses not paid yet	20,000
- Expenses paid in advance	40,000
	(B) 1,40,000

Profit = (A) - (B) = 2,34,000 - 1,40,000 = Rs. 94,000

(C) Hybrid Basics

Revenues : Rs.	
Income received	2,40,000
Expenses :	
Expenses paid	1,60,000
+ Expenses not paid yet	20,000
- Expenses paid in advance	40,000
	1,40,000

Profit = Revenues - Expenses
= 2,40,000 - 1,40,000
= Rs.1,00,000

Factors Common to Every Business

To have a clear understanding of the Double Entry System, it is necessary to keep in mind the following factors which are common to every business:

1. The business organization has to enter into business dealings with a number of persons or firms or companies etc. So, an account of each person or firm or company, with whom the business organization has business dealings, is opened. Such accounts are known as Personal Accounts.

2. The business enterprises must necessarily have some assets such as stock, cash, furniture, building, machinery etc., with the help of which the business enterprise may be carried on. Therefore, an account of each asset in the business enterprise is opened. Such accounts are classified as Real or Property Accounts.

3. There must be certain sources from which the income of the business enterprise is derived. Similarly certain expenses must be incurred to earn the income. Therefore, an account of each expense and income is opened in the books. Such accounts are known as Nominal or Fictitious Accounts.

Thus, three types of accounts, namely, Personal Accounts, Real or Property Accounts and Nominal or Fictitious Accounts are opened to keep a complete record of all the financial transactions of the business organization.

Double Entry System

Double entry system owes its origin to an Italian merchant named Lucas Pacioli who wrote the first book entitles 'De Computis et Scripturis' on double entry accounting in the year 1494. We have seen earlier that every business transaction has two aspects. i.e., when we receive something, we give something else in return. For example, when we purchase goods for cash, we receive goods and give cash in return; similarly in a credit sale of goods, goods are given to the customer and the customer becomes debtor for the amount of goods sold to him. This method of writing every transaction in two accounts is known as Double Entry System of Accounting. Of the two accounts, one account is given debit while the other account is given credit with an equal amount. Thus, on any date, the total of all debits must be equal to the total of all credits because every debit has a corresponding credit.

Rules of the Double Entry System

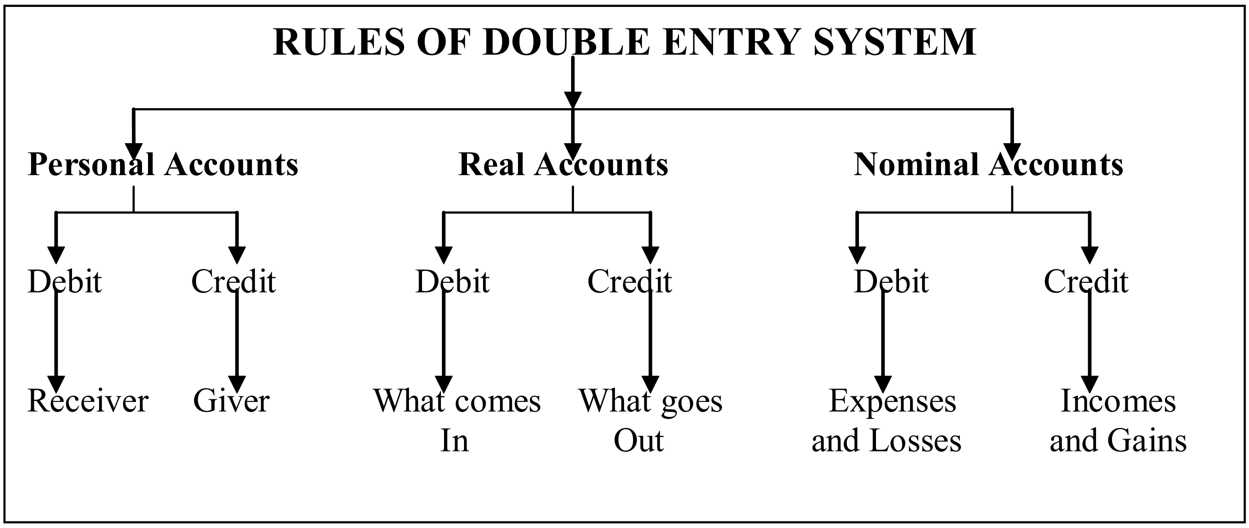
There are separate rules of the double entry system in respect of personal, real and nominal accounts which are discussed below:

1. Personal Accounts. These accounts record a business's dealings with persons or firms or companies. The person receiving something is given debit and the person giving something is given credit. For example, if Ram sells goods to Raman on credit, Raman's account will be given debit (in Ram's books) as he is the receiver of goods and Ram's account will be credited (in Raman's books) as he is the giver of goods. When Raman makes the payment for these goods, Ram's Account will be debited in Raman's books as he is the receiver of cash and Raman's Account will be given credit in Ram's books as he is the giver of cash. So, the rules is: debit the receiver and credit the giver.

2. Real Accounts. These are the accounts of assets such cash, stock, goods, furniture, building, plant etc. Asset entering the business is given debit and asset leaving the business is given credit. For example, when goods are sold for cash. Cash Account will be given debit as cash comes in and Goods Account will be credited as goods go out. So, the rule is: debit what comes in and credit what goes out.

3. Nominal Accounts. These accounts deal with expenses, incomes, gains, profits and losses. Accounts of expenses and losses are debited and accounts of incomes, gains and profits are credited. For example, when salary is paid to an employee, Salary Account will be debited as it is an expense and Cash Account (real account) will be credited as it goes out. Similarly when dividend is received, Cash Account will be debited as cash is received and Dividend Account will be credited as it is an income. Thus, the rule is : debit all expenses and losses and credit all incomes and gains.

The rules of double entry system are shown in the following chart:



Analysis of Transactions:

To make a correct record of the transaction, each transaction must be analysed. The following questions may be asked in this respect:

(i) Which are the two accounts involved in the transaction to be recorded?

(ii) Whether the two accounts involved in the transaction are personal, real or nominal?

(iii) What rules of debit and credit are applicable to the accounts involved?

(iv) Which account should be debited or credited?

The above method will make the recording of transactions more simple and easy. The chart given on the next page explains the procedure of analysing the transactions.

Activity G:

What is an Accounting process?

1.9 Summary

The primary function of accounting is to provide relevant financial information to users for making decisions and taking actions. The primary means of providing financial information to investors, Creditors and other external users is through financial statements.

Accounting, being a man-made system, has evolved over a period of time to provide financial information of a business enterprise to users of accounting information. A large number of groups with varied interests in affairs of business enterprise have emerged over a period of time, especially after emergEnce of corporate form of organisation involving separation of ownership and management. Accounting, is rightly called the language of business, communicates financial information to variety of users by developing financial reports/statements. To satisfy the need of different users, differ branches of accounting has come into existence.

This unit covers the meaning and definitions of accounting; attributes of accounting; main objectives of accounting; scope of accounting; need of accounting; differentiation between book-keeping and accounting; Accounting process; Basic of accounting or approaches of accounting, which are widely accepted - (a) Cash basic of accounting, (b) Accrual or Mercantile basic of accounting, and (c) Hybrid or Mixed basic of accounting; Summary; Key words; Self-assessment questions etc.

THE CHART OF ANALYSIS OF TRANSACTIONS

Transactions	Two Accounts Involved	Classification of Accounts	Rule for Debit and Credit	Explanation	Account to be debited with Rs.	Account to be Credited with Rs.
Started business with Rs. 1,50,000	Cash	Real	Debit what comes in	Cash enters the business	Cash 1,50,000	----
	Capital	Personal	Credit the giver	Proprietor is giver of cash	----	Capital 1,50,000
Purchased furniture	Furniture	Real	Debit what comes in	Furniture comes in	Furniture 40,000	----
for Rs. 40,000 on	Ramesh	Personal	Credit the giver	Ramesh is a giver of furniture	----	Ramesh 40,000
credit from Ramesh						
Goods purchased for	Purchases	Real	Debit what comes in	Goods comes in the business	Purchase 1,20,000	----
cash Rs. 1,20,000	Cash	Real	Credit what goes out	Cash goes out of the business	----	Cash 20,000
Goods sold to Dayal	Dayal	Personal	Debit the receiver	Dayal is a receiver of goods	Dayal 25,000	----
For Rs. 25,000 on credit	Sales	Real	Credit what goes out	Goods go out of the business	----	Sales 25,000
Paid salaries to staff	Salaries	Nominal	Debit the expenses &	Salaries are expenses	Salaries 28,000	----
Rs. 28,000	Cash	Real	Credit what goes out	Cash goes out of the business	----	Cash 28,000
Goods worth Rs. 5000	Sales Return	Real	Debit what comes in	Goods come in the business	Sales Return 5000	----
returned by Dayal	Dayal	Personal	Credit the giver	Dayal is the giver of goods	----	Dayal 5000
Rs. 5000 Commission	Cash	Real	Debit what comes in	Cash comes in the business	Cash 5000	----
received	Commission	Nominal	Credit all incomes	Commission is income	----	Commission 5000
			and gains			

1.10 Key Words

For proper understanding of accounting system, it is necessary to understand terms that are used in the business world. Some important terms are explained and reproduced below:

Assets : Tangible objects or intangible rights owned by an enterprise and carrying probable future benefits.

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 value.

Business Transactions : Any exchange of money or money's worth as goods and services between two parties is called a business transaction. It may relate to purchase and sale of goods, receipts and payment of cash and rendering of services by one party to another.

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.

Drawings : Any amount or goods withdrawn by the owner of a business for personal use is called drawings.

Expenditure : Incurring a liability, disbursement of cash or transfer of property for the purpose of obtaining assets, goods or services.

Expense : The cost relating to the operation of an accounting period or the revenue earned during the period or the benefit or which do not extend that period.

Goods : This includes all articles, commodities or merchandise in which the business deals. Thus, cloth would be goods for a dealer in cloth, furniture would be goods for a dealer in furniture and so on.

Goodwill : An intangible asset arising from business connection or trade name or reputation of an enterprise.

Income : It is the favourable change in owner's equity which results from business operations. In other words, income is an inflow of assets which results in an increase in the owner's equity.

Inventory : Tangible property held for sale in the ordinary course of business, or in the process of the production for such sale, or the consumption in the production of goods or services for sale, including maintenance supplies and consumable other than machinEry spares.

Liability : The financial obligation of an enterprise other than owner's funds.

Loss : A loss is expenditure without any benefit to the concern. On the other hand, expense is incurred to result in some benefits.

1.11 Self Assessment Questions

1. Define Accounting. How does it differ from Book-keeping?
2. What is accounting? Explain objectives and need of accounting.
3. What do you mean by accounting process? What are the steps involved in accounting process?
4. What are the Basics / approaches of accounting? Explain.
5. Explain the scope and need of accounting.

6. Define the following Key words:
   (i) Capital
   (ii) Sundry creditors
   (iii) Sundry debtors
   (iv) Revenue
   (v) Expense
   (vi) P & L Account
   (vii) Balance Sheet
7. State whether the following statements are true or false:
   a. Accounting deals with quantifiable information.
   b. Accounting aims to communicate financial information to investors only.
   c. The term book-keeping and accounting can be used interchangeably.
   d. Financial accounting provides information for management.
   e. Income statement reveals the result of operations during a particular period of time.
   f. Book-keeping includes interpretation of financial statements.
   g. Business obligations towards outsiders are termed as liabilities.

1.12 Reference Books

1. Lal Jawahar, Accounting Theory.
2. Rathnam, Accounting and Financial Management.
3. Gupta, Advanced Accountancy.
4. Jain , Khandelwal; Pareek; Menaria;Salvi, Financial Accounting.
5. Shukla; Grewal; Gupta, Advanced Account.
6. Aaker,D.A.;Anthony,Robert N, Accounting Principles.

Unit - 2 Accounting Concepts, Conventions, Basic Accounting Terms

Structure of Unit:

2.0 Objectives

After studying this unit, you would be able to:

- Understand the introduction of theory base of accounting.
- Explain the nature of accounting concepts and conventions.
- Understand the meaning and purpose of various accounting concepts and conventions used in preparation of financial statements.
- Understand the meaning of basic accounting terms.
- Explain the accounting equation.

2.1 Introduction

Accounting aims to communicate and report on the economic activities of business concern through general purpose financial statements with a view to aid external users groups in decision-making. As accounting communicates financial information for decision-making to parties outside the reporting enterprise, it is necessary that financial statements of different enterprises are prepared on uniform basis and an enterprise maintains consistency in preparation of financial statements over a period of time. If, every business enterprise could follow its own notion about the accounting terms like revenue, expenses, assets, liabilities, income etc., there will be complete chaos. To have uniformity and consistency in preparation and presentation of financial statements accounting operates within a framework of 'Generally Accepted Accounting Principles' (GAAP); follows a conceptual framework and adheres to the 'Accounting Standards (AS) issued by the regulatory authority for standardisation of accounting policies to be adopted under specific circumstances. The term GAAP is used to describe rules developed for preparation of financial statements and is variously called concepts, conventions, axioms, postulates, principles, modifying principles etc. The conceptual framework of accounting deals with users, attributes, objectives, elements, creation and presentation of financial statements. Accounting standards are the policy documents issued by the regulatory accountancy body, relating to various aspects of measurement, treatment and disclosure of accounting transactions and events with a view to harmonize and standardize accounting policies. GAAP, conceptual framework and accounting standards are referred to as the theory base of accounting.

Accounting, being a man-made system, must evolve and adjust itself to the changes in needs of the mankind. As a result, the theory base of accounting comprising of accounting principles, conceptual framework and policy documents is not as exact and rigid as laws of natural sciences. It is bound to be inexact as it is part of a social system. It must be clearly understood that accounting theory is not and probably will never be in a completely stable state. It is constantly evolving and is influenced by changes in the social, legal and economic environment; needs of users of financial information and professional accountancy bodies like the Institute of Chartered Accountants of India (ICAI), the American Institute of Certified Public Accountants (AICPA), International Accounting Standards Board (IASB), and Financial Accounting Standards Board (FASB) etc.

The GAAP are the building blocks of the accounting language. Rather, they are the pillars on which the structure of accounting information is created. If we remove these principles, the entire structure of accounting will come down, The GAAP, which the makers and users of accounting information should understand before analysis and interpretation of financial statements, includes accounting principles.

Accounting principles can be classified into two categories:

(i) Accounting concepts, and
(ii) Accounting conventions.

2.2 Accounting Concepts

Accounting concepts may be considered as postulates i.e., basic assumptions or conditions upon which the science of accounting is based. There is no authoritative list of these concepts but most of the concepts have fairly general support. These are given below:

(i) Separate Entity Concept

This concept implies that a business unit is separate and distinct from the person who supplies capital to it. Irrespective of the form of organisation, a business unit has got its own individuality as distinguished from the person who own or control it. The accounting equation (i.e. Assets = Liabilities + Capital) is an expression of the entity concept because it shows that the business itself owns the assets and in term owns the various claimants. Business is kept separate from the proprietor so that transactions of the business may also be recorded with him. In case this concept is not followed affairs of the business will be mixed up with the private affairs of the proprietor and the true picture of the business will not be available. For example, if the proprietor of the business invests Rs. 25,000 into the business it will be deemed that he has given that much of money to the business as a loan which will be shown as a liability in the books of the company. On receipt of the amount, Cash Account will be debited and the Proprietor's Capital Account will be credited. Similarly, on withdrawal of the amount from the business for personal use of the proprietor, the Proprietor's Capital or Drawings Account will be debited and Cash Account will be credited.

Legally, however, a sole proprietor is personally liable for his business debts and may be required to use non-business assets (i.e. his private assets) to make the payment to his business creditors. Conversely, business assets are not immune from claims of the sole proprietor's personal creditors. In the eyes of law business and non-business assets and liabilities are treated alike in case of a sole proprietor. Similarly, in case of a partnership firm, business assets of the firm are used first for paying business liabilities of the firm and if a surplus remains after paying the firm's liabilities, a partner can use his share of the surplus for the payment of his private liabilities. In the same way, private assets of the individual partners are first utilised for the payment of their individual private liabilities and if there is a surplus in any partner's private estate, it shall be treated as part of partnership property and can be utilised for the payment of firm's liabilities.

In case of joint stock companies, there is a legal distinction between the owners (i.e. shareholders) and the business. Shareholders are not liable for the debts of their company beyond the amount of capital they have agreed to subscribe. The accounting treatment of capital contributed by shareholders is the same as it is in the case of sole trader and partnership, except of course that the capital of a joint stock company is divided into a number of shares. Thus the effect to the business entity concept in case of a joint stock company is to recognise its separate identity from that of its shareholders.

(ii) Stable Money Measurement

Numerous transactions affect the business in varied ways. However, recording, classification and, particularly, summarisation of these heterogeneous business transactions requires that these transactions are expressed in terms of a common unit of measurement. For accounting, we assume that money serves as a common denominator for expressing business transactions. Hence, transactions, even if they affect the results of the business materially, are not recorded if they are not convertible in money terms.

Money provides a standard of exchangeability and implicit assumption is that changes in the purchasing power of monetary unit are not of sufficient importance as to require adjustment. The changes in the purchasing power of the monetary unit are caused by the changes in the prices. Price level change is a common phenomenon but for accounting purpose, it is ignored.

To access the financial health of a business, it is necessary that total value of assets and liabilities are determined. Suppose, a business enterprise has following resources (assets) and obligations (liabilities): **(i)** A three-storey building constructed on a 1000 sq. m. plot; **(ii)** Furniture consisting of ten chairs, five tables and five godrej almirahs; **(iii)** Rs. 10,000 cash; **(iv)** 2,000 units of a product held for resale; **(v)** Amounts to be received from credit customers for 200 units sold on credit basis; **(vi)** Rs. 30,000 payable to the Punjab National Bank on account of loan; **(vii)** Amount payable to the supplier for 600 units of a product supplied on credit basis.

From the above details, it is very difficult to assess the financial health of the business. To make this information meaningful from the point of view of the users of accounting information, it is necessary that these assets and liabilities are expressed in terms of a common unit. In the absence of the common denominator, a 1000 sq.m. plot, ten chair sets expressed in heterogeneous units cannot be added to provide a meaningful figure. After expressing all assets and liabilities in rupees, total assets and total liabilities can be easily calculated. To calculate net worth of a business, total liabilities are subtracted from the total assets. However, using money as a unit of measurement gives rise to the following limitations:

- **Non-Monetary Events:** For accounting, all transactions are to be expressed in terms of money. It means all those transactions or events which cannot be expressed in terms of money will not be recorded. Thus, non-monetary events which cannot be expressed in terms of money are excluded. Accounting is supposed to ascertain the results of business and there are many events, which though affect the results of business materially are not recorded because they are not convertible in money terms. For example, entrance of a new competitor in the market, rift between production and marketing department, ill health of the managing director etc. are significant but will not find any place in accounting records. Thus, users of accounting information should not expect to get a complete picture of the business events from accounting records. They must be aware of the fact that records of non-monetary events, howsoever significant they may be, are not kept.

- **Fluctuation in the value (or purchasing power) of money:** Fluctuation in the purchasing power of money are inversely related with fluctuations in the level of prices. Money serves as a common denominator only when there are no significant changes in the level of prices and, consequently, the purchasing power of money. But the fact is that significant changes in the level of prices are experienced in day to day life. As a result, financial statements fail to depict the accurate picture of the business. However, in the absence of any other generally acceptable unit which could replace money unit, money is still used as a common-unit of measurement.

(iii) Going Concern Concept

It is assumed that a business unit has a reasonable expectation of continuing business at a profit for an indefinite period of time. A business unit is deemed to be a going concern and not a gone concern. It will continue to operate in the future. Transactions are recorded in the books keeping in view the going concern aspect of the business unit. It is because of this concept that suppliers supply goods and services and other business firms enter into business transactions with the business unit. Suppliers will not supply goods and services and other person will not have business dealings with the business entity if they have the feelings that the concern will be liquidated. This assumption provides much of the justification for recording fixed assets at original cost (i.e. acquisition cost) and depreciating them in a systematic manner without reference to their current realisable value. It is useless to show fixed asset in the Balance Sheet at their estimated realisable value if there is no immediate expectation of selling them. Fixed assets are acquired for use in the business for earning revenues and are not meant for resale, so they are shown at their book values and not at their current realisable values. But when the concern is not a going concern and is to be liquidated, current realisable values of fixed assets become relevant.

Similarly, the going concern concept supports the treatment of prepaid expenses as assets even though they may be virtually unsaleable. Prepaid expenses are made assets on the assumption that the business entity will continue in future and the benefit of prepaid expenses will be utilised in future. A less direct effect of the going concern concept is that it lays emphasis on the determination of net income rather than on the valuation of assets. The earning capacity of the business entity is more significant than the market value of its individual assets in judging the overall worth of a business. Because of this emphasis on the earnings, the accountant directs his attention to the proper allocation of incomes and expenses to the current period and does not bother about the market value of fixed assets which will not be sold.

The following are the cases where going concern concept is not valid:

1. When an enterprise was set up for a particular purpose which has been achieved or to be achieved shortly.
2. When a company is declared sick by BIFR.

3. When an enterprise has been in the grip of severe financial crisis and is expected to wind up shortly.

4. When a receiver or liquidator has been appointed in case of a company which is to be liquidated.

(iv) Accounting Period Concept

Truly speaking, the measurement of income or loss of a business entity is relatively simple on a whole-life basis. A complete and accurate picture of the degree of success achieved by a business unit cannot be obtained until it is liquidated, converts its assets into cash and pays off its debts. On liquidation, it is possible to determine with finality its net income. But the owners, the investors and overall the Government, all are impatient and do not want to wait, until the dissolution of the concern, to know what has been the result of the business activities. All these persons are interested in regular reports and accounts at proper intervals to know "how things are going?" This means that the final accounts must be prepared on a periodic basis rather than waiting till the business is terminated.

Under the going concern concept it is assumed that a business entity has a reasonable expectation of continuing business for an indefinite period of time. This assumption provides much of the justification that the business will not be terminated, so it is reasonable to divide the life of the business into accounting period so as to be able to know the profit or loss of each such period and the financial position at the end of such a period.

Normally accounting period adopted is one year as it helps to take any corrective action, to pay income tax, to absorb the seasonal fluctuations and for reporting to the outsiders. A period of more than one year reduces the utility of accounting data.

The principle of segregating capital expenditure from revenue expenditure is based on the accounting period concept. The revenue expenditure for a particular period is transferred to the Profit and Loss Account of that period whereas capital expenditure is carried forward to the extent its benefit will be utilised in future accounting periods. Thus, the accounting period concept plays a very important role in determinate of the income of a particular accounting period. It is also helpful in ascertaining the true and fair view of the financial position of a business entity on a particular data and at a particular point of time.

(v) Cost Concept

The cost is the monetary price for the acquisition of assets for the business enterprise. Cost concept implies that an asset is recorded in the account books at a price paid to acquire it. The original or acquisition cost relates to past and, therefore, it is referred to as historical cost. It is the basis for the valuation of the assets in the financial statements. Further, the cost concept means original or acquisition cost less depreciation charges on that asset. For example, suppose that a building was purchased in the year 2007 at a cost price of Rs. 5,00,000. In the year 2007 and afterwards this asset will be shown in the balance sheet at a cost price of Rs. 5,00,000 less depreciation.

The effect of cost concept seems to be irrelevant when the price of the asset goes on increasing in the market. In such a case, the balance sheet does not exhibit a true financial position of the business. It has, therefore, become a matter of dispute among the accountants as to whether the assets should be shown in the balance sheet at historical cost or at current cost. But the majority of the accountants are in favour of disclosing the assets in the balance sheet at historical cost because it is very difficult to ascertain the current cost of the assets, specially for those assets on which depreciation has been charged. They also feel that the technology has not developed considerably and it is difficult to ascertain the current cost of the ancient machines. If the current cost is ascertained on the basis of price index, there are many difficulties in getting the relevant price index.

It is still a matter of controversy as to whether the current cost be ascertained on the basis of price index of the country or the companies should prepare their price index for each asset separately. In view of these difficulties, the majority of the accountants still feel that the assets should be valued on historical cost price basis and the cost concept implies this aspect.

(vi) Revenue Recognition (or Realisation) concept

Business enterprises utilise resources to earn revenue by sale of goods or rendering of services. American Accounting Association defines revenue as "the monetary expression of the aggregate of products or services transferred by an enterprise to its customers during a period of time" and according to Robert N. Anthony "revenue is considered as being earned on the date at which it is realised, that is the date when goods or services are furnished to the customers in exchange for cash or for other valuable consideration".

Thus revenue is considered as being realised or earned on the date when the sale process is complete and transfer of title or ownership takes place. It results in increase in owner's equity. It has nothing to do with inflow of cash. Goods can be sold for cash or on credit. Thus, earning of revenue is different from cash collection from customers.

Generally, revenue is considered as realised or earned in the accounting sense on *sale basis* i.e., at the time when goods are transferred with title or services are rendered or when the sale process is virtually complete. However, in some exceptional cases, following alternatives are used for recognition of revenue:

Cash Basis: In case of doubt about the collection of amount, revenue is considered as realised only when cash is received. In this case collection of revenue earned instead of earning of revenue, assumes importance. For example, lawyers, chartered accountants, doctors and other professional generally record revenue when the amount is actually received.

Production Basis: Revenue is recognised at the time of production when :

1. Product can be marketed easily at an objectively determined price. For example, in case of gold, as marketing of the product is not a problem and the price is capable of objective measurement, revenue is recognised in the period in which gold is mined.
2. In case of long-term contracts, contractor may elect to take up revenue as earned or realised on the basis of percentage of work completed during a particular accounting period. This will help in staggering the revenue over the period of contract. If total revenue is recognised in the year of final completion, it may create problem from income-tax point of view.

(vii) Expense Recognition Concept

Expense refers to the portion of the cost outlay (or expenditure) which is consumed in the process of obtaining revenue in an accounting period. Expenses decrease owner's equity. It connotes resources consumed to produce and sell goods and/or to render services. It means that a portion of the revenue earned represents the recovery of cost of resources used and the surplus, if any, is termed as income. Thus, recognition of expenses is very important to obtain information about income.

Expenses need to be distinguished from 'Expenditure'. Expenditure leads to outflow of economic resources from the business. However, this outflow can be useful to the business in two ways:

- Either, it gives benefit over the current accounting period, for example, salaries paid to the staff, rent paid for the premises etc. Such expenditures are called 'Revenue Expenditures'. Since the benefit expires in the current accounting period itself, they are treated as expenses of the current accounting period; or
- It gives benefit over many accounting periods to come, for example, cost paid for acquiring

a machinery expected to run for 10 years. Such expenditures are called 'Capital Expenditure'. Since its benefit extends over many accounting periods, the portion used or consumed or expired during current year (called depreciation) is treated as an expense and unexpired portion is taken to the balance sheet as an asset of the business. In other words, the cost of fixed asset is systematically allocated over its useful economic life.

According to American Accounting Association "Expense is given recognition in the period in which there is (a) a *direct* identification or *association with the revenue* of the period, as in case of merchandise delivered to the customer, (b) an *indirect association with the revenue* of the period, as in case of office salaries or rent, or (c) a measurable expiration of asset cost even though *not associated with the production of revenue* for the current period, as in cases of losses from flood or fire". It also includes systematic allocation of capital expenditures, the benefits of which occur in the current accounting period as in case of depreciation.

Thus, cost of resources consumed, which is also termed as expired cost or expense, may be directly or indirectly related with obtaining of revenue including portion of capital expenditure allocated to the period (called **utilised cost**) and sometimes it is lost within the period under consideration without any association with the production of revenue during the relevant period (called **lost cost**).

In nutshell, cost is the total outlay or expenditure on acquiring resources required for production of goods or rendering of services. Cost of resources utilised and lost during a particular period is termed as expired cost or expense and is charged to the revenue of the period to obtain information about income. Costs of resources remaining unutilised or unexpired at the end of the period are carried forward to the next accounting period and are termed as assets.

(viii) Matching Concept

This concept recognises that the determination of profit or loss on a particular accounting period is a problem of marketing the expired cost allocated to an activity period. In other words, the expenses which are actually incurred during a specific activity period, in order to earn the revenue for the said period must be matched against the revenue which are realised for that period. For this purpose, expenses which are specially incurred for earning the revenue of the related period are to be considered. In short, all expenses incurred during the activity period must not be taken. Only relevant cost should be deducted from the revenue of a period for periodic income statement, i.e., the expenses that are related to the accounting period shall be considered for the purpose of matching. This process of relating costs to revenue is called matching process. It should be remembered that cost of fixed asset is not taken but only the depreciation on such fixed asset related to the accounting period is taken (For the purpose of matching, prepaid expenses are excluded from the cost but outstanding expenses are added to the total cost for ascertaining the cost related to the period). Like costs all revenues earned during the period are not taken, but revenue which are related to the accounting period are considered.

Application of matching concept created some problems which are noted below:

(a) Some special items of expenses e.g., preliminary expenses, expenses in connection with the issue of shares and debentures, advertisement expenses etc., cannot be easily identified and matched against revenues of a particular period.

(b) Another problem is that how much of the capital expenditure should be written off by way of depreciation for a particular period for matching against revenue created the problems of finding out the expected life of the asset. As such, accurate matching is not possible.

(c) In case of long term contracts usually, amount is not received in proportion to the work done. As a result, expenditures which are carried forward and not related to the income received, may create some problems.

(ix) Dual Aspect Concept

It can easily be seen that in business, as elsewhere, funds can be raised in any of the following ways:

- Additional capital (increases owners' equity)
- Additional loans (increases outside liability)
- Earning revenue (increases owners' equity)
- Making profits (increases owners' equity)
- Disposing or reducing some of the assets (reduces assets).

Thus, all increases in liabilities (including owners' equity) and reduction in assets represent sources of funds.

Similarly, the funds thus raised, may be put to any of the following uses :

- Purchasing of assets (increases assets)
- Incurring operational expenses (decrease owners' equity)
- Discharging earlier liabilities (decreases liability)
- Keeping idle funds so that cash balance increases (increases assets)
- Suffering losses (decreases owners' equity).

Thus all reflection must reveal that in a business, the sum of the Source of Funds must equal the sum of *Uses of Funds*. This is because, whatever funds are raised by the business, either through capital or operations or from outsiders, must be tied up in one or the other form of uses.

Thus the dual aspect concept implies that:

- Owners' Equity + Outside Liability = Assets

This equation is known as the 'Fundamental Accounting Equation'. We shall see that the entire mechanics of financial accounting revolves around this equation. The various liabilities and assets that appear in the Balance Sheet are governed by the concepts just mentioned above.

(x) Objective Evidence Concept

Objectivity connotes reliability, trustworthiness and verifiability, which means that there is some evidence in ascertaining the correctness of the information reported. Entries in accounting records and data reported in financial statements must be based on objectively determined evidence. Without close adherence to this principle, the confidence of many users of the financial statements could not be maintained. Invoices and vouchers for purchases and sales, bank statements for amount of cash at bank, physical checking of stock in hand etc. are examples, of objective evidence which are capable of verification. As far as possible, every entry in accounting records should be supported by some objective evidence. Evidence should be such which will minimise the possibility of error and intentional bias or fraud. Evidence is not always conclusively objective for there are numerous occasions in accounting where judgments and other subjective factors play part. In such situation, it should be seen that most objective evidence available should be used. For example, the Provision for Doubtful Debts Account is an estimate of the losses expected from failure to collect sales made on credit. Estimation of this account should be made on such objective factors as past experience in collecting debtors and reliable forecasts of future business activities.

(xi) Accrual Concept

The essence of the accrual concept is that revenue is recognised when it is realised, that is when sale is complete or services are given and it is immaterial whether cash is received or not. Similarly, according to this concept, expenses are recognised in the accounting period in which they help in earning the revenue whether cash is paid or not. Thus, to ascertain correct profit or loss for an accounting period and to show the true and fair financial position of the business at the end of the accounting period, we make record of all expenses and incomes relating to the accounting period whether actual cash has been paid or received or not. Therefore, as a result of the accrual concept, outstanding expenses and outstanding incomes are taken into consideration while preparing final accounts of a business entity.

Activity A:

Examine the accounting concepts of money measurement, going concern and their significance in the preparation of financial statements.

2.3 Accounting Conventions

The Oxford Advanced Learner's Dictionary has defined the word 'Convention' as practice or custom based on general consent. **Kohler** has observed that convention is 'a statement or rule of practice which, by common consent, is implied in the solution of a given class of problems or guides behaviour in a certain kind of situation'. An axiom and convention may be indistinguishable, thus, the use of straight line depreciation for long is regarded as a convention, has tended to take on the character of an axiom. A convention dictates many of the activities of the public accountant, such as measures of materially, style and content of financial statements, the features of audit reports etc.

In International Accounting Standards, the conventions have been termed as accounting policies. In practice the generally accepted accounting policies are known as accounting conventions, which have been adopted by accountants for a long time.

Types of Accounting Conventions: The Accounting conventions are mainly of four types :

(i) Convention of Consistency
(ii) Convention of Full Disclosure
(iii) Convention of Conservatism
(iv) Convention of Materiality

These conventions have been discussed in detail hereinafter.

(i) Convention of Consistency: The Consistency convention implies that same accounting policies will be used for similar items over the year. In this way more meaningful inter-period comparisons can be made. If the income statement for the current period shows higher earnings than the preceding period, the user is entitled to assume that business operations have been more profitable provided there is no change in the accounting policies adopted by the enterprises. The business entity should be consistent in the accounting practices or principles in respect of the assets, equities, revenues and expenses.

It is only when the accounting principles are uniformly followed from year to year that the results obtained will be comparable. The rationale for this concept is that frequent changes in accounting treatment would make the Balance Sheet and the Income Statement unreliable for end users.

While giving audit reports the auditors have to certify that the accounting principles in preparing financial statements for a particular year are consistent with those of the previous year. But it should not be construed by this statement that the business enterprise cannot make changes in its accounting policies. If it wants to introduce any change in its accounting policies, it may do so. However, such a change should be reported in its financial statements and its effect on income statement and balance sheet should be shown separately.

(ii) Convention of Full Disclosure: Every business enterprise prepare its final accounts at the end of each financial year. The final accounts contain income statement and balance sheet. Quite a number of persons are interested in studying these statements. They include owners, employees, debtors, investors, Government, and consumers. Hence, it is necessary that the financial information as contained in these statements is reported objectively so that these statements may present a true and fair view of an enterprise.

Generally, it is observed that the companies in order to make their new share issue a success conceal their negative points and present a rosy picture of their establishment to the outsiders. Such a presentation is against the canons of accounting and is also contrary to law. On the other hand some cautious companies create secret reserves which are used in lean times to hide weakness. Both these situations are unjust and unethical. Hence, all the entities should present their financial statements in such a way that true and fair view of the enterprise is presented.

(iii) Convention of Conservatism: Conservatism is a policy of playing safe in the world of uncertainties. It is a quality of judgement to be exercised in evaluating risks and uncertainties present in the business to ensure that reasonable provisions are made for anticipated losses in the realisation of recorded assets and settlement of obligations. The working rule is: "anticipate no gains but provide for all possible losses, and if in doubt write it off." When applied to business income this convention results in the recognition of all losses that have been incurred or are likely to occur and to admit the gains only when they have been realised. According to this convention, care should be taken in valuing the current assets like closing stock which should be valued at lower of the cost or market price. If the value of closing stock has gone down in the market, it should be written down to the extent of reduction in value. But no 'write ups' should be followed if the market shows an upward trend, unless the goods are sold and the gain is actually realised. The convention of conservatism is based on the plea that the understatement of earnings and assets is less dangerously misleading than the overstatement.

(iv) Convention of Materiality: There may be a great deal of financial information which can be provided for any business, but in order to make financial statements more meaningful and to minimise costs, accountants should report only such information which is material. Materiality is an implicit guide for the accountants in deciding what should be disclosed in the financial statements. There is, however, some difficulty in defining materiality because this convention lacks operational definition. Most definitions of materiality stress the role of accountants' judgement in interpreting what is and what is not material. While at the same time stressing its importance, materiality is essentially a matter of professional judgement. An individual item should be judged material if the knowledge of that item could reasonably be deemed to have influence on the users of the financial statements. For example, suppose a waste paper basket is purchased in a business. Technically it is a fixed asset of the business as its life is likely to last for more than one accounting period. Therefore, annual depreciation should be provided on this asset. But, the amount spent on this purchase is so insignificant that the accountant may treat it as revenue expenditure and charge the whole amount to profit and loss account in the year of purchase.

Activity B:

Explain the accounting concept of income and show how its determination is influenced by accounting conventions.

2.4 Basic Accounting Terms

For proper understanding of accounting system, it is necessary to understand important terms that are used in the business world. Some important terms are reproduced below:

***Assets*:** Tangible objects or intangible rights owned by an enterprise and carrying probable future benefits.

***Liability*:** The financial obligation of an enterprise other than owners' funds.

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.

Expense: The cost relating to the operation of an accounting period or the revenue earned during the period or the benefit of which do not extend that period.

Income: Money or money equivalent earned or accrued during an accounting period, increasing the total of previously existing net assets and arising from sales and rentals of any type of goods or services commissions, interest, gifts, and recoveries from damage and windfalls from any outside source.

Expenditure: Incurring a liability, disbursement of cash or transfer of property for the purpose of obtaining assets, goods or services.

Revenue: The gross inflow of cash, receivables or other consideration arising in the course of 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. It excludes amounts collected on behalf of third parties such as certain taxes. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

Debtors: Persons from whom amounts are due for goods sold or services rendered or in respect of contractual obligations. Also termed as debtor, trade debtor, account receivable.

Creditors: Amount owed by an enterprise on account of goods purchased or services received or in respect of contractual obligations. Also termed as trade creditor or account payable.

Goods: Any item of merchandise, raw materials, or finished goods; a single element of wealth; a commodity.

Cost: Expenditure or outlay of cash, other property, capital stock or services or the incurring of a liability therefore, identified with goods or services acquired or with any loss incurred and measured by the amount of cash paid or payable or the market value of other property. Capital stock or services given in exchange or in other situations, any commonly accepted basis of valuation.

Stock: Tangible property held for sale in the ordinary course of business, or in the process of the production for such sale or the consumption, in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares.

Purchase: An outlay for property or service, the property or service acquired.

Sales: The aggregate amount for which sales are affected 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.

Profit: 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.

Loss: Any item of expense, as in the term profit and loss, decrease in assets or increase in liabilities during a period from peripheral, incidental or occasional transactions of an enterprise.

Gain: The net result of a concluded transaction or group of transactions or the transactions of an operating period, following the application of usual accounting rules or values appearing in income tax regulations. A gain or credit increases the capital or a loss or debit decreases it.

Voucher: A document which serves as evidence of the disbursement of cash. Example: a receipted bill; a cancelled cheque; a petty cash receipt; the carbon copy of a cheque. A document serving as evidence of the authority to disburse cash. Example: an approved invoice from a supplier.

***Discount*:** An allowance given for the settlement of a debt usually as a result of payment before it is due. It is called cash discount. While the discount allowed to a class of customers on a list price before consideration of credit terms; as Rule, invoice prices are recorded in the books of account net after the deduction of trade and quantity discounts.

***Transaction*:** An event or condition the recognition of which gives rise to an entry in accounting records. A transaction as conceived by the accountant is made up of an equality between credits and debits, the former representing, the source, the latter, the immediate identification and disposition.

***Drawings*:** Any amount or withdrawal by owner for his personal use is called drawings.

2.5 Accounting Equation

Modern accounting is based on double entry system of book-keeping. Its basis is accounting equation. Simply it can be presented as:

Gross Liabilities (L) = Assets (A)

All valuable items of business are assets. Usually assets are tangible e.g., cash, bank balance, land, building, machine, debtors etc. Some assets are intangible e.g., goodwill, patent rights, copy rights, trademarks. Claims against these assets are liabilities. Claims of proprietors or shareholders are internal liabilities. Claims of outside persons e.g., creditors and financial institutions etc., are external liabilities. Accounting equation can also be represented as:

Capital (C) + Outside Liabilities (L) = Assets (A)

Accounting equation is also termed as *Balance Sheet equation*.

Balance Sheet is a statement of financial position of a business on a certain date. All assets (debit balances) are shown on right hand and liabilities (credit balances) on left hand. The totals of the two sides are equal. A form of the Balance Sheet is given below:

Balance Sheet of Mr. X as on 31.03.2010

Liabilities	**Rs.**	**Assets**	**Rs.**
Capital	470000	Goodwill	10000
Loan	180000	Land & Buildings	200000
Creditors	170000	Plant & Machinery	180000
Bills Payable	50000	Furniture	70000
		Investments	90000
		Stores	45000
		Stock in Trade	40000
		Sundry Debtors	80000
		Bills Receivable	25000
		Cash at Bank	85000
		Cash in Hand	45000
	870000		**870000**

On the basis of the above balance sheet accounting equation can be expressed as:

Capital (C) + Liabilities (L) = Assets (A)

Rs. 4,70,000 + 4,00,000 = 8,70,000

Illustration 1:

Mohan started a business with cash Rs. 5,00,000. How will you write this transaction in the Accounting Equation?

Solution:

Cash is an asset, which belongs to the proprietor Mohan. The claim of proprietor on the business assets is termed as capital (C). Since there are no external claims on the assets, the external liability (L) is nil.

C	+	L	=	A
= 5,00,000 (Capital)	+	0	=	5,00,000 (Cash)

Illustration 2:

External liabilities and Assets of a business are Rs. 70,000 and Rs. 4,50,000 respectively. How much is the capital?

Solution:

According to Accounting equation :

= C + L = A
= C + 70,000 = 4,50,000
= C = 4,50,000 - 70,000
= C = Rs. 3,80,000
Rs. 3,80,000 is capital.

Illustration 3:

Vivek invested cash of Rs. 3,00,000 in a business, took a loan of Rs. 2,00,000 from a bank and purchased goods worth Rs. 50,000 from Mahesh. Find out (i) the Assets of Vivek and (ii) prepare the Balance Sheet.

Solution:

(i) The amount invested by the proprietor is called capital. Hence, capital is Rs. 3,00,000. Bank Loan and Mahesh are external liabilities of the business, According to Accounting Equation :

C + L = A
= Rs. 3,00,000 + Rs. 2,50,000 = A
or A = Rs. 5,50,000
Total Assets = Rs. 5,50,000

(ii) **Balance Sheet of Mahesh**

Liabilities	Rs.	Assets	Rs.
Capital	300000	Cash in hand	500000
Bank Loan	200000	Stock in goods	50000
Mahesh (Creditors)	50000		
	550000		**550000**

Effect of Transactions on Accounting Equation:

Business transactions do not affect the balancing of accounting equation. It may increase both the sides, decrease both the sides or may have no change. Business transactions may result in profit or loss but outside liabilities remain unaffected. It is the capital which is affected. Profit increases capital and claim on assets and loss decreases capital and also the claim on assets. These effects can be studied from the following equation table:

Equation Table

Effect	Cause
(i) Increase in assets (+A)	(i) Decrease in other assets (-A), or (ii) Increase in external liabilities (+L), or Increase in capital (+C)
(ii) Decrease in assets (-A)	(i) Increase in other assets (+A) or (ii) Decrease in external liabilities (-L), or Decrease in capital (-C)
(iii) Increase in external liabilities (+L)	(i) Increase in assets (+A), or (ii) Decrease in external liabilities (+L), or Increase in capital (+C)
(iv) Decrease in external liabilities (-L)	(i) Decrease in other assets (-A), or (ii) Increase in external liabilities (+L), or Increase in capital (+C)
(v) Increase in capital (+C)	(i) Increase in assets (+A), or (ii) Decrease in external liabilities (-L), or Decrease in capital (-C)
(vi) Decrease in capital (-C)	(i) Decrease in other assets (-A), or (ii) Increase in external liabilities (+L), or Increase in capital (+C)

Note: Cause and effect of increase in capital and profits are the same. So also cause and effect of decrease in capital and loss are the same.

Illustration 4:

Prove that the accounting equation is satisfied in the following transactions and prepare the Balance Sheet of Govind after final transaction:

(i) Govind commenced business with cash Rs. 60,000.
(ii) Bought furniture Rs. 5,000 on credit from Mahesh.
(iii) Cash purchase Rs. 20,000.
(iv) Bought goods worth Rs. 10,000 from Suresh.
(v) Paid cash to Mahesh Rs. 3,000.
(vi) Govind invested additional capital of Rs. 10,000.
(vii) Paid Salary Rs. 2,000.

Solution :

(i) Govind is the proprietor of the business, he has invested cash Rs. 60,000. Rs. 60,000 cash is the business asset, since the entire cash belongs to the proprietor, Rs. 60,000 is the capital of Govind.

Equation :

C	+	L	=	A	
60,000	+	0	=	60,000 (cash)	

(ii) Furniture purchased on credit has now become business asset while Mahesh has become the creditor of the business. Mahesh is therefore the external liability.

Equation I:

	C	+	L	=	A			
	60,000 +	0	=	60,000				
		0	+	5,000	=	0	+	5,000
Effect of II		(External liability)						(Furniture)
Equation II	60,000 +		5,000	=	60,000 +		5,000	
	(C)		(L)	=	(Cash) +		(Furniture)	

(iii) When goods are purchased in cash, cash being business asset decreases, on the other hand goods become stock in trade, which is also a business asset. Thus one business asset (stock) increases by decreasing another business asset (cash):

Equation II:

		C	+	L	=	A		
		60,000	+	5,000	=	60,000 +	5,000	
						(Cash)	(Furniture)	
(iii)	Effect of equation (iii)	0	+	0	=	-20,000 + 0	+20,000	
						(Cash)	(Stock)	
Equation III		60,000 +		5,000	=	40,000 +	5,000 +	20,000
		(C)		(L)		(Cash)	(Furniture)	(Stock)

(iv) In this transaction Stock in trade increases by increasing the external liability due to Suresh:

	C	+	L	=	A	
Equation III	60,000	+	5,000	=	40,000+ 5,000	+20,000
Effect of equation IV	0	+	10,000	=	0 + 0	+10,000
Equation IV	60,000	+	15,000	=	40,000 + 5,000	+ 30,000
	(C)		(L)		(Cash) (Furniture)	(Stock)

(v) In this transaction external liability of Mahesh decreases because business has paid cash to Mahesh, but at the same time cash (business asset) also comes down:

	C	+	L	=	A	
Equation (IV)	60,000	+	15,000	=	40,000 + 5,000	+30,000
Effect of V	0	-	3,000	=	-3,000 + 0	+0
Equation V	60,000	+	12,000	=	37,000 + 5,000	+ 30,000
	(C)		(L)		(Cash) (Furniture)	(Stock)

(vi) When the proprietor brings additional capital, his capital increases in the business together with the business assets, which he invests. Therefore cash and capital both increases:

	C	+	L	=	A	
Equation (V)	60,000	+	12,000	=	37,000 + 5,000	+30,000
Effect of VI	10,000	+	0	=	10,000 + 0	+0
Equation VI	70,000	+	12,000	=	47,000 + 5,000	+ 30,000
	(C)		(L)		(Cash) (Furniture)	(Stock)

(vii) When expenses are paid, the claims of the proprietor decreased Therefore, in accounting equation capital will decrease and cash will also decline:

	C	+	L	=	A	
Equation (VI)	70,000	+	12,000	=	47,000 + 5,000	+30,000
Effect of VII	-2,000	+	0	=	-2,000 + 0	+0
Last Equation	68,000	+	12,000	=	45,000 + 5,000+	30,000
	(Capital)		(Outside Liabilities)		(Cash) (Furniture)	(Stock)

Balance Sheet of Govind

as on ....

Liabilities	**Rs.**	**Assets**	**Rs.**
Capital	68000	Furniture	5000
Creditors (Outside Liability)	12000	Stock	30000
		Cash	45000
	80000		**80000**

2.6 Summary

Accounting is considered to be the language of business. Like any sensible language, accounting therefore should have its own grammar and syntax. Though not rigid and exact, accounting has its set of principles commonly known as Generally Accepted Accounting Principals (GAAP). Such principles are classified into two Categories: Accounting Concepts and Accounting Conventions. Accounting Concepts include separate entity concepts, money measurement concept, going concern concept, accounting period concept, cost concept, revenue recognition concept, expense recognition concept, matching concept, dual aspect concept, objective evidence concept and accrual concept. Major accounting conventions are that of consistency, full disclosure, conservatism and materiality. Basic accounting equation (Capital + Outside Liabilities = Assets) forms the basis of entire accounting system which is based on double entry system.

2.7 Key Words

Accounting Principles: Comprise accounting concepts and conventions. Concepts imply basic assumptions and conventions indicate customs and traditions followed by accountants.

Depreciation: Is a permanent, continuous and gradual reduction in the book value of fixed asset.

Double Entry Book-keeping System: Follows the principle of "every debit has a corresponding credit" and hence, total of all debits has to be equal to the total of all credits.

Methods of Depreciation: Various methods are available for calculating the amount of depreciation to be charged to Profit and Loss Account. Amount of Depreciation is a function of Time, Usage, and cost of maintaining the fixed assets and Provision of funds for replacing the assets.

Types of Expenditure: For the purpose of accounting, the amount of money that is paid in the business is classified as: **Capital Expenditure** which indicates the amount of funds paid for acquiring the infrastructure properties required for doing the business that are technically referred to as Fixed Assets. **Revenue Expenditure** indicates the amount of funds paid during a certain period with the intention to receive the return during the same period. **Deferred Revenue Expenditure**, indicates the amount of funds paid which does not result into the acquisition of any fixed asset.

2.8 Self Assessment Questions

1. What is meant by full disclosure?
2. What is meant by convention of consistency?
3. Business is an independent entity. Explain.
4. What do you mean by accounting Principles?
5. Which convention is used for valuation of assets?
6. What is meant by concept?
7. What is cost concept?
8. What do you understand by the term "Principles and Postulates of accounting"? Explain the difference between these two.
9. Discuss, in detail the following concepts and conventions of accounting:

   (a) The Accrual concept (b) The Materiality Convention,and(c) The Realisation Concept.

10. Explain the following terminology-

(i) Balance Sheet, (ii) Current assets,(iii) Current Liabilities (iv) Provisions,(vi) Capital Expenditure.

11. Show the accounting equation on the basis of following transactions:

    1. Commenced business with cash Rs. 35000; goods Rs.8000 and furniture Rs.15,000
    2. Purchased goods from Namita on credit Rs.55,000
    3. Sold goods on credit Rs.65,000 (costing Rs.55,000)
    4. Purchased furniture for house hold Rs. 15,000
    5. Cash received from debtors Rs.45,000
    6. Paid for wages Rs.1000 and received commission 1000 (Ans:1,70,000)

2.9 Reference Books

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3. Gupta, Advanced Accountancy.
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5. Shukla; Grewal; Gupta, Advanced Accounts.
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Unit - 3 Books of Original Entries

Structure of Unit:

3.0 Objectives

After Completing this unit, you will be able to :

- Define account, debit, credit, journal and journalising;
- Understand the rules of debit and credit and their significance in accounts;
- Analyse and journalise transactions in the books of accounts;
- Identify some special transactions;
- Assess advantages and limitations of a journal;
- Make compound entry and opening entry.

3.1 Introduction

Double entry system is the scientific method which is followed in recording business transactions. Each transaction is recorded in its two fold aspects as per specified rules which provide complete and reliable record for decision making. The books which are used for recording business transactions are known as accounting books. A number of books are kept to record the business transactions. As the transactions occur it is recorded first in the journal. Journal is a primary book of entries, also known as 'Book of Original Entry.' Small traders having small number of transactions use one book named journal to record business transactions while traders having a large number of transactions use subsidiary books. The transactions are classified and all items are posted from journal to ledger under different classified heads, i.e., accounts. Trial balance is prepared at the and of the year and financial statements, viz., profit and loss account and balance sheet are prepared to reveal the financial results for a given period and financial position on a particular date.

3.2 Meaning of Account

An account is a formal individual record of transactions relating to a person, thing, income or expense in a specific format. All transactions belonging to one category are grouped at one place with the help of journal. An account has two distinct sides- the debit on the left hand side and credit on the right hand side.

3.3 Meaning of Debit and Credit

Debit word has been derived from the Latin word ‘debere’ which means ‘to owe’ and Credit word has been derived from the Latin word ‘credere’ which means ‘to believe’.

Whatever increases assets and decreases liabilities is known as debit.

Whatever increases liabilities and decreases assets is known as credit.

As we know that an account has two sides. The word 'debit' written as Dr. means to write an amount on the left hand side of an account and the word 'credit' written as Cr. means to write an amount on the right hand side of an account. The following format will help us to understand whatever has been written earlier:

Name of the Account

Dr.	**Cr.**

Activity A

A businessman wants to record the transactions relating to wages. you are required to prepare an appropriate format.

3.6 Rules of Debit and Credit

According to English approach, the following three rules are followed to record transactions in the books of accounts:

1 **Personal Account** : Debit the receiver and credit the giver.

2. **Real Account** : Debit what comes in and credit what goes out.

3. **Nominal Account** : Debit all expenses and losses and credit all incomes and gains.

We can understand these rules with the help of the following examples :-

(i) Example for Personal Account: If the business pays Rs. 15,000 to Anshuman then Anshuman’s account will be debited because Anshuman is a receiver. if the business receives Rs. 15,000 from Manish then Manish's account will be credited because Manish is giver.

(ii) Example for Real Account: If the business purchases furniture of Rs. 25,000 for cash then furniture account will be debited and cash account will be credited because both accounts are real accounts. In this case furniture is coming in and cash is going out of business.

(iii) Example for Nominal Account: Salaries paid by cashier. In this case salaries account will be debited because salary is an expense for the business.

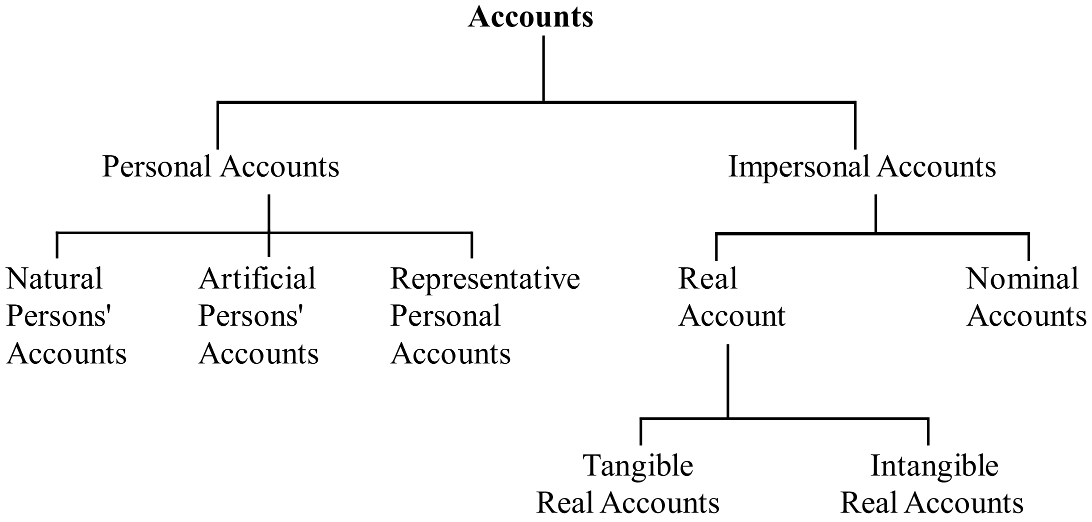
3.4 Classification of Accounts

It is essential to know about the nature of accounts because it will help to determine that which account is to be debited and which account is to be credited. There may be three categories of business transactions:

(i) Business transactions relating to persons and institutions which are called personal accounts.

(ii) Business transactions relating to assets, possessions or property which are called real accounts and

(iii) Business transactions relating to expenses and incomes which are called nominal accounts. The following exhibit will help us to understand the different kinds of accounts.



PERSONAL ACCOUNTS :

The accounts which are related to a person, firm, company or an institution are called personal accounts. Personal accounts can be classified into following three categories:

(i) Natural Persons' Accounts: The accounts of human beings are termed as natural persons accounts. For example, Anubhooti's account, Saurabh's account, Gaurav's account. Proprietor's Capital account, Proprietor's Drawings account.

(ii) Artificial Persons' Account: Accounts of institutions or corporate bodies which do not have physical existence as human beings but these are recognised as persons are termed as artificial persons' accounts. For example, any firm's account, any company's accounts, bank account, any club's account, any government's account, insurance company's account, any co-operative society's account, any institution's account.

(iii) Representative personal accounts: The accounts which represent a particular person or group of persons is termed as representative personal account. For Example, if a business is not able to pay commission for last three months to all the agents or some of them. The agents will be treated as creditors of the business. The amount standing against these creditors will be added and put under one common title outstanding commission account. The outstanding commission represents agents, therefore, it will be treated as representative personal account. Outstanding salaries account, prepaid rent account, unearned interest account, accrued interest account are some other examples of representative personal accounts.

REAL ACCOUNTS:

The accounts which are related to those assets, commodities or possessions whose value can be measured in terms of money. For example, plant and machinery account, building account, patent and copyright account, goodwill account, cash account, bills receivable account, purchases account, sales account etc. Real accounts may be classified into tangible real accounts and intangible real accounts.

(i) Tangible Real Accounts: The accounts which are related to such things which can be seen or touched. These things physically exist in the business. For example, building, furniture, stock, cash etc. It should be remembered that bank account is a personal account because the banking company is an artificial person.

(ii) Intangible Real Accounts: The accounts which are related to such things which can not be seen or touched in the physical sense but can be felt, purchased, sold and measured in terms of money. For example goodwill, patent, copyright, and trade marks.

NOMINAL ACCOUNTS:

These accounts do not have any existence. These are opened in names only in the books to explain the nature of transaction. For example wages paid, rent paid, commission paid, interest received, discount received etc. These accounts are opened for a particular financial year, therefore, these are closed at the end of the year. The balances of these accounts are not carried forward to next financial year.

Activity B

An inexperienced businessman provides you a list of accounts. Please help him to classify the nature of accounts

(i) Bank account	(ii) Machinery account	(iii) Rent account
(iv) Interest account	(v) Capital account	(vi) Goodwill account
(vii) Salary Outstanding account		(viii) Gopal's account
(ix) Govt. of Rajasthan's account		(x) Cash account

3.5 Significance of Debit and Credit in Accounts

Significance of debit and credit in accounts is being explained here for better understanding:

(i) Personal Accounts: If a person's account is debited then it can be said that he owes to the business. The amount is to be received from him and thus, he becomes a debtor of the business. If he is already debtor of the business and further again his account is debited, it will reveal that the amount of debt has been increased but in this situation his account is credited then it can rightly be said that the amount of debt in his account has been decreased. A person becomes debtor whenever business sells goods on credit to him. If a person sells goods to the business on credit then his account will be credited and he will become a creditor of the business. It shows the amount is to be paid to the creditor. If the account of creditor already exists in the books of accounts and further again credited then it will reveal increase on the credit side. If creditor's personal account is debited then it will reveal that creditor has been paid.

(ii) Real Accounts: Real account depicts financial position of a business concern. Debit in a real account shows an increase in the value of an asset. It indicates that an asset has been acquired. Credit in a real account shows a reduction in the value of the assets which indicates that the asset or its part has been sold off.

(iii) Nominal Accounts: Debit in nominal account shows that how much expenses and losses incurred during a particular period while credit in nominal account shows that how much incomes and gains earned during a particular period.

3.7 Meaning of Journal and Journalising

The word journal has been derived from the French word 'Jour' which means 'Day'. According to this journal is meant by daily record. In words of Carter, "The Journal or daily record as originally used, is a book of prime entry in which transactions are copied in order of date from a memorandum or waste book. The entries as they copied are classified into debits and credits, so as to facilitate there being correctly posted afterwards in the ledger." According to R.L.Gupta and V.K.Gupta , "It is a book of original entry wherein transactions are recorded chronologically (i.e. in order of date), showing date for each, amounts and accounts to be debited and credited and an explanation. The form in which it is recorded is known as journal and recording a transaction in the journal is known as journalising.

3.8 Format of Journal

Journal of Shri/Ms...

Date (1)	Particulars (2)	Ledger Folio (3)	Dr. (Amount) (4)	Cr. (Amount) (5)

Note :- In Practice, the columns are not numbered as given in the above format. The columns have been numbered to help in understanding.

1. Date: The year is written on the top and date and month of transaction is recorded afterwards.

2. Particulars: The two aspects of a transaction are written in this column. Account to be debited is written in the first line and the word 'Dr.' is suffixed at the end of column. The account to be credited is written in the second line. 'To' word is prefixed to the name of account. There should be a few space away from the margin of first line. A brief description of the transaction known as narration is written in the third line. A line is drawn after narration which indicates that the entry has been completed. After this the same process is repeated for next transaction.

3. Ledger Folio or L.F.: The page number of ledger in which the concerned account has been posted is written in this column.

4. Debit amount: The amount to be debited is written against debit account in the fourth column.

5. Credit Amount: The amount to be credited is written against credit account in the fifth column.

3.9 Special Points to be Considered

1. Word 'a/c' is not used after personal account. The word 'a/c' can be used after adding ''s' with the name, e.g., Rajesh's a/c

Rajesh a/c ☒ Rajesh's a/c ☑

2. According to business entity concept, two accounts relating to proprietor are opened. When the proprietor brings cash, assets and goods into the business, his 'Capital Account' is credited. If the owner takes goods or cash for personal use and any personal payment is made out of business fund then 'Drawings Account' is debited.

3. The commodity which are purchased for sale purpose at a profit is called goods. For example, If a furniture dealer purchases 'furniture', it will be treated as goods for him and 'purchases account' will be opened but in case a book seller purchases furniture for business, it will not be treated as goods and 'furniture account' will be opened. Goods account for the purpose of passing entries is classified into following five categories :-

1. Purchases Account
2. Purchases Returns Account
3. Sales Account
4. Sales Returns Account
5. Stock Account -
   (i) Opening Stock
   (ii) Closing Stock

4. Determination of nature of transaction whether for cash or on credit :

(i) If any transaction related to purchase or sale is given with the name of vendor or buyer but it is not clear that transaction is for cash or on credit, e.g., goods purchased from Manu.

– Treat as credit transaction.

(ii) Name of buyer/vendor is not given, only goods purchased or sold is given, e.g., goods purchased.

– Treat as cash transaction.

(iii) Name of buyer/vendor is given with receipt/payment, e.g., goods purchased from Manu for cash.

– Treat as cash transaction.

(iv) If the name of person is given with receipts and payments of nominal accounts, e.g., salary paid to Govind.

– No personal account will be opened and it will be treated as cash payment.

3.10 The Process of Journalising

(i) First of all, it should be noted that which accounts are being affected in the transaction.

(ii) The type of these accounts should be determined.

(iii) The rules of debit and credit should apply according to the type of accounts.

Illustration 1 :

Subhash had the following transactions. Analyse the transaction to determine the nature of account and state which account will be debited and which account will be credited. Also pass journal entries:

2010		**Rs.**
June 1	Subhash started business with cash	75,000
June 3	Purchased goods from Hari	35,000
June 8	Sold goods for cash	20,000
June 11	Purchased goods	15,000
June 13	Sold goods to Naveen	10,000
June 15	Paid cash to Hari	35,000
June 20	Received cash from Naveen	10,000
June 25	Withdrew cash for personal use	5,000
June 27	Purchased furniture	8,000
June 28	Received interest	1,000
June 29	Paid salary to Ayush	6,000
June 30	Paid rent	2,000

Solution :

Date of Transaction	Affected Account	Type of Account	Reason	Dr. or Cr.
2010				
June 1	Cash a/c	Real	Cash comes in	Dr.
	Capital a/c	Personal	Subhash is giver	Cr.
June 3	Purchases a/c	Real	Goods comes in	Dr.
	Hari's a/c	Personal	Hari is giver	Cr.
June 8	Cash a/c	Real	Cash comes in	Dr.
	Sales a/c	Real	Goods goes out	Cr.
June 11	Purchases a/c	Real	Goods comes in	Dr.
	Cash a/c	Real	Cash goes out	Cr.
June 13	Naveen's a/c	Personal	Naveen is receiver	Dr.
	Sales a/c	Real	Goods goes out	Cr.
June 15	Hari's a/c	Personal	Hari is receiver	Dr.
	Cash a/c	Real	Cash goes out	Cr.
June 20	Cash a/c	Real	Cash comes in	Dr.
	Naveen,s a/c	Personal	Naveen is giver	Cr.
June 25	Drawings a/c	Personal	Owner is receiver	Dr.
	Cash a/c	Real	Cash goes out	Cr.
June 27	Furnitures a/c	Real	Furniture comes in	Dr.
	Cash a/c	Real	Cash goes out	Cr.
June 28	Cash a/c	Real	Cash comes in	Dr.
	Interest a/c	Nominal	Interest is income	Cr.
June 29	Salary a/c	Nominal	Salary is an expense	Dr.
	Cash a/c	Real	Cash goes out	Cr.
June 30	Rent a/c	Nominal	Rent is an expense	Dr.
	Cash a/c	Real	Cash goes out	Cr.

Note: This table has been given to understand Journalisation. it is not a part of journal.

Journal of Subhash

Date	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.)
2010					
June 1	Cash a/c	Dr.		75,000	
	To Capital a/c				75,000
	(For started business with cash.)				
June 3	Purchases a/c	Dr.		35,000	
	To Hari's a/c				35,000
	(For goods purchased from Hari.)				
June 8	Cash a/c	Dr.		20,000	
	To Sales a/c				20,000
	(Being goods sold for cash.)				
June 11	Purchases a/c	Dr.		15,000	
	To Cash a/c				15,000
	(Being goods purchased for cash.)				
June 13	Naveen	Dr.		10,000	
	To Sales a/c				10,000
	(For goods sold to Naveen.)				

Date	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.)
June 15	Hari	Dr.		35,000	
	To Cash a/c				35,000
	(For cash paid to Hari.)				
June 20	Cash a/c	Dr.		10,000	
	To Naveen's a/c				10,000
	(Being cash received from Naveen.)				
June 25	Drawings a/c	Dr.		5,000	
	To cash a/c				5,000
	(Withdrew cash for personal use.)				
June 27	Furnitures a/c	Dr.		8,000	
	To cash a/c				8,000
	(Being furniture purchased for cash.)				
June 28	Cash a/c	Dr.		1,000	
	To Interest a/c				1,000
	(Being interest received for cash.)				
June 29	Salary a/c	Dr.		6,000	
	To cash a/c				6,000
	(Being salary paid.)				
June 30	Rent a/c	Dr.		2,000	
	To cash a/c				2,000
	(For rent paid.)				
	Total			**2,22,000**	**2,22,000**

3.11 Casting and Carry Forward

At the end of a page a line is drawn in the column of particulars and amount. The word 'Total c/f' (Total Carried forward) is written in the column of 'particulars' and amount columns are totalled. On the next page the word 'Total b/f' (Total brought forward) is written in the column of 'particulars' and amount is written in debit and credit columns. When all entries are completed, the word 'Grand Total' is written in the column of 'particulars' and debit and credit columns are totalled. This work is called as casting of journal.

3.12 Compound Entries

If two or more transactions of similar nature take place on the same date and either Dr. or Cr. account is common, then instead of passing separate entry for each transaction, only one entry is passed. Such entry is called 'compound entry'. There may be three following ways to record compound entries:-

(i) Debit a particular single account and credit several other accounts;

(ii) Debit several accounts and credit a particular single account;

(iii) Debit several accounts and credit several accounts.

Example :

On June 6, 2010 purchased goods from Ravi and Rajesh Rs. 9,000 and Rs. 12,000 respectively. Separate entries will be made as under :

Journal of ....

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
2010				
June 6	Purchases a/c Dr.		9,000	
	To Ravi			9,000
	(For goods purchased from Ravi on credit.)			
June 6	Purchases a/c Dr.		12,000	
	To Rajesh			12,000
	(For goods purchased from Rajesh on credit.)			

In place of the above two entries, we may pass the following compound entry

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
2010				
June 6	Purchases a/c Dr.		21,000	
	To Ravi			9,000
	To Rajesh			12,000
	(For goods purchased from Ravi & Rajesh on credit.)			

Activity C

Fill in the blanks :

(i) Satish started his business with Rs. 5,00,000. His capital account will be .... and cash account will be ....

(ii) He purchased goods from Alok. Purchases account will be .... and .... account will be ....

(iii) He paid commission to Raju. .... account will be .... and .... will be ....

(iv) Purchased goods. Purchases account will be .... and .... will be ....

(v) Purchased furniture for cash. .... account will be debited and .... account will be credited.

(vi) He received interest. .... account will be debited and interest account will be ....

(vii) Withdrew cash for personal use. .... account will be debited and .... account will be credited.

3.13 Journal Entries of Some Special Transactions

1. Distribution of goods as free samples: When a trader wants to increase the volume of sales, he distributes goods as free samples. Goods as free samples are distributed out of goods purchased. It is not treated as sales and valued at cost price. It is treated as advertisement expense and the following entry is made:

Advertisement a/c Dr.
To Purchases a/c
(For goods distributed as free samples.)

2. Goods given in Charity: Goods given in charity is an expense. It is not a sale, therefore, amount of purchases is reduced with the cost price of goods. The following entry is made :

Charity a/c Dr.
To Purchases a/c
(For goods given away as Charity.)

3. Goods withdrawn by proprietor for personal use: When the goods are withdrawn by the proprietor for personal use, it is also valued at cost price and reduced from purchases. The following entry is made :

Drawings a/c Dr.
To Purchases a/c
(For goods taken away for personal use.)

4. Loss of goods by theft, fire or other reasons: Sometimes, loss of goods is the result of certain accidents such as theft, fire, earthquakes, flood etc.

In all such cases the following entry is made:

Loss by theft / fire / flood etc. a/c Dr.
To Purchases a/c
(Goods Lost.)

If the goods were insured. The following entry is made:

Insurance Co. a/c Dr.
To Loss by theft / fire / flood etc. a/c
(Insurance claimed.)

On receipt of full amount of claim:

Cash a/c Dr.
To Insurance Co. a/c
(Received full amount of claim.)

If the claim is partly accepted:

Cash a/c	Dr.	(Amount received)
Profit & Loss a/c	Dr.	(Loss)
To Insurance Co. a/c		(Total claim)
(Received partly insurance claim)		

5. Bad debts: Goods are sold to customers for cash or on credit. In case, goods are sold on credit, the customer becomes debtor. If the amount due from debtor is not realised because of debtor's insolvency, death or other reason, it is known as bad debt. In this situation the following entry is made :

Bad debts a/c Dr.
To Debtor's personal a/c
(For amount due written off as bad debts.)

In case of insolvency, if any amount is received in pro-rata distribution, then the following entry is made :

Cash a/c Dr.
Bad debts a/c Dr.
To Debtor's personal a/c
(For receipt of .... paisa in a rupee from ....)

6. Bad debts recovered: If any debtor's account was previously written off as 'Bad-debts account' and subsequently the amount is recovered from him then it is called 'Bad-debts recovered'. In this situation customer's account is not credited and the following entry is made :

Cash a/c	Dr.		
To Bad debts recovered a/c			
(Bad debts recovered.)			

7. Sales tax: If a businessman collects sales tax from customers along with the amount of sales, then it is his duty to deposit the amount to the Government. The following entry is made in this situation:

(a) On sale :

Cash a/c	Dr.	
To Sales a/c		
To Sales tax a/c		

(b) Amount of sales tax deposited to the Government.

Sales tax a/c	Dr.	
To Cash a/c		

8. Discount: If any due amount is received or paid after deducting some amount then such a reduction is known as discount. It may be of two types :

(i) Trade discount and (ii) Cash discount

(i) Trade discount: When a seller allows a deduction at a certain percentage of the list price to the person (buyer) engaged in the same trade, it is called trade discount. The object of trade discount is to increase sales and to help the retailer to make some profits even if he sells goods at their catalogue price. Trade discount is not recorded in books of buyer and seller and invoice is prepared after deducting trade discount from sales price. In case any goods from such goods is returned by the buyer, only net amount will be considered for recording the transaction.

For example, Mr. Mohan sells goods of the list price of Rs. 20,000 at 10% trade discount to Vishnu, the following entry will be made:

		Rs.	Rs.
Vishnu	Dr.	18,000	
To Sales a/c			18,000
(For goods sold less trade discount on credit.)			

(ii) Cash discount: Goods are purchased and sold on credit. If the seller offers to deduct a certain amount from the amount due from buyer for getting payment within stipulated time then it is termed as 'cash discount'. Cash discount is allowed at the time of payment and its main object is to induce debtors for prompt payment. If the trader is a seller then he will allow discount which is loss for him, therefore, it is debited. Conversely, if the trader is a purchaser then he will receive discount which is gain for him, therefore, discount received is credited.

Example: Pass journal entries for the following transactions :

(i) Received cash from sunil Rs. 1800 and discount allowed to him Rs. 200.

(ii) Paid to Ajay Rs. 24,500 in full settlement of Rs. 25,000.

			Rs.	Rs.
(i)	Cash a/c	Dr.	1800	
	Discount allowed a/c	Dr.	200	
	To Sunil			2000
	(For cash received from Sunil and discount allowed.)			
(ii)	Ajay	Dr.	25,000	
	To Cash a/c			24,500
	To Discount received a/c			500
	(For cash paid to Ajay and discount received.)			

Note: If a customer is allowed both trade and cash discount then first of all trade discount is deducted from the list price and then cash discount on net amount should be calculated. For example, goods sold for cash Rs. 10,000 to Dinesh less 20% trade discount and 5% cash discount. In this situation the following entry will be passed :

Cash a/c	Dr.	7,600	
Discount a/c	Dr.	400	
To sales a/c			8,000

(For goods sold for cash less trade discount and cash discount allowed.)

9. Banking Transactions: The following entries are made in the books of accounts for different bank transactions :

(i) When account is opened in bank or cash is deposited into bank:
Bank a/c Dr.
To Cash a/c

(ii) For cash withdrawn from bank for office use:
Cash a/c Dr.
To Bank a/c

(iii) For cash withdrawn from bank for personal use:
Drawings a/c Dr.
To Bank a/c

(iv) When cheques, drafts received from customers are not deposited into the bank on the same day:
Cash a/c Dr.
To Debtor's Personal a/c

(v) When above cheques, drafts are deposited into the bank after receiving day then on that date:
Bank a/c Dr.
To Cash a/c

(vi) When cheques, drafts received from customers are deposited into the bank on the same day:
Bank a/c Dr.
To Debtor's Personal a/c

(vii) For payment by cheque:
Personal a/c Dr.
To Bank a/c

(viii) For payment of expenses by cheque:
Expenses a/c Dr.
To Bank a/c

(ix) If the amount is directly deposited by the customer in our bank account:
Bank a/c Dr.
To Personal a/c

(x) Cheque deposited is dishonoured:
Personal a/c Dr.
To Bank a/c

(xi) Bank charges for services:
Bank charges a/c Dr.
To Bank a/c

(xii) Interest allowed by bank:
Bank a/c Dr.
To Interest a/c

(xiii) Interest charged by bank:
Interest a/c Dr.
To Bank a/c

(xiv) Payment by cheque for purchase of an assets:
Assets (particular) a/c Dr.
To Bank a/c

Activity D

(i) A trader has not sold goods but used goods for different purposes. List the name of different purposes and pass necessary journal entries.

(ii) A trader allows trade discount and cash discount. Give journal entry with a suitable example.

Illustration 2:

Record the following transactions in the journal of Damodar Prasad:

2010

May 1 Damodar prasad started business with cash Rs. 80,000; furniture Rs. 20,000; Machinery Rs. 35,000 and stock Rs. 10,000.
May 3 Purchased goods for cash Rs. 25,000.
May 5 Sold goods to Rajeev of the list price of Rs. 20,000 at trade discount of 5%.
May 6 Goods purchased from Jitendra of Rs. 15,000 less trade discount 10%.
May 7 Rajeev returned goods worth Rs. 4,000.
May 8 Returned goods to Jitendra worth Rs. 3000.
May 10 Withdrew cash Rs. 500 and goods of Rs. 2,000 for personal use.
May 12 Received commission Rs. 500.
May 15 Received from Rajeev Rs. 14,500 in full settlement of his account.
May 16 Cash paid to Jitendra in full settlements Rs. 10,000.
May 18 Opened a bank account with the Bank of Rajasthan Limited Rs. 30,000.
May 19 Furniture purchased of Rs. 10,000 and payment made by cheque.
May 21 Paid telephone rent Rs. 1000.
May 25 Received an order for goods from Rakesh.
May 28 Cash sales Rs. 10,000 and sales tax realised @ 10% on sales.
May 31 Paid for rent Rs. 1100, salaries Rs. 3600 and insurance premium Rs. 800.

Solution : **Journal of Damodar Prasad**

Date	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.)
2010					
May 1	Cash a/c	Dr.		80,000	
	Furniture a/c	Dr.		20,000	
	Machinery a/c	Dr.		35,000	
	Stock a/c	Dr.		10,000	
	To Capital a/c				1,45,000
	(For Started business with cash, furniture, machinery and stock.)				

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
May 3	Purchases a/c Dr. To Cash a/c (Being good purchased for cash)		25,000	 25,000
May 5	Rajeev Dr. To sales a/c (For goods sold less trade discount)		19,000	 19,000
May 6	Purchases a/c Dr. To Jitendra (For good purchased less trade discount)		13,500	 13,500
May 7	Sales returns a/c Dr. To Rajeev (For goods returned by Rajeev and trade discount adjusted.)		3,800	 3800
May 8	Jitendra Dr. To Purchases returns a/c (For goods returned to Jitendra and trade discount adjusted.)		2,700	 2700
May 10	Drawings a/c Dr. To Cash a/c To Purchases a/c (Being cash and goods withdrew for personal use.)		2,500	 500 2000
May 12	Cash a/c Dr. To Commission a/c (For received commission)		500	 500
May 15	Cash a/c Dr. Discount a/c Dr. To Rajeev (For cash received and discount allowed)		14,500 700	 15,200
May 16	Jitendra Dr. To Cash a/c To Discount a/c (For cash paid and discount received.)		10,800	 10,000 800
May 18	Bank a/c Dr. To Cash a/c (Being cash deposited into bank)		30,000	 30,000
May 19	Furniture a/c Dr. To Bank a/c (Purchased furniture and payment made by cheque.)		10,000	 10,000
May 21	Telephone rent a/c Dr. To Cash a/c (Paid telephone rent.)		1,000	 1,000
May 25	No entry will be made for order received			

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
May 28	Cash a/c Dr.		11,000	
	To Sales a/c			10,000
	To Sales Tax a/c			1,000
	(Cash sales and sales tax realised.)			
May 31	Rent a/c Dr.		1,100	
	Salaries a/c Dr.		3,600	
	Insurance Premium a/c Dr.			800
	To Cash a/c			5,500
	(For rent, salaries and insurance premium paid.)			
	Total		**2,95,500**	**2,95,500**

Illustration 3 :

Journalise the following transactions :

2010

July 1	Purchased goods from Mahendra for cash Rs. 60,000 and on credit Rs. 40,000.
July 2	Purchased furniture from Swastik Furnitures for personal use worth Rs. 12,000 and for office use worth Rs. 8,000.
July 5	Cash deposited into bank Rs. 25,000
July 7	Goods returned to Mahendra Rs. 7000.
July 11	Goods sold to Kailash for Rs. 20,000 and carriage paid Rs. 1000. This amount is to be realised from Kailash.
July 14	Purchased goods by cheque Rs. 3000.
July 17	Received a cheque from Kailash and deposited in the bank on same day.
July 20	Received Rs. 5000 from travelling salesman for goods sold by him after deducting travelling expenses Rs. 400.
July 22	Insured goods destroyed by fire and insurance company has accepted the claim Rs. 6000.
July 26	Received the amount of claim from the insurance company Rs. 6000.
July 27	Received interest from investment Rs. 1500.
July 29	Paid rent out of personal cash Rs. 3200.
July 31	Paid salaries to staff Rs. 4000.

Solution :

Journal of ....

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
2010				
July 1	Purchases a/c Dr.		1,00,000	
	To Cash a/c			60,000
	To Mahendra			40,000
	(Being goods purchased for cash and credit from Mahendra.)			
July 2	Furnitures a/c Dr.		8,000	
	Drawings a/c Dr.		12,000	
	To Swastik Furnitures a/c			20,000
	(Purchased furniture for business and personal use.)			

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
July 5	Bank a/c Dr. To Cash a/c (Being cash deposited to Bank.)		25,000	 25,000
July 7	Mahendra Dr. To Purchases returns a/c (Good returned to Mahendra)		7,000	 7,000
July 11	Kailash Dr. To Sales a/c To Cash a/c (Sold goods and carriage paid on behalf of customer.)		21,000	 20,000 1,000
July 14	Purchases a/c Dr. To Bank a/c (Goods purchased and payment made by cheque.)		3,000	 3,000
July 17	Bank a/c Dr. To Kailash (Being received cheque from Kailash and deposited into bank)		21,000	 21,000
July 20	Cash a/c Dr. Travelling expenses a/c Dr. To Sales a/c (Cash received from travelling salesman after deducting travelling expenses.)		5,000 400	 5,400
July 22	Insurance company a/c Dr. To Purchases a/c (Goods destroyed by fire and the claim accepted by insurance Co.)		6,000	 6,000
July 26	Cash a/c Dr. To Insurance Company a/c (Amount of claim received.)		6,000	 6,000
July 27	Cash a/c Dr. To Interest a/c (Being interest received.)		1,500	 1,500
July 29	Rent a/c Dr. To Capital a/c (Being the rend paid out of personal cash.)		3,200	 3,200
July 31	Salaries a/c Dr. To Cash a/c (Being salaries paid.)		4,000	 4,000
	Total		**2,23,100**	**2,23,100**

3.14 Opening Journal Entry

The balances of assets and liabilities relating to previous year's balance sheet will have to be brought forward to current year's books of accounts. This is done by way of passing a journal entry which is called opening entry. For this purpose all accounts related to assets side are debited and all accounts related to liabilities side are credited. In case, the amount of capital is not given then the difference between assets and liabilities will be taken as amount of capital.

Illustration 4 :

The following are the ledger balances as at 31st March, 2010.

	Rs.		Rs.
Building	1,00,000	Creditors	35,000
Machinery	70,000	Bank Loan	50,000
Furniture	30,000	Capital	1,50,000
Debtors	25,000		
Cash	10,000		

Pass journal entries to open accounts in the new accounting year.

Solution :

Journal

Date	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.)
2010					
April, 1	Buildings a/c	Dr.		1,00,000	
	Machinery a/c	Dr.		70,000	
	Furnitures a/c	Dr.		30,000	
	Debtors a/c	Dr.		25,000	
	Cash a/c	Dr.		10,000	
	To Creditors a/c				35,000
	To Bank Loan a/c				50,000
	To Capital a/c				1,50,000
	(For assets and liabilities brought in new accounting year.)				

Activity E

(i) A book keeper has made mistakes in passing journal entries. He requests you to rectify the following entries :

Date	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.)
2010					
April 6	Drawings a/c	Dr.		25,000	
	To Sales a/c				25,000
	(For goods costing Rs. 20,000 of which sale price 25,000 is withdrew by proprietor for personal use.)				
April 10	Cash a/c	Dr.		2,000	
	To Sitaram				2,000
	(Being received cash from Sitaram previously written off as bad debts.)				
April 15	Cash a/c	Dr.		1,000	
	Discount a/c	Dr.		4,000	
	To Deepak a/c				5,000
	(For 20 paisa per rupee received from the assets of Deepak on his insolvency.)				

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
2010 April 20	Furniture a/c Dr. To Maheshwari Furnitures a/c (For Furniture purchased from Maheshwari Furnitures and payment made by cheque.)		12,000	 12,000

3.15 Advantages of Journal

1. Permanent record of Transaction : It provides a permanent record because all the transactions are systematically recorded in order of date.

2. Application of accounting principles : Double entry system is based on two aspects viz., debit and credit. Every entry of transactions provides information regarding debit and credit. It ensures that accounting principles have been followed.

3. Help in posting: Journal provides a base for posting of a transaction into ledger. Although posting of a transaction can be done without journal entry but in case where a transaction affects more than two accounts it will create complexity.

3.16 Limitations of Journal

1. Journal does not provide daily cash balance.

2. Posting of every transaction from journal to ledger becomes difficult.

3. If all the transactions are recorded in the journal then the journal will be too long.

3.17 Sub-Division of Journal

In case of a large business where transactions are of repetitive and similar in nature and sufficiently large in number then it is not practicable to record all transactions in one journal. In practice, it is necessary to keep separate books for recording of transactions. The division of main journal into sub-journal is known as 'Sub-division of journal' and the separate books for this purpose are known as subsidiary books.

3.18 Summary

Double entry system is based on this assumption that every transaction has two aspects viz., debit and credit. The transaction is first recorded in journal which provides base for posting into ledger. In case of small trader only a journal book is kept while in case of a large business subsidiary books are kept. Transactions relating to a person, thing, income and expense are grouped at one place which is known as an account. Accounts have been categorised into two groups viz., personal accounts and impersonal accounts, personal accounts include natural personal accounts, artificial personal accounts, representative personal accounts. Impersonal accounts have been classified into real accounts and nominal accounts. Real accounts have been classified again into tangible real accounts and intangible real accounts. In case of personal account we debit the receiver and credit the giver. The debit in personal account depicts a person owes to business and credit in personal account depicts the business owes to a person. In case of real account we debit what comes in and credit what goes out. The debit in real account reveals the increase in the value of assets while credit reveals a reduction in the value of an asset. Nominal accounts are opened to explain that how cash comes in and how cash goes out. All the expenses and losses are debited and all incomes and gains are credited in case of nominal accounts. If any prefix or suffix is added with nominal account, it is known as representative personal account. Nominal accounts are opened for a particular financial year and their balances are not brought forward to next accounting year. Debit in nominal account shows an increase in expense / loss and credit shows an increase in an income / gain. Transactions are recorded chronologically in the form which is known as journal and the process of recording a transaction in the journal is known as journalising. Journal contains five columns viz., Date, Particular, L.F., Dr. amount and Cr. amount. Narration is written in the column of particulars after debiting and crediting the aspects of the transaction. At the end of the page amounts of debit and credit columns are totalled and carried forward. On the next page the word 'Total b/f' is written to show total brought forward and amount are written in debit and credit columns. At the end of the journal the word 'Grand Total' is written in the column of particulars and debit and credit column are totalled. It should be noted while passing entries that account or a/c word is not added with personal accounts. Drawings and Capital accounts are opened in place of proprietor's name. Goods account is not opened but five accounts viz., purchases a/c, purchases returns a/c, sales a/c, sales returns a/c and stock a/c (opening stock, closing stock) are opened in place of goods account. It is not necessary to pass separate entries for transactions of similar nature. If two or more transactions of similar nature take place, we should pass a compound entry. Goods distributed as free samples, goods given in charity, goods withdrawn by proprietor for personal use and loss of goods by fire, theft and other reasons should not be treated as sales but should be deducted from purchases by way of crediting purchases account at cost price. Bad debts, bad debts recovered, discount, sales tax and banking transactions are to be considered as specific transactions. Previous year's balance is brought to new accounting year by way of passing opening entries. Although journal provides systematic record of transactions, ensures the follow-up of accounting principles and helps in posting but it does not provide daily cash record and posting of each transaction from journal becomes difficult. Having a large number of transactions, journal is divided into sub-journal and separate books are kept for this purpose.

3.19 Key Words

1. Account: An account is a formal individual record of transactions relating to a person, thing, income and expenses in a specific format.

2. Debit: Whatever increases assets and decreases liabilities.

3. Credit: Whatever increases liabilities and decreases assets.

4. Personal Accounts: The accounts which are related to a person, firm, company or institution.

5. Real Accounts: The accounts which are related to those assets, commodities or possessions whose values can be measured in terms of money.

6. Nominal Accounts: These accounts do not have any physical existence. These are opened in name only in the books to explain the nature of transaction.

7. Journal: A book of original entry which contains chronological record of transactions.

8. Journalising: Recording of a transaction in journal.

9. Ledger Folio: The page number of ledger in which the concerned account has been posted.

10. Entry: To record the transaction in the books of accounts.

11. Compound entry: To pass a single entry for two or more transactions of similar nature taken place on the same date.

12. Bad debts: The amount due from debtor is not realised because of debtor's insolvency, death or other reason.

13. Bad debts recovered: Realisation of the amount from debtor whose account was previously written off as bad debts.

14. Discount: A reduction granted by seller.

15. Trade discount: A reduction granted by a seller from the list price of goods or service to increase the sale volume.

16. Cash Discount: A reduction granted by a seller from the invoice price to encourage prompt payment.

17. Opening Journal Entry: The entry which is passed to bring the balances of assets and liabilities relating to previous year's balance sheet to current year's books of accounts.

18. Sub-division of Journal: To keep separate books of accounts to record a large number of transactions.

3.20 Self Assessment Questions

1. What is journal and journalising? Explain the rules of journalising various types of accounts with suitable examples.

2. How goods account is classified? Pass journal entries in case of special transactions relating to goods.

3. Is there any difference between compound entry and opening entry? Explain with suitable example.

4. What are the advantages and limitations of a journal? Write the explanation of the format of journal.

5. Enter the following transactions in the books of Anuj.

2010

April 1	Started business with cash Rs. 1,25,000.
April 2	Purchased goods for cash Rs. 40,000.
April 3	Sold goods for cash Rs. 30,000.
April 5	Purchased furniture Rs. 8,000.
April 8	Bought goods from Tarun Rs. 25,000.
April 9	Withdrew goods for personal use Rs. 3,000.
April 12	Received an order for goods Rs. 2,000 from subrat and received Rs. 500 as advance.
April 15	Purchased office stationery Rs. 500.
April 17	Sold goods for cash to Ganesh for Rs. 500 and collected 10% sales tax on it.
April 18	Sold goods to Praveen Rs. 15,000 at a trade discount of 5%.
April 19	Paid to Tarun Rs. 24,000 in full settlement.
April 20	Opened a bank account with SBBJ Rs. 30,000.
April 21	Purchased a computer from Vikas Electronic and payment made by cheque Rs. 20,000.
April 22	Paid life insurance premium Rs. 1,000.
April 24	Received a cheque of Rs. 13,500 from praveen and deposited into the bank on the same day.
April 27	Bank charges Rs. 50.
April 29	Sales tax deposited.
April 30	Paid salaries Rs. 5,000, Rent Rs. 3,000.

6. Satyabhan started business with cash Rs. 2,75,000, furniture worth Rs. 7,000 and goods worth Rs. 20,000 on June 1, 2010. Journalise the following transactions in his books.

2010

June 2	Opened a bank account with PNB Rs. 2,00,000
June 3	Purchased furniture of Rs. 10,000 and payment made by cheque.
June 6	Purchased goods for Rs. 50,000 and payment made by cheque.
June 7	Sold goods for cash Rs. 40,000.
June 10	Sold goods to Suraj for cash Rs. 10,000 at a trade discount of 2% and cash discount of 3%.
June 11	Proprietor withdrew cash Rs. 5,000 and goods worth Rs. 3,000 for personal use.
June 13	Insured goods destroyed by fire Rs. 6,000.
June 14	Insurance company accepted a claim of Rs. 5,000.
June 17	Received Rs. 5,000 from Insurance company.
June 18	Goods purchased from sanjeev for Rs. 45,000 at a trade discount of 10%.
June 19	Returned goods to sanjeev for Rs. 5,000.
June 20	Goods sold to Yogesh for Rs. 30,000.
June 22	Yogesh returned $1/10^{th}$ of the goods sold to him.
June 24	Additional cash introduced by proprietor Rs. 25,000.
June 25	Purchased postal stamps Rs. 100.
June 26	Yogesh became insolvent and he paid 20 paisa in a rupee.
June 28	Paid commission for Rs. 750.
June 30	Paid for Rent Rs. 5,000, salaries Rs. 6,000 and sundry expenses Rs. 2,500.

3.21 Reference Books

1. Fundamentals of Accounting - R.L. Gupta and V.K. Gupta

2. Fundamentals of Accounting - Jain, Khandelwal and Pareek

3. Book-Keeping and Accountancy - M.L. Sharma, D.K. Bhardwaj and D.K. Jain

4. Introduction to Accountancy - T.S. Grewal

Unit - 4 Subsidiary Books - I

Structure of Unit:

4.0 Objectives

After completing this unit, you will be able to :

- Define subsidiary book.
- Assess the advantages of subsidiary books.
- Explain various types of subsidiary books.
- Make various types of subsidiary books.
- Differentiate debit note and credit note.

4.1 Introduction

All business transactions are to be first recorded in journal. If the size of the business is a small one, then only one journal is sufficient to enter each and every transaction. When the size of a business is large then it will be inconvenient to record all transactions in a single book. Therefore, main journal is divided into sub-journal in order to avoid delay in collecting required information and to facilitate division of work. A separate book is used for each category of transactions which are of similar nature. These books are called subsidiary books.

4.2 Types of Subsidiary Books

The following are the most commonly used subsidiary books:-

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

4.3 Advantages of Subsidiary Books

1. Facilitates division of Work:- The work of recording and posting may be divided into several assistants at the same time. It will not only save the time but also reduce the possibility of errors.

2. Facility in checking:- If there is any mistake in ledger posting and the trial balance does not tally then it will be easy to locate errors with the help of subsidiary books. A subsidiary book contains one type of transactions.

3. Full Information at one place:- All transactions of similar nature are entered in one book. For example, all credit purchases of goods are recorded in one book called purchases book which shows amount of total credit purchases.

4. Responsibility of work:- If any error is committed in a particular subsidiary book, then the person entrusted with that particular subsidiary book will be held responsible.

5. Specialisation and Efficiency:- When a person is entrusted with a particular type of work, then he gains complete knowledge about that work. This leads to specialisation and efficiency.

6. Protection from fraud:- Books are automatically checked due to division of work. It provides protection from fraud.

Activity A

A business has a large number of transactions. List the name of books to be kept.

Only cash book will be discussed in subsequent unit. The remaining subsidiary books are being discussed in this unit.

4.4 Purchases Day Book

The book which is used for recording credit purchases of goods in which the businessman deals is known as purchases day book. Goods purchased for cash and goods purchased on credit which is not for resale to earn profit are not recorded in the purchases day book.

For example, If a furniture trader purchases furniture on credit, then it will be recorded in purchases day book because purchase of furniture on credit will be treated as goods. If he purchases machine on credit, then it will not be treated as goods and will not be recorded in purchases day book. This book is also known as ‘Purchases Book’, ‘Purchases Journal’ ‘Invoice Book’ or ‘Bought Book’. The entries in the purchases day book, are passed from invoices received from suppliers.

Format of Purchases Day Book

Date	Particulars	Invoice No.	L.F.	Amount (Rs.)	
				Details	Total

The details of the columns of purchases book and procedure to record the transactions in purchases book are being explained here:-

1. Date:- Date of transaction is written in this column.

2. Particulars:- The name of the vendor from whom goods are purchased is written in the first line. A line should be drawn under the name of vendor. Details of goods such as quantity, name, quality, price are written in particulars column. Trade discount, expenses and sales tax are also written in this column.

3. Invoice Number:- The number of the bill, on the basis of which the transaction is recorded in the purchases book is written in this column.

4. Ledger Folio or L.F.:- The page number of ledger where the posting of transaction is made is written in this column.

5. Details:- Individual amounts of different goods bought are written in this column. The column is also used to deduct the amount of trade discount and for adding expenses incurred on goods purchases and sales tax.

6. Total Amount:- The last column is used to write the net amount of every transaction. The net amount column is totalled up at the end of a particular period. The book is closed by writing 'Purchases account Dr.' in the particulars column and the total is debited to purchases account in the ledger. Thus, purchases book provides information regarding total credit purchases.

Illustration 1:

Prepare a purchases book from the following transactions of Vardhman Book House, Kota: 2010

June 6	Purchased from Shivam Book House (Pvt.) Ltd. Jaipur on credit 50 Books of Cost Accounting @ Rs. 200 each 100 Books of Business Statistics @ Rs. 150 each Trade discount @ 10% Invoice No. 67
June 15	Purchased from Garima Publications, Jaipur on credit 60 Books of Management Accounting @ Rs. 120 each 80 Books of Financial Management @ Rs. 125 each Trade discount @ 15% Invoice No. 227
June 23	Purchased from Gupta Furnitures, Kota on credit 10 chairs @ Rs. 600 each 3 tables @ Rs. 400 each
June 30	Purchased from Sultan chand & Sons, New Delhi on credit 30 Books of Income Tax @ Rs. 140 each 20 Books of Economics @ Rs. 80 each Trade discount @ 5% packing charges Rs. 200 Invoice No. 113

Solution :

Purchases Book of M/s Vardhman Book House, Kota

Date	Particulars	Invoic No.	L.F.	Amount (Rs.) Details	Amount (Rs.) Total
2010	**Shivam Book House (P) Ltd., Jaipur**	67			
June 6	50 Books of Cost Accounting @ Rs. 200 each			10,000	
	100 Books of Business Statistics @ Rs. 150 each			15,000	
				25,000	
	Less : Trade discount @ 10%			2,500	22,500

Date	Particulars	Invoic No.	L.F.	Amount (Rs.) Details	Total
June 15	**Garima Publications, Jaipur**	227			
	60 Books of Manag. Accounting @ Rs. 120 each			7,200	
	80 Books of Financial Manag. @ Rs. 125 each			10,000	
				17,200	
	Less : Trade discount @ 15%			2,580	14,620
June 30	**Sultan chand & Sons, New Delhi**	113			
	30 Books of Income Tax @ Rs. 140 each			4,200	
	20 Books of Economics @ Rs. 80 each			1,600	
				5,800	
	Less : Trade discount @ 5%			290	
				5,510	
	Add : Packing charges			200	5,710
June 30	Purchases a/c Dr.				42,830

Note : Furniture purchased has not been recorded in purchases book because furniture is not goods for the business and assets are not recorded in this book.

4.5 Multi Column Purchases Book

If a business has two or more departments and a large number of transactions takes place then the businessman will be interested in knowing separate purchases record and individual performance of each department. In such a situation the format of purchases book explained earlier will not serve the purpose. The trader either should maintain a separate purchases book for each department or should maintain multi-columns purchases book. Only date, name of vendor, invoice number and total amount are written in multi-column purchases book. There is no need to write the description of goods e.g., quantity, quality, price etc. because all details may be obtained from invoices. This method of making multi-column book may be used in sales book, purchases return book and sales return book.

Illustration 2 :

Enter the following transactions in the multi-column purchases book of Kamal Kirana Store:

2010

March 1	Purchased from Narayan Das & Sons, Bharatpur.	
	50 tins Ghee @ Rs. 1200 per tin	
	70 tins Oil @ Rs. 700 per tin	
	20 bags sugar @ Rs. 500 per bag	Invoice No. 27
March 14	Purchased from Ganesh Bros. Jaipur	
	30 tins Ghee @ Rs. 1100 per tin	
	80 tins Oil @ Rs. 650 per tin	
	25 bags sugar @ Rs. 450 per bag	
	Trade discount @ 10%	Invoice No. 108
March 30	Purchased from Jagdish & Co. Agra	
	60 Tins Ghee @ Rs. 1000 per tin	
	90 tins Oil @ Rs. 600 per tin	
	35 bags sugar @ Rs. 400 per bag.	Invoice No. 217

Solution :

Multi-Column Purchases Book

Date	Particulars	Invoice No.	L.F.	Total Amount	Ghee	Oil	Sugar
2010							
March 1	Narayan Das & Sons, Bharatpur	27		119,000	60,000	49,000	10,000
March 14	Ganesh Bros., Jaipur	108		86,625	29,700	46,800	10,125
March 30	Jagdish & CO. Agra	217		128,000	60,000	54,000	14,000
March 30	Purchases a/c Dr.			333,625	149,700	149,800	34,125

4.6 Sales Day Book

The book which is used for recording credit sales of goods in which the trader deals is known as sales day book. Sale of goods for cash and sale of asset on cash or credit are not recorded in this book. Invoice is taken as basis for recording transaction in this book. Invoice contains description of goods. The format of sales book and procedure to record transaction is similar to that of purchases book. The name of customer to whom goods are sold on credit will be written in the column of particulars. Trade discount is deducted from sales price and sales tax, if any, is added to sales price. The book is closed by writing 'sales a/c Cr.' in the particulars column and the total is credited to sales account in the ledger. Sales book provides information pertaining to total credit sales.

Illustration 3:

Write up sales book from the following transactions of Sharma Electronics, Ajmer.

2010

Feb. 1 Sold to M/s Ram & Sons, Bhilwara on credit:
50 Table fans @ Rs. 400 each
30 Ceiling fans @ Rs. 600 each
100 Tube lights @ Rs. 150 each
Trade discount @ 10%

Feb. 12Sold to M/s Hariom Bros., Udaipur on credit:
10 Washing machines @ Rs. 3000 each
40 Heaters @ Rs. 200 each
70 Electric irons @ Rs. 500 each
Trade discount @ 5%

Feb. 25Sold to Khandelwal Electricals, Banswara in cash
60 Mixi @ Rs. 1200 each
120 Table lamps @ Rs. 120 each

Feb. 28Sold old furniture to Bansal Furniture House, Ajmer on credit
5 Chairs @ Rs. 70 each
2 Tables @ Rs. 90 each

Solution:

Sales Book

Date	Particulars	Invoice No.	L.F.	Amount (Rs.) Details	Total
2010	**M/s Ram & Sons., Bhilwara**				
Feb. 1	50 Table fans @ Rs. 400 each			20,000	
	30 Ceiling fans @ Rs. 600 each			18,000	
	100 Tube lights @ Rs. 150 each			15,000	
				53,000	
	Less : Trade discount @ 10%			5,300	47,700

Date	Particulars	Invoice No.	L.F.	Amount (Rs.)	
				Details	Total
Feb. 12	**<u>M/s Hariom Bros., Udaipur</u>**				
	10 Washing machines @ Rs. 3000 each			30,000	
	40 Heaters @ Rs. 200 each			8,000	
	70 Electric irons @ Rs. 500 each			35,000	
				73,000	
	Less : Trade discount @ 5%			3,650	69,350
Feb. 28	Sales a/c Cr.				1,17,050

Note:

1. Goods sold to Khandelwal Electricals, Banswara on Feb. 25 have not been recorded in this book because cash sales are not recorded in this book.

2. Furniture is an asset for business, it has also not been recorded in the sales book.

4.7 Purchases Returns Book

This book is meant for recording transactions relating to return of goods purchased on credit. It is also called 'Returns outward Book'. Goods purchased are returned due to inferior quality and defective goods. If goods are in excess of the order placed and not upto the standards then goods can also be returned. In some cases, where it is not possible to return goods physically due to heavy damage, overcastting of invoice, goods included in invoice but not sent, charging excess price of goods, the seller allows rebate from the amount of invoice. It is also treated as returns when the information pertaining to the return of goods or rebate to be received is given by the purchaser to seller. The purchaser issues a debit note to seller which indicates that purchaser has debited to seller's account with the amount of rebate to be claimed. The terms debit note and credit note are being explained here:

Debit Note: The note which is sent by the purchaser to the seller to inform that goods purchased on credit is being returned due to specified reasons and the seller's account has been debited in his books. Debit note is prepared in duplicate. The original copy is sent to the seller and the duplicate copy is kept in office record. The specimen of 'Debit note' is as under :

Specimen of Debit Note

DEBIT NOTE

Debt Note No ....
Sender's (Purchaser) Address
....
Date : ....

To
(Name of Seller) ....
Address ....

We debit your account with the following amount :

Reasons	Particulars	Amount
....	....	....
....	....	....
	Total	

E. & O.E.

For (Name of Purchaser)
Name of Sender with designation

Note :

1. Amount of trade discount will be adjusted in debit and credit note and returns books viz., sales returns book and purchases returns book.

2. It is suggested that buyer should record the transactions in purchases returns book after getting the credit note.

Credit Note: The note which is sent by the seller to the purchaser to inform that goods sold on credit has been received and entered in sales return book. The buyer's account has been credited. It is also prepared in duplicate. The specimen of Credit Note is being given here:

Specimen of Credit Note

CREDIT NOTE		
To (Name of Purchaser) .... Address		Credit Note No .... Sender's (Seller) Address .... Date : ....
	We credit your account with the following amount	
Reasons	**Particulars**	**Amount**
....	....	....
....	....	....
	Total	
O. & O.E.		For (Name of Seller) Name of Sender with designation

Format of Purchases Returns Book

Purchases Returns Book

Date	**Particulars**	**Debit / Credit Note No.**	**L.F.**	**Amount (Rs.)**	
				Details	**Total**
s					
	Purchases Return a/c Cr.				

> **Activity B**
>
> Bhanu Bros., Jodhpur returned goods worth Rs. 4,000 to Shantunu & Co., Jalore on June 21, 2010. Both parties seek your help in preparing debit and credit note. It is requested you to help them.

Illustration 4:

From the following transactions prepare Purchases Returns Book of Jain Book House.

2010

June 7 Goods returned to Chandak Bros :
5 Books of Accountancy @ Rs. 200 each
3 Books of Statistics @ Rs. 180 each
Trade Discount @ 10% credit Note No. 20 received.

June 18 Allowance claimed from Bhattar & Company on account of mistake in the invoice Rs. 150 Debit Note No. 7.

June 27 Goods returned to Bharati Pustak Bhandar
10 Books of Economics @ Rs. 175 each Debit Note No. 8

Solution :

Purchases Returns Book of Jain Book House

Date	**Particulars**	**Debit / Credit No.**	**L.F.**	**Amount (Rs.)**	
				Details	**Total**
2010	**Chandak Bros.**	20			
June 7	5 Books of Accountancy @ Rs. 200 each			1,000	
	3 Books of Statistics @ Rs. 180 each			540	
				1,540	
	Less : Trade discount @ 10%			154	1,386
June 18	**Bhattar & Company**	7		150	150
June 27	**Bharti Pustak Bhandar**	8			
	10 Books of Economics @ Rs. 175 each			1,750	1,750
June 30	Purchases Returns a/c Cr.				3,286

4.8 Sales Returns Book

When goods sold to customers on credit are returned to the business (seller) then the transactions relating to return of goods sold are recorded in a book called Sales Returns Book. Reasons for returning goods and claiming reduction in invoice price are similar to purchases return as explained earlier. A credit note is prepared and sent to customer. The procedure of entering transactions in Sales Return Book is also similar to that of Purchases Return Book. At the end of the period the last column is totalled and the word 'Sales Return a/c Dr.' is written in the column of particulars.

Illustration 5:

Record the following transactions into the Sales Return Book of Ratan Lal & Sons.

2010

July 8 Goods returned by Neeraj Kumar Rs. 1,000 Credit Note No. 23

July 20 Ranga & Co. returned goods worth Rs. 600 on account of bad quality; Credit Note No. 24

July 28 Sent Credit Note No. 25 to Kedarmal & Sons. due to overcasting in Invoice Rs. 6750 instead of Rs. 5750.

Solution :

Sales Returns Book of Ratan Lal & Sons

Date	Particulars	Debit / Credit Note No.	L.F.	Amount (Rs.)	
				Details	Total
2010					
July 8	Neeraj Kumar	23		-	1,000
July 20	Ranga & Company	24		-	600
July 28	Kedarmal & Sons	25		-	1,000
July 31	Sales Returns a/c Dr.				2,600

4.9 Bills Receivable Book

When goods are sold on credit then the buyer promises to make payment at a future date. The seller, generally obtain written documents in form of agreement from buyer in evidence of transaction. It is known as bills of exchange, promissory notes and hundies. The bill of exchange is written by seller (creditor) and accepted by buyer (debtor). When a bill of exchange is accepted by debtor, it is recorded in bills receivable book. The format of Bills Receivable Book is given below:

Format of Bills Receivable Book

Date	Particulars (From whom bill received)	Term	Date of Maturity	L.F.	Amount (Rs.)	Remarks

Illustration 6:

Prepare a Bills Receivable Book from the following transactions :

2010
March 7 Received from Laxmikant his acceptance at three months for Rs. 600.
March 25 Drew a bill on Mansukh Lal at 4 months for Rs. 3,000 and Mansukh Lal accepted it.
March 31 Prabodh gave his acceptance at 5 months for Rs. 900.

Solution:

Bills Receivable Book

Date	Particulars (From whom bill received)	Term	Date of Maturity	L.F.	Amount (Rs.)	Remarks
2010						
March 7	Laxmikant	3 month	June 10		600	
March 25	Mansukh Lal	4 month	July 28		3000	
March 31	Prabodh	5 month	Sept. 3		900	
March 31	Bills Receivable a/c Dr.				4500	

Note: Expiry date of term is known as date of maturity. Three days called ‘days of grace’ are added to the stated terms of payment to calculate date of maturity.

4.10 Bills Payable Book

When a trader purchases goods on credit then he accepts bills. Such bills are recorded in Bills Payable Book. The Format of Bills Payable Book is given below:

Format of Bills Payable Book

Date	Particulars (To whom given)	Term	Date of Maturity	L.F.	Amount (Rs.)	Remarks

Illustration 7:

Enter the following transactions in Bills Payable Book:

2010

April 6 Gave a promissory note to Deep Chand & Sons. for Rs. 2700 payable after 3 months.

April 20 Accepted a bill 2 months after date for Rs. 1800 drawn by Verma Bros.

Solution:

Bills Payable Book

Date	Particulars (To whom acceptance given)	Term	Date of Maturity	L.F.	Amount (Rs.)	Remarks
2010						
April 6	Deep Chand & Sons	3 month	July 9		2700	
April 20	Verma Bros.	2 month	June 23		1800	
April 30	Bills Payable a/c Cr.				4500	

4.11 Journal Proper

Transactions which can not be recorded in above mentioned subsidiary books are recorded in a special book known as 'Journal proper'. It is a residuary book treated as eighth subsidiary book. The format and procedure to record in Journal proper is similar to that of journal explained earlier in detail. Examples of transactions recorded in a journal proper are being explained here:

1. Opening entries: A journal entry which is made in the beginning of new accounting year to bring the balances of assets and liabilities from previous year's balance sheet. For this purpose, all assets accounts are debited and all liabilities accounts are credited.

2. Rectifying entries: Entries to rectify errors committed while posting, totalling and balancing etc. are passed in journal proper.

3. Transfer entries: When one account is to be transferred to another account, then transfer entry is passed. Generally, such accounts are part of another account. For example, drawings account is a part of capital account. Therefore, it is transferred to capital account.

4. Closing entries: Closing entries are passed at the end of the accounting year, when final accounts are to be prepared. Accounts pertaining to goods and nominal accounts are closed by transferring them to trading and profit and loss account and entries to this effect are made in journal.

5. Adjustment entries: Some items may remain unrecorded and unadjusted upto the end of accounting period, e.g., outstanding expenses, accrued income, closing stock etc. These items should be recorded and adjusted by way of passing adjustment entries to reveal the correct financial result and financial position.

6. Miscellaneous entries: Items which are of infrequent nature and not recorded in any other subsidiary books are recorded in journal proper. Purchase and sale of fixed assets on credit, bad debts, goods withdrawn for personal use by proprietor, goods lost by fire and theft, goods given in charity and distributed as free samples, dishonour of B/R, cancellation of B/P are entered in journal proper.

> **Activity C**
> A businessman maintains subsidiary books. He wants to know that what type of transactions should be recorded in journal proper. List such transactions

Illustration 8 :

Enter the following transactions in the journal proper of M/s Vipin & Co.:

2010

May.3 Old furniture sold on credit to Himanshu Rs. 3,000.

May 11 Goods taken away for personal use Rs. 7,00.

May 19 Harish was declared insolvent and a sum of Rs. 4,500 was written off as bad debts.

May 27 Purchased machinery from Krishna Gopal Rs. 24,500.

May 29 Rs. 600 received from Ram was wrongly credited in the account of Ramesh.

Solution :

Journal Proper of M/s Vipin & Co.

Date	Particulars		L.F.	Amount (Rs.)	
				Dr.	Cr.
2010					
May 3	Himanshu	Dr.		3,000	
	To Furnitures a/c				3,000
	(For Furniture sold on credit)				
May 11	Drawings a/c	Dr.		700	
	To Purchases a/c				700
	(Being goods withdrawn for personal use)				
May 19	Bad debts a/c	Dr.		4,500	
	To Harish				4,500
	(Amount written off as bad debts in Harish's a/c)				
May 27	Machinery a/c	Dr.		24,500	
	To Krishna Gopal				24,500
	(Being machinery purchased on Cedit)				
May 29	Ramesh	Dr.		600	
	To Ram				600
	(For amount wrongly credited in Ramesh account.)				
	Total			**33,300**	**33,300**

Illustration 9:

Enter the following transactions of Bhawani & Co. in proper books of original entry:

2010		Rs.
March 3	Goods purchased from Mahesh & Co. Trade discount @ 15%	30,000
March 6	Goods sold to Vineet Bros. Trade discount 10%	35,000
March 7	Goods returned to Mahesh & Co.	4,000
March 9	Goods returned by Vineet Bros.	2,000
March 12	Goods purchased from Surendra & Co.	20,000
March 18	Goods sold to Anil Bros.	25,000
March 20	Furniture purchased from Ashu Timbers	10,000
March 22	Goods returned to Surendra & Co.	3,000
March 26	Goods returned by Anil Bros.	5,000
March 29	Anil Bros. was declared insolvent and a dividend of 30 paisa in a rupee could be received from him.	
March 30	Goods worth Rs. 2000 withdrew for personal use by proprietor.	

Solution:

Purchases Book

Date	Particulars	Invoice No.	L.F.	Amount (Rs.) Details	Total
2010					
Mar. 3	Mahesh & Co. : Goods Purchased			30,000	
	Less : Trade discount @ 15%			4,500	25,500
Mar. 12	Surendra & Co. : Goods Purchased			20,000	20,000
	Purchases a/c Dr.				45,500

Sales Book

Date	Particulars	Invoice No.	L.F.	Amount (Rs.) Details	Total
2010					
Mar. 6	Vineet Bros. : Goods Sold			35,000	
	Less : Trade discount @ 10%			3,500	31,500
Mar. 18	Anil Bros. : Goods Sold			25,000	25,000
	Sales a/c Cr.				56,500

Purchases Return Book

Date	Particulars	Debit / Credit Note No.	L.F.	Amount (Rs.) Details	Total
2010					
Mar. 7	Mahesh & Co.			4000	
	Less : Trade discount @ 15%			600	3,400
Mar. 22	Surendra & Co.			3000	3,000
	Purchases Returns a/c Cr.				6,400

Sales Return Book

Date	Particulars		Debit / Credit Note No.	L.F.	Amount (Rs.)	
					Details	Total
2010						
Mar. 9	Vineet Bros.				2,000	
	Less : Trade discount @ 10%				200	1,800
Mar. 26	Anil Bros.				5,000	5,000
	Sales Returns a/c	Dr.				6,800

Journal Proper

Date	Particulars		L.F.	Amount (Rs.)	
				Dr.	Cr.
2010					
Mar. 7	Furnitures a/c	Dr.		10,000	
	To Ashu Timber's a/c				10,000
	(Furniture purchased from Ashu Timbers)				
Mar. 29	Bad debts a/c	Dr.		14,000	
	To Anil Bros. a/c				14,000
	(Being Anil Bros., a debtor declared insolvent @ 70% of Rs. 20,000 due from him written off as bad debts.)				
Mar. 30	Drawings a/c	Dr.		2,000	
	To Purchases a/c				2,000
	(withdrew goods worth Rs. 2000 for personal use)				
	Total			26,000	26,000

4.12 Summary

Only one journal is sufficient to record transactions in case of small business but where the size of business is large and a large number of transactions take place, it will be convenient to maintain subsidiary books. Generally, eight subsidiary books viz., cash book, purchases book, sales book, purchases return book, sales return book, bills receivable book, bills payable book and journal proper are kept in the business concerns. Division of work, facility in checking, full information at a place about transactions of similar nature, responsibility of work, specialisation and efficiency, protection from fraud are some advantages which may be obtained by maintaining subsidiary books. Purchases book is used to record only credit transactions of goods purchased. Cash purchases of goods and purchases of assets on credit and cash are not entered in the purchases book. If a business has two or more department and a large number of transaction takes place then multi column purchases book is maintained to reveal individual performance of each department. Likewise, purchases book, the sales book is also used to record only credit transactions of goods sold. Transactions relating to cash sales and sales of asset are not recorded in sales book. If goods purchased on credit are returned to seller due to some reasons e.g. inferior quality, defective goods, goods not upto the standards etc. then such transactions will be entered in purchases return book. In case goods are not returned due to heavy damage of goods, overcasting of invoice, charging excess price of goods, then these transactions will also be recorded in purchases return books. It should be kept in mind while recording the transactions relating to goods returned that the amount of trade discount, if any, should also be adjusted at this time. Although the entry pertaining to return of goods purchased is passed on the basis of debit note but it is suggested that buyer should record the transactions in purchases return book after receiving the credit note. When goods sold to customer on credit are returned to the business then the transactions relating to return of goods sold are recorded in sales return book. Sales return book is prepared on the basis of credit note. If there is any claim of reduction in invoice price, it should also be recorded in this book. Generally, goods are purchased and sold on credit. In such a case the seller obtain written documents in form of agreement from buyer in evidence of transaction. Bills receivable book and bills payable book are kept to record these transactions. All the remaining transactions which cannot be recorded in the above explained subsidiary books are recorded in Journal proper. Opening entries, rectifying entries, transfer entries, closing entries, adjustment entries and miscellaneous entries are made in journal proper.

4.13 Key Words

Subsidiary Book: A separate book which is used for each category of transactions which are of similar nature.

Purchases Book: The book which is used for recording credit purchases of goods in which the businessman deals.

Sales Book: The book which is used for recording credit sales of goods in which the trader deals.

Purchases Returns Book: The book which is meant for recording transactions relating to return of goods purchased on credit.

Sales Returns Book: The book which is meant for recording transactions relating to return of good sold on credit.

Debit Note: The note which is sent by the purchaser to the seller to inform that goods purchased on credit is being returned due to specified reasons and the seller's account has been debited in his book.

Credit Note: The note which is sent by the seller to the purchaser to inform that goods sold on credit has been received and entered in sales return book. The buyer's account has been credited.

Bills Receivable Book: The book which contains the record of bill of exchange accepted by debtor.

Bills Payable Book: The book which contains the record of bill of exchange accepted by business.

Journal Proper: A residuary book which is used to record these transactions which cannot be recorded in all other subsidiary books.

Multi-Column Purchases Book: The purchases book which is used to reveal the individual performance or detail of each department relating to goods purchased on credit.

4.14 Self Assessment Questions

1. What is meant by Subsidiary books? Describe the advantages of keeping subsidiary books.

2. What is journal proper? What types of transactions are recorded in journal proper? Explain with suitable examples.

3. Write a short note on debit note and credit note.

4. Prepare the purchases book of M/s Tinku Furnitures from the following transactions.

2010

Feb 1 Purchased from M/s Ravindra Furnitures on credit
20 Tables @ Rs. 300 each
10 Chairs @ Rs. 500 each
Trade discount @ 5% Invoice No. 22

Feb 14	Purchased from Shekhar Bros. on credit 30 Table @ Rs. 250 each 20 Chairs @ Rs. 400 each Invoice No. 76
Feb 26	Sold to Vijay & Co. on credit 15 Tables @ Rs. 400 each 25 Chairs @ Rs. 600 each

(Ans. Purchases a/c Dr. Rs. 25,950)

5. From the following transactions of Nagendra & Co., prepare Sales Book.

2010	
March 7	Sold to Vimal & Co. on credit 5 bags of wheat @ Rs. 4000 per bag 10 bags of Gram @ Rs. 5000 per bag Trade discount @ 10% Invoice No. 36
March 17	Sold to Agarwal Grain Merchant on credit 10 bags of wheat @ Rs. 4,500 per bag 20 bags of Gram @ Rs. 6000 per bag
March 28	Sold old furniture to Furniture Mart on credit Rs. 3000
March 30	Sold to Badri Narayan & Co. for cash 8 bags of wheat @ Rs. 4600 each 12 bags of Gram @ Rs. 6100 each

(Ans. Sales a/c Cr. Rs. 2,28,000)

6. Enter the following transactions in Purchases Return Book and Sales Return Book of M/s Medatwal & Sons :

2010	
Feb. 8	Rajan returned goods being broken in transit Rs. 1600
Feb. 12	Returned goods to Onkar Bros. for Rs. 3000.
Feb. 16	Received allowance of Rs. 1000 from Dhankar & Co. due to overcharge in their invoice.
Feb. 21	Sent a credit note to Bhuvan Bros. on account of excess total of invoice Rs. 600.

(Ans. Purchases return a/c Cr. Rs. 4,000, Sales return a/c Dr. 2,200)

7. Prepare journal proper from the following transactions:

2010	
March 1	Rent outstanding for Rs. 700.
March 5	Withdrew goods worth Rs. 2000 for personal use of proprietor.
March 6	Received Rs. 4500 from sanju, wrongly credited to Anju account.
March 8	Goods worth Rs. 600 destroyed by fire.
March 10	Insurance company accepted the claim.
March 17	Mansingh has been declared insolvent and Rs. 7500 could not be realised from him.
March 26	Furniture purchased from Manju Furnitures Rs. 3000 on credit.
March 31	Interest on capital Rs. 800.

(Ans. Total of Journal Rs. 19,700)

8. Enter the following transactions in appropriate books of Saraswat & Co.:

2010		Rs.	
May 5	Goods purchased from Vipul & Co.	7,000	
May 6	Goods sold to Kaushal Bros.	11,000	
May 10	Goods returned to Vipul & Co.		1,500
May 11	Goods reutrned by Kaushal Bros.		1,200
May 17	Goods purchased from Girijesh Bros. Trade discount 10%	1,5000	
May 18	Goods withdrawn for personal use	2,500	
May 20	Old machinery purchased from Pratibha Engineering Co.	20,000	
May 22	Goods returned to Girijesh Bros.	2,000	
May 23	Goods sold to Paliwal Bros. Trade discount 5%	15,000	
May 24	Goods purchased from Sanjeet & Co. for cash		5,000
May 26	Goods returned to Paliwal Bros.	3,000	

(Ans. Purchases a/c Dr. Rs. 20,500 ; Sales a/c Cr. Rs. 25,250 ; Purchases return a/c Cr. Rs. 3,300 Sales Return a/c Dr. Rs. 4,050 ; Total of Journal Rs. 22,500)

4.15 Reference Books

1. Fundamental of Accounting - R.L. Guputa and V.K. Gupta

2. Fundamental of Accounting - Jain, Khandelwal, Pareek

3. Book-keeping and Accountancy - M.L. Sharma, D.K. Bhardwaj and D.K. Jain

4. Introduction to Accountancy - T.S. Grewal.

Unit - 5 Subsidiary Books - II

Structure of Unit:

5.0 Objectives

After Completing this unit, you will be able to:

- Understand the meaning of cash book;
- Explain kinds of cash book;
- Prepare various kinds of cash book;
- Analyse advantage of cash book.

5.1 Introduction and Meaning

There are a large number of cash transactions in any business. Many of these transactions involve heavy amount. Therefore, it becomes necessary to keep a separate book to record cash transactions. Transactions relating to cash receipts and cash payments are recorded in cash book. Thus, cash book may be defined as a subsidiary book/special journal which is kept to record all cash transactions. All the cash transactions are first recorded in cash book and then after with the help of cash book they are posted in various accounts in ledger. There is no need to open cash or bank account in ledger because transactions are recorded in cash book in the form of ledger account. All cash receipts are entered on the left hand side or debit side of the cash book while all cash payments are entered on the right hand side or credit side. Cash book serves the purpose of both subsidiary book as well as an account of ledger.

5.2 Advantages of Cash Book

1. It helps the business to know regularly the balance of cash in hand and at bank. The balance can be verified with the actual amount of cash box.

2. Cash book performs the dual role of subsidiary book and ledger. Thus, it avoids unnecessary labour of posting each item of receipt and payment to cash account in ledger.

3. If the cash book is maintained properly, it will reduce the chances of fraud.

4. Disputes regarding business transactions can be solved on the basis of cash book because it can be produced as evidence.

Activity A :
A trader seeks your advice regarding advantages of cash book. Explain him the advantages of maintaining a cash book.

5.3 Kinds of Cash Books

The businessmen maintain various types of cash book as per their requirement. The different kinds of cash book are being explained here in detail:

1. Single column cash book or simple cash book;

2. Double column cash book or Two column cash book;

3. Three column cash book;

4. Petty cash book.

5.3.1 Single Column Cash Book

A cash book which contains only one column of amount and serves the purpose of cash account is known as single column cash book. A single column cash book is suitable for those traders who do not keep bank accounts and have only cash transactions. This book is divided in two parts like an account. The debit side is used to record all cash receipts and the credit side is used to record all cash payments date wise. The format of single column cash book is as under :

Cash Book of ....

Dr. Cr.

Date	Particulars	V.N.	L.F.	Amount (Rs.)	Date	Particulars	V.N.	L.F.	Amount (Rs.)

5.3.2 Method of Preparation of Single Column Cash Book

First of all, the closing balance of previous day is recorded as opening balance on debit side as 'To balance b/d.' Whenever cash is received from any source (revenue or capital) is written on the debit side and whenever cash payment is made on any account (revenue or capital) is written on the credit side. As it has been explained earlier that cash book is just like cash account therefore, rules relating to real account will be applicable. The word 'To' is used with every debit entry in cash book and the word 'By' is used with every credit entry in cash book. Voucher number is the receipt number or payment number which is written in the column of V.N. and used as the base for the entry. Generally, cash book is balanced daily to reconcile with balance of cash box. It can also be balanced weekly or monthly. It depends on the need and nature of the business. It should be kept in mind that the balance in cash book always shows a debit because it limits maximum payment upto total amount in receipt side. At the end of the period both columns are totalled and the deficiency is written as 'By balance c/d' on credit side.

Illustration 1:

Prepare a single column cash book of Girdhari Bros. on the basis of the following transactions and find out the balance:

2010		Rs.
Jan. 1	Cash in hand	15,000
Jan. 2	Goods purchased for cash	9,000
Jan. 3	Goods sold	16,000
Jan. 8	Received from sudhakar	7,000
Jan. 12	Purchased furniture for office use	5,000
Jan. 14	Withdrew for personal use	2,000
Jan. 17	Received Interest	1,000
Jan. 18	Purchased goods from Abhishek on credit	15,000
Jan. 20	Goods Sold	12,000
Jan. 22	Paid Wages	4,500
Jan. 27	Purchased stationery	500
Jan. 31	Rent paid	3,000

Solution :

Cash Book of Girdhari Bros.

Dr. **Cr.**

Date	Particulars	V.N.	L.F.	Amount (Rs.)	Date	Particulars	V.N.	L.F.	Amount (Rs.)
2010					2010				
Jan. 1	To Balance b/d			15,000	Jan. 2	By Purchases a/c			9,000
Jan. 3	To Sales a/c			16,000	Jan. 12	By Furnitures a/c			5,000
Jan. 8	To Sudhakar			7,000	Jan. 14	By Drawings a/c			2,000
Jan. 17	To Interest a/c			1,000	Jan. 22	By Wages a/c			4,500
Jan. 20	To Sales a/c			12,000	Jan. 27	By Stationery a/c			500
					Jan. 31	By Rent a/c			3,000
					Jan. 31	By Balance c/d			27,000
				51,000					**51,000**

5.3.3 Double Column Cash Book

A cash book which contains two columns of amount on both side is called the double column cash book. The first column of amount is for discount and the second column of amount is for cash. All cash receipts and discount allowed are recorded on the debit side and all cash payments and discount received are recorded on the credit side. As it has been explained earlier that it is a common practice in business to sell and purchase goods on credit. Cash discount is allowed to debtors to encourage them to make payments before the expiry of credit period. In such a case where the debtor pays the amount before the expiry of credit period and avails cash discount, then his account is recorded on the debit side of cash book and the actual amount is written in the cash column and the amount allowed him as discount is written in the discount column. On the other hand, if the payment is made before the expiry of credit period to a creditor, then the trader is entitled for discount which is called discount received. At the time of payment creditor's account is entered on the credit side of cash book and the actual amount of cash is put in the cash column and the amount of discount received is put in discount column. The remaining procedure of recording transactions is similar to that of single column cash book. Only cash column is balanced while closing the cash book. Discount allowed and discount received columns are not balanced but merely totalled. There is no opening balance of discount allowed and discount received account in cash book.

Format of Two Column Cash Book:

Two Column Cash Book

Dr. **Cr.**

Date	Particulars	V.N.	L.F.	Discount (Rs.)	Cash (Rs.)	Date	Particulars	V.N.	L.F.	Discount (Rs.)	Cash (Rs.)

Illustration 2:

Draw up the two column cash book from the following transactions and bring down the balance as on April 15, 2010:

2010

April 1	Started business with cash Rs. 30,000. The trader pays Rs. 10,000 for goods purchased and Rs. 30,000 for furniture purchased.
April 4	Goods sold for cash Rs. 15,000
April 6	Goods Purchased from verma Bros. on 10 days credit Rs. 20,000
April 7	Purchased stationery for cash Rs. 2,000
April 9	Goods sold to Geeta Ram & Co. on 7 days credit Rs. 15,000
April 12	Paid cash to Verma Bros. Rs. 18,000 in full settlement.
April 13	Drew cash for personal use Rs. 2,000.
April 14	Received cash from Geeta Ram & Co. Rs. 14,500 in full settlement.

Solution :

Cash Book

Dr. **Cr.**

Date	Particulars	V.N.	L.F.	Discount (Rs.)	Cash (Rs.)	Date	Particulars	V.N.	L.F.	Discount (Rs.)	Cash (Rs.)
2010						2010					
Apr. 1	To Capital a/c				30,000	Apr. 1	By Purchases a/c				10,000
Apr. 4	To Sales a/c				15,000		By Furniture a/c				3,000
Apr. 14	To Geeta Ram			500	14,500	Apr. 7	By Stationery a/c				2,000
						Apr. 12	By Verma Bros.			2,000	18,000
						Apr. 13	By Drawings a/c				2,000
						Apr. 15	By Balance c/d				24,500
				500	59,500					2,000	59,500
2010											
Apr. 16	To Balance b/d				24,500						

Note: Discount columns in cash book are only memorandum columns. The discount column does not serve the purpose of discount account. Therefore, two accounts (Discount allowed and discount received) are to be opened in ledger.

5.3.4 Three Column Cash Book

In the present era, most of transactions are through bank. Almost all traders open a bank account. Here, bank account means current account. It is very convenient for the trader to receive payments by cheques and to make payments by cheques. Till now, we have come to know about two-column cash book. We can add a third column both to the debit and credit side of cash book in order to enter the details of bank transactions. All deposits into bank are entered on debit side and all withdrawals from bank are entered on credit side of cash book. Three column cash book provides information pertaining to cash, discount and bank transactions. The three column cash book fulfils the purpose of cash account and bank account, therefore, there is no need to open a separate cash account and bank account in the ledger.

Format of Three Column Cash Book:

Three Column Cash Book

Dr. **Cr.**

Date	Particulars	V.N.	L.F.	Discount (Rs.)	Cash (Rs.)	Bank (Rs.)	Date	Particulars	V.N.	L.F.	Discount (Rs.)	Cash (Rs.)	Bank (Rs.)

The first column of discount is a nominal account. The second column of cash is a real account and the third column of bank is a personal account. Thus, the three column cash book represents all three types of accounts. The following points should be kept in mind while preparing three column cash book;

1. Opening Balance: As it has been explained earlier that payments cannot exceed receipts, therefore, cash column of three column cash book will also show a debit balance. The word 'To balance b/d' will be written in the particulars column on the debit side. The bank column generally shows a debit balance but in cash of overdraft, it may have a credit balance. If the bank column of cash book has a debit balance, then the word 'To Balance b/d' will be written on debit side. Otherwise in case of credit balance of bank column, the word 'By Balance b/d' will be written on credit side in the column of particulars.

2. Receipts of Cheques and Bank Draft: If the cheques and drafts received from customers are not deposited into bank on the same day then it is recorded on debit in cash column. Whenever these cheques or drafts are deposited in the bank, it will be treated as cash deposited in bank. If any cheque or draft received and deposited in the bank on the same day, then it will be recorded on the debit side in the bank column.

3. Payment by Cheque: When a payment is made by cheque, the entry will appear on the credit side in the bank column.

4. Dishonour of a Cheque: When a cheque received from a customer is dishonoured, then it is recorded on the credit side of cash book in bank column. The name of customer is written in the column of particulars. If the trader issues cheque and it returned dishonoured then the name of creditor will be written in the column of particulars on the debit side and the amount of dishonoured cheque will be entered on debit side in bank column.

5. Interest and dividend collected on securities by bank or interest allowed by the bank on balance is entered on the debit side in bank column while bank charges for services are entered on the credit side in bank column.

6. Contra Entry: Contra means 'in other side'. When a transaction affects both cash and bank account then such transaction is entered on both side of cash book. Such entries are known as contra entries.

The word 'C' is written on both sides in the column of L.F. to indicate that these entries will not be posted in the ledger. Contra entries are passed either for cash deposited into bank or cash withdrew from bank for business use. If any cheque or draft received from customer earlier is deposited into bank on the subsequent day, then it will also be treated like cash deposited into bank and a contra entry will be passed. At the end of the period, the balance of cash book is taken. Cash column is balanced in the same way as explained earlier and discount columns are merely totalled not balanced. Although, bank column is balanced in the same way as cash column but it may reveal either a debit or a credit balance.

> **Activity B:**
>
> A business enterprise has a large number of transactions. Suggest him a suitable format for cash book. He is confused regarding transactions involve both cash and bank account. Give a suitable example to pass contra entry.

Illustration 3:

Enter the following transactions in a three column cash book :

2010		Rs.
Jan. 1	Cash in hand	15,000
	Bank overdraft	50,000
Jan. 2	Sold goods for cash	35,000
Jan. 4	Sold goods for cheque and deposited in the bank on the same date	30,000
Jan. 5	Sold goods for cheque	27,000
Jan. 7	Cheque deposited in the bank	27,000
Jan. 10	Goods purchased and paid by cheque	4,000
Jan. 11	Received a cheque for Jai kumar and deposited it into the bank	2,900
	Discount allowed	100
Jan. 12	Paid Krishna by cheque	7,700
	He allowed discount	300
Jan. 13	Withdrew from Bank (i) for business use	5,000
	(ii) for personal use.	2,000
Jan. 18	Bank charged interest on securities	1,800
Jan. 23	Wages paid in cash	2,500
Jan. 27	Received from Kajor Mal a cheque for Rs. 18,500 in full settlement of his account for Rs. 20,000. The cheque was deposited in the bank on the same date.	
Jan. 31	Salary paid to employees by cheque.	26,000
Jan. 31	Deposited into bank	40,000

Solution:

Three Column Cash Book

Dr. **Cr.**

Date	Particulars	V.N.	L.F.	Discount (Rs.)	Cash (Rs.)	Bank (Rs.)	Date	Particulars	V.N.	L.F.	Discount (Rs.)	Cash (Rs.)	Bank (Rs.)
2010							2010						
Jan. 1	To Balance b/d				15,000		Jan. 1	By Balance b/d					50,000
Jan. 2	To sales a/c				35,000		Jan. 7	By Bank a/c		c		27,000	
Jan. 4	To sales a/c					30,000	Jan. 10	By purchases a/c					4,000
Jan. 5	To sales a/c				27,000		Jan. 12	By Krishna			300		7,700
Jan. 7	To cash a/c		c			27,000	Jan. 13	By cash a/c		c			5,000
Jan. 11	To Jai kumar			100		2,900	Jan. 13	By Drawings a/c					2,000
Jan. 13	To Bank a/c		c		5,000		Jan. 23	By Wages a/c				2,500	
Jan. 18	To Interest a/c					1,800	Jan. 31	By Salary a/c					26,000
Jan. 27	To Kajor Mal			1500		18,500	Jan. 31	By Bank a/c		c		40,000	
Jan. 31	To cash a/c		c			40,000	Jan. 31	By Balance c/d				12,500	25,500
				1,600	82,000	1,20,200					300	82,000	1,20,200
2010													
Feb. 1	To Balance b/d				12,500	25,500							

Illustration 4:

Prepare a three column cash book from the following transactions:

2010

March 1	Cash in hand Rs. 11,000 ; Balance at Bank Rs. 20,500
March 3	Cash sales Rs. 13,000
March 5	Deposited into Bank Rs. 15,000
March 6	Received a cheque for Rs. 1,500 from Nisha.
March 8	Cheque received from Nisha deposited into bank.
March 10	Paid to Nirmal by cheque Rs. 1,800 and discount allowed by him Rs. 200.
March 12	Cash purchases Rs. 26,000
March 14	Withdrew from bank for business use Rs. 10,000
March 15	Received cheque for Rs. 1,900 from Anshul & Co. allowed him discount Rs. 100.
March 17	Cash paid for stationery Rs. 250.
March 20	Cash sales Rs. 18,000.
March 22	Cheque received from Anshul & Co. deposited into bank.
March 24	Received a cheque of Rs. 2,500 from Sancheeta and deposited the same into bank.
March 26	Cheque received from Anshul & Co. dishonoured.
March 28	Paid rent by cheque Rs. 2,000.
March 31	Bank charges Rs. 100.

Solution :

Three Column Cash Book

Dr. **Cr.**

Date	Particulars	V.N.	L.F.	Discount (Rs.)	Cash (Rs.)	Bank (Rs.)	Date	Particulars	V.N.	L.F.	Discount (Rs.)	Cash (Rs.)	Bank (Rs.)
2010							2010						
Mar. 1	To Balance b/d				11,000	20,500	Mar. 5	By Bank		c		15,000	
Mar. 3	To sales a/c				13,000		Mar. 8	By Bank		c		1,500	
Mar. 5	To cash a/c		c			15,000	Mar. 10	By Nirmal			200		1,800
Mar. 6	To Nisha				1,500		Mar. 12	By purchases a/c				26,000	
Mar. 8	To cash a/c		c			1,500	Mar. 14	By cash a/c		c			10,000
Mar. 14	To Bank		c		10,000		Mar. 17	By Stationery a/c				250	
Mar. 15	To Ansul & Co.			100	1,900		Mar. 22	By Bank		c		1,900	
Mar. 20	To sales a/c				18,000		Mar. 26	By Ansul & Co.			100		1,900
Mar. 22	To cash a/c		c			1,900	Mar. 28	By Rent a/c					2,000
Mar. 24	To Sancheeta a/c					2,500	Mar. 31	By Bank charges					100
							Mar. 31	By Balance c/d				10,750	25,600
				100	55,400	41,400					300	55,400	41,400

Illustration 5 :

Enter the following transactions in the cash book with Discount, Cash and Bank columns.

2010

April 1	Cash in hand Rs. 65,000
April 2	Opened a bank account and deposited Rs. 20,000 into the bank.
April 5	Goods purchased from Raghvendra for Rs. 10,000 for cash.

April 8	Goods purchased for Rs. 5,000 and payment made by cheque, discount received Rs. 500.
April 10	Sold goods to Ritesh for cash Rs. 7,000.
April 12	Withdrew from bank Rs. 6,000 for office use.
April 15	Purchased furniture from Sheetal Furnitures for Rs. 4,000 and paid him by means of a bank draft purchased for Rs. 4,010.
April 18	Honoured our own acceptance by cheque Rs. 6,000.
April 21	Wages paid Rs. 100 for cash.
April 22	Received a cheque from Bharat Lal to whom goods were sold for Rs. 2,000 discount allowed 10%.
April 23	Received payment of a loan of Rs. 3,000 and deposited Rs. 1,000 out of it into bank.
April 26	Withdrew for personal use Rs. 500.
April 28	Paid rent by a cheque of Rs. 1,500.
April 30	Paid salaries Rs. 3,000 for cash.
April 30	Cheque received from Bharat Lal deposited into bank.

Solution :

Three Column Cash Book

Dr. **Cr.**

Date	Particulars	V.N.	L.F.	Discount (Rs.)	Cash (Rs.)	Bank (Rs.)	Date	Particulars	V.N.	L.F.	Discount (Rs.)	Cash (Rs.)	Bank (Rs.)
2010							2010						
Apr. 1	To Balance b/d				65,000		Apr. 2	By Bank		c		20,000	
Apr. 2	To Cash a/c		c			20,000	Apr. 5	By Purchases a/c				10,000	
Apr. 10	To Sales a/c				7,000		Apr. 8	By Purchases a/c			500		4,500
Apr. 12	To Bank		c		10,000		Apr. 12	By cash a/c		c			10,000
Apr. 22	To Bharat Lal			200	1,800		Apr. 15	By Furniture a/c					4,000
Apr. 23	To Loan a/c				3,000		Apr. 15	By Bank charges					10
Apr. 23	To Cash a/c		c			1,000	Apr. 18	By B/P					6,000
Apr. 30	To Cash a/c		c			1,800	Apr. 21	By Wages a/c				1,000	
Apr. 30	To Balance c/d					3,210	Apr. 23	By Bank		c		1,000	
							Apr. 26	By Drawings a/c				500	
							Apr. 28	By Rent a/c					1,500
							Apr. 30	By Salaries a/c				3,000	
							Apr. 30	By Bank		c		1,800	
							Apr. 30	By Balance c/d				49,500	
				200	86,800	26,010					500	86,800	26,010

5.3.5 Petty Cash Book

In every business, a large number of payments are usually repetitive in nature and of small amounts. If all these payments are recorded in the main cash book as and when they occur, it will be very cumbersome. The main cash book may become very bulky and the cashier may also be overburdened. A separate employee who is also known as petty cashier is appointed to avoid this inconvenience. A separate book is maintained to record all small payments which is called the petty cash book. A petty cashier is handed over a small sum. He is authorised to make all payments upto a certain limit. These payments should be supported by Vouchers. In absence of voucher, a certificate of payment countersigned by responsible person should be produced.

5.3.6 Petty Cash Systems

A head cashier may adopt anyone of the following two systems of making advances to petty cashier:

1. Fixed advance system: A petty cashier is handed over a fixed sum of advances in the beginning. At the end of the given period he submits the accounts to the head cashier along with the balance of amount. The amount spent by him for petty expenses in the previous period is not considered and he again receives a fixed periodical advance. This method does not serve the purpose of control.

2. Imprest system: The head cashier advances a fixed amount to petty cashier in the beginning of the period. At the end of the period, he submits the accounts to the head cashier who makes the payment of amount spent by petty cashier after auditing the accounts. Thus, the balance of petty cash book on every first day of the period (Weekly, Quarterly, Monthly) will remain same to the first day of the previous period. The amount so advanced to petty cashier is known as 'imprest'.

5.3.7 Advantages of Petty Cash Book

1. A petty cashier maintains petty cash book which reduces burden and saves time and labour of head cashier, therefore, he can devote his full time on other important aspects.

2. Frequent checking of accounts helps to reduce errors and frauds.

3. Small payments are shown separately in petty cash book and postings are made with totals. It saves time and energy for posting small items to ledger accounts.

4. Petty cash book is checked by head cashier from time-to time which helps to exercise proper control on expenses.

5.3.8 Preparation of Petty Cash Book

The format of petty cash book is being illustrated here under:

Format of Petty Cash Book

Receipts Rs.	Date	Particulars	V. N.	Total Payments Rs.	Carriage & Cartage Rs.	Printing & Stationery Rs.	Travelling Rs.	Postage & Telegrams Rs.	Refreshment Rs.	Miscellaneous Exp. Rs.

Generally, the above format is used to record a large number of small payments but the number of columns for the amount on payment side besides the first total column amount may be increased or decreased as per requirement. If petty cash book is already maintained in the business then in the beginning of the period 'To Balance b/d' is written in the column of particulars and amount is written in the column of receipts. Cash or cheque received by petty cashier is entered as 'To cash a/c' or 'To bank' in the column of particular and amount is put in receipts column. If any payment is made, the amount is first recorded in the total payments column and after wards it is recorded in the respective column of the expenditure. If there are such payments for which a separate column does not exist then it will be recorded in the miscellaneous column. The detail in particular column is written after 'By'. All amount columns are totalled at the end of the period. Total amount column reveals the total amount spent and to be reimbursed. Balance of petty cash book is written as 'By Balance c/d' in particulars column and amount in 'total payments' column. When an advance is given to petty cashier it is recorded as 'By petty cash a/c' on credit side of cash book and on receipt of account, all expenses are debited and petty cash a/c is credited in journal proper.

Activity C:

A petty cashier is first time handed over a small sum. He has a little knowledge about recording procedure. Explain him the procedure of recording along with the format of petty cash book.

Illustration 6:

The petty cashier of sharada & Co. maintains a petty cash book which shows a balance of Rs. 300 and receives Rs. 2200 from head cashier on April 1, 2010. Record the following transactions in petty cash book under imprest system.

2010		Rs.
April 1	Stationery purchased	200
April 3	Paid for cartage	50
April 4	Paid for postal expenses	80
April 5	Paid for refreshment charges	140
April 8	Paid for printing expenses	160
April 10	Paid for repairs of computer	180
April 12	Paid for telegram charges	70
April 15	Paid for newspaper bill	150
April 17	Paid for taxi fare	300
April 18	Paid for charity	100
April 20	Paid for office expenses	250
April 25	Paid wages for cleaning office	90
April 30	Paid for miscellaneous expenses	350

Solution :

Petty Cash Book of Sharda & Co.

Recipts Rs.	Date	Particulars	V. N.	Total Payment Rs.	Carriage & Cartage Rs.	Printing & Stationery Rs.	Travelling Rs.	Postage & Telegrams Rs.	Refresh-ment Rs.	Office Exp. Rs.	Misc. Exp. Rs.
	2010										
300	Apr. 1	To Balance b/d									
2,200	Apr. 1	To Cash a/c									
	Apr. 1	By Stationery		200		200					
	Apr. 3	By Cartage		50	50						
	Apr. 4	By Postal Exp.		80				80			
	Apr. 5	By Refreshment		140					140		
	Apr. 8	By Printing		160		160					
	Apr. 10	By Repairs		180							180
	Apr. 12	By Telegram		70				70			
	Apr. 15	By News paper		150							150
	Apr. 17	By Taxi fare		300			300				
	Apr. 18	By Charity		100							100
	Apr. 20	By Office Exp.		250						250	
	Apr. 25	By Wages		90						90	
	Apr. 30	By Misc. Expenses		350							350
				2,120	50	360	300	150	140	340	780
	Apr. 30	By Balance c/d		380							
2,500				2,500							
	2010										
380	May 1	To Balance b/d									
2,120	May 1	To Cash a/c									

5.4 Summary

Cash book is maintained to record transactions relating to cash receipts and cash payments. Cash book serves the purpose of cash account and bank account, Therefore, there is no need to open cash or bank account in the ledger. All cash receipts are entered on the debit side of the cash book and all cash payments are entered on the credit side of the cash book. Cash book helps to know regularly the balance of cash in hand and at bank. It also helps in case of any dispute and reduces the chances of fraud. The businessman maintains various types of cash book as per their requirement. Single column cash is useful for only those traders who have only cash transactions. Cash book also shows a debit balance because payments cannot exceed receipts.

Vouchers are used as base for recording transactions in cash book. Double column cash book contains two columns of amount on both sides. All cash receipts and discounts allowed are recorded on the debit side and all cash payments and discount received are recorded on the credit side of cash book. Cash discount is allowed by the seller to buyer to encourage them to make payments before the expiry of credit period. If the debtor pays before the expiry of credit period than the trader allows him discount. When the trader pays before the expiry of credit period then the trader receives discount. Discount columns are merely totalled not balanced. These do not serve the purpose of accounts, therefore, discount allowed and discount received accounts are opened in the ledger. Three column cash book provides information pertaining to cash, discount and bank transactions. Three column cash book represents all three types of accounts, cash column has always a debit balance. Discount column are not balanced and bank column may have either debit or credit balance. Cheque and bank drafts received from customers and deposited into bank on the same date are recorded on the debit side in the bank column while cheques and bank draft received from customers and not deposited into bank on the same date are treated as cash and recorded on debit side in cash column. Whenever these cheques are deposited into bank, these will be treated as cash deposited to bank. Any payment made by cheque will be recorded on the credit side of cash book in the bank column. If customer's cheque is dishonoured, it is recorded on the credit side in bank column. If cheque issued to creditor is dishonoured then the name of creditor will be written on the debit side and amount in bank column. If any transaction affect both cash and bank account, then such transactions are entered on both side as contra entry.

Petty cash book is maintained where a large number of payments are repetitive in nature and of small amounts. The main cashier advances a small sum to petty cashier who is responsible to maintain petty cash book. Petty cashier is authorised to make all payments upto a certain limit. Although, there are two petty cash systems viz., fixed advance system and imprest system but it is more useful to adopt imprest system. If a petty cash book is maintained then it will reduce burden of head cashier and will help to exercise proper control on expenses. It also saves time and energy for posting small items to ledger accounts. Receipt column of petty cash book is used to show opening balance of petty cash book and cash or cheque received from the head cashier. All the payments are first recorded in the total column and then after posted in related column of expense. If there is no column related to a particular item then it will be shown in 'Miscellaneous expenses' column. At the end of the period, petty cash book is balanced and the deficiency is written in the column of particulars as 'By Balanced c/d' and amount in 'Total payment column'.

5.5 Key Words

1. Cash Book: A separate book which is used to record transactions relating to cash receipts and cash payments.

2. Single Column Cash Book: A cash book which contains only one column (cash) of amount.

3. Double Column Cash Book: A cash book which contains only two column (discount and cash) of amount.

4. Discount Allowed: A reduction in payment allowed by seller to buyer to encourage to make payments before expiry of credit period.

5. Discount Received: A reduction in payment allowed to trader by creditor for payments before expiry of credit period.

6. Three Column Cash Book: A cash book which provides information pertaining to cash, discount and bank transactions.

7. Contra Entry: When a transaction affects both cash and bank account, then such transaction is recorded on the both side of cash book. Such entry is known as contra entry.

8. Petty Cash Book: A cash book which is used to record a large number of payments which are repetitive in nature and of small amounts.

9. Fixed Advance System: The system in which a fixed amount is handed over to petty cashier in the beginning of period irrespective of amount spent by him.

10. Imprest system: A fixed amount is advanced to petty cashier in the beginning of the period. The petty cashier submits accounts to the head cashier and he is advanced the amount equal to amount spent by him.

5.6 Self Assessment Questions

1. What are the types of cash book? Why is it necessary to have a cash book? Write the advantages of cash book.

2. What do you mean by a three column cash book? Explain the procedure of preparing it.

3. Write short notes on:

(a) Contra entry
(b) Petty cash book
(c) Imprest system of petty cash

4. Prepare a single column cash book of Nand Kishore from the following transactions:

2010		Rs.
Jan. 1	Cash in hand	11,200
Jan. 3	Goods purchased from Omprakash in cash	4,000
Jan. 6	Received cash from Mahaveer	6,000
Jan. 9	Cash sales	3,200
Jan. 14	Paid to Gyarasi Lal	3,200
Jan. 16	Goods purchased from Guru and paid cash	4,800
Jan. 21	Furniture purchased from Geeta furnitures in cash	4,000
Jan. 26	Sold goods to Rameshwar in cash	5,000
Jan. 28	Paid salaries	2,000
Jan. 31	Rent paid	1,000

(Ans : Balance of cash book Rs. 6,400)

5. Enter the following transactions in Two column cash book of Mauli.

2010		Rs.
March 1	Cash in hand	62,500
March 3	Goods purchased	45,000
March 7	Paid to Sukesh	10,000
	Discount received	625

March 11	Sold goods to Ajitabh for cash	20,000
March 16	Received from Amitabh	24,500
	Discount allowed	500
March 19	Sold goods	7,500
March 24	Balkrishna's account had a debit of Rs. 1,5000. He paid Rs. 13,750 and received Rs. 1,250 as discount.	
March 26	Sold goods to Shreya for cash	22,500
March 29	Rs. 10,000 were to be paid to Nikhil but his account was settled by paying Rs. 9,500	
March 30	Salaries paid	7,500
March 31	Rent paid	10,000
March 31	Stationery purchased for cash	1,000

(Ans : Balance of cash book Rs. 67,750, Discount (Dr) Rs. 1,750 (Cr) Rs. 1,125)

6. Enter the following transactions in the three column cash book of Ghiya & Co. :

2010	
May 1	Cash balance Rs. 45,480 and Bank balance (Cr.) 6,480
May 3	Paid to Prakash Rs. 2,800.
May 4	Cash sales Rs. 6,500.
May 6	Deposited into Bank Rs. 20,000.
May 7	Purchased furniture from Akash Furniture House for Rs. 6,000 and paid him by cheque.
May 9	Withdrew Rs. 2,000 by cheque for personal use.
May 10	Drew from bank for office use Rs. 4,000.
May 12	Paid wages Rs. 2,000.
May 14	Received a cheque of Rs. 6,900 from Prabhav in full settlement of his account which shows a debit balance of Rs. 7,000 and deposited the same into bank.
May 15	Purchased goods from Bhatnagar Bros. for Rs. 10,000 at a trade discount of 10% and paid him by cheque after deducting Rs. 100 cash discount.
May 17	Purchased goods from Mukund for Rs. 10,000 and paid by cheque.
May 22	Cash sales Rs. 24,000.
May 26	Goods sold to Vipul Rs. 10,000 and received a cheque from him after deduction of 1% cash discount. The cheque has been deposited into bank.
May 28	Purchased machinery for Rs. 40,000 and payment made by cheque.
May 31	Paid rent Rs. 1,500 and salary Rs. 2,500.

(Ans : Cash balance Rs. 55,180, Bank balance Rs. 44,580 (Cr), Total Discount (Dr) Rs. 200 and (Cr) Rs. 100)

7. Prepare three column cash book of Sunny & Co. from the following transactions.

2010		Rs.
June 1	Cash in hand	10,000
June 1	Bank overdraft	2,500
June 2	Deposited into Bank	3,500
June 4	Cash sales	3,200
June 6	Received cheque from Nishu	750
June 8	Purchased stationery in cash	100
June 11	Cheque of Nishu deposited into Bank	
June 13	Bank charged fee	100
June 15	Withdrew from bank	350
June 18	Cheque received from Nishu was dishonoured	

June 21	Paid cash to Gopi chand Rs. 350 and received discount Rs. 5.	
June 23	Drew a cheque for personal use	300
June 25	Received cheque of Rs. 450 from Rakshit Bros. which was deposited into the bank on the same date, discount allowed him Rs. 10.	
June 30	Paid rent by cheque	350

(Ans : Cash in hand Rs. 9,600, Bank balance Rs. 350, Total Discount Column (Dr) Rs. 10 and (Cr) Rs. 5)

8. On the basis of the following transactions, prepare a petty cash book.

2010		Rs.
Feb. 1	Received from head cashier as imprest cash balance	2,000
Feb. 5	Paid for cartage	80
Feb. 7	Paid for stationery	580
Feb. 12	Paid taxi charges	100
Feb. 14	Paid for postage stamp	400
Feb. 18	Paid for refreshment	100
Feb. 20	Paid for wages	60
Feb. 24	Paid to Harishanker against his account	260
Feb. 28	Paid for miscellaneous expenses	200

(Ans : Total expenses Rs. 1,780, Balance in hand Rs. 220, Cash received on March 1, Rs. 1780)

5.7 Reference Books

1. Fundamentals of Accounting - R.L. Guputa and V.K. Gupta

2. Fundamentals of Accounting - Jain, Khandelwal, Pareek

3. Book-keeping and Accountancy - M.L. Sharma, D.K. Bhardwaj and D.K. Jain

4. Introduction to Accountancy - T.S. Grewal.

Unit - 6 Ledger Posting and Trial Balance

Structure of Unit:

6.0 Objectives

After completing this unit you will be able to:

- Understand the nature and format of ledger accounts;
- Learn the method of posting into ledger;
- Know how to balance an account;
- Describe the nature and format of trial balance;
- Enhance the practical knowledge about preparation of trial balance.

6.1 Introduction

After recording the transactions in the journal, recorded entries are classified and grouped into by preparation of accounts and the book, which contains all accounts (viz. personal, real and nominal accounts), is known as Ledger. It is known as principal book of account in which account-wise balance of each account is determined.

6.2 Specimen of Ledger Account

A ledger account has two sides - debit (left part of the account) and credit (right part 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 (Rs).	Date	Particulars	J.F.	Amount (Rs.)

6.3 Posting

The process of transferring the debit and credit items from journal to classified accounts in the ledger is known as posting.

6.4 Rules Regarding Posting of Entries in the Ledger

1. Separate account is opened in ledger book for each account and entries from ledger 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 represent 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. For example: Rent paid by cash Rs. 500. The journal entry for this transaction would be.

	Dr. (Rs.)	Cr. (Rs.)
Rent A/c Dr.	500	
To Cash A/c		500

This shall be posted to Rent A/c on the debit side by entering "To Cash A/c".

6.5 Balancing an Account

At the end of each month or year or any particular day, it may be necessary to ascertain the balance in an account. This is not too difficult a thing to do; suppose a person has bought goods worth Rs. 1,000 and has paid only Rs. 850; he owes Rs. 150 and that is balance in his account. To ascertain the balance in any account, what is done is to total the sides and ascertain the difference; the difference is the balance. If the credit side is bigger than the debit side, it is a credit balance. In the other case it is a debit balance. 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 is transferred to the profit and loss account. Only personal and real accounts ultimately show balances. In the illustration given above, one will have noticed that the capital account, the purchases account, sales account, the discount account, the rent account and the salary account have not been balanced. The capital account will have to be adjusted for profit or loss and that is why it has not been balanced yet.

Illustration 1

Prepare the Stationery Account of a firm for the year ended 31.12.2009 duly balanced off, from the following details:

2009		**Rs.**
Jan. 1	Stock in hand	480
April 5	Purchase of stationery by cheque	800
Nov. 15	Purchase of stationery on credit from Five Star Stationery Mart	1280
Dec. 31	Stock in hand	240

Solution

Stationery Account

Dr.					Cr.
Date	**Particulars**	**Rs.**	**Date**	**Particulars**	**Rs.**
1.1.2009	To Balance b/d	480	31.12 .2009	By Profit and loss A/c (Balancing figure)	2,320
5.4.2009	To Bank A/c	800			
15.11.2009	To Five Star Stationery Mart A/c	1,280	31.12 .2009	By Balance c/d	240
		2,560			**2,560**

6.6 Trial Balance

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 reasonable 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 is not proof of cent per cent accuracy, because some errors like 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 accounting year 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.

6.7 Rules of Preparing the Trial Balance

While preparing the trial balance from the given list of ledger balances, following rules should be taken into care:

1. The balances of all (i) assets accounts (ii) expenses accounts (iii) losses (iv) drawings (iv) cash and bank balances are placed in the debit column of the trial balance.

2. The balances of all (i) liabilities accounts (ii) income accounts (iii) profits (iv) capital are placed in the credit column of the trial balance.

6.8 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.

(ii) Financial statements are normally prepared on the basis of agreed trial balance; otherwise the work may be cumbersome. Preparation of financial statements, therefore, is the second objective.

(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	L.F.	Dr. Amount (Total or Balance)	Cr. Amount (Total or Balance)
			Rs.	Rs.

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 fourth column the total of the debit side of the account concerned or the debit balance, if any is entered.
(iv) In the next column, the total of the credit side or the credit balance is written,
(v) The two columns are totalled at the end.
(vi) The first and third column needs no explanation.

Still, the preparation of the trial balance is very useful; without it, the preparation of financial statement, the profit and loss account and the balance sheet, would be difficult.

6.9 Initial Illustrations

Illustration 2

From the following ledger balances, prepare a trial balance of Anuradha Traders as on 31st March, 2010:

Account Head	Rs.
Capital	1,00,000
Sales	1,66,000
Purchases	1,50,000
Sales return	1,000
Discount allowed	2,000
Expenses	10,000
Debtors	75,000
Creditors	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

Dr. Balance	Rs.	Cr. Balance	Rs.
Purchases	1,50,000	Capital	1,00,000
Sales return	1,000	Sales	1,66,000
Discount allowed	2,000	Creditors	25,000
Expenses	10,000	Interest received on investments	1,5,000
Debtors	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 3

One of your clients, Mr. Singhania has asked you to finalise his accounts for the year ended 31st March, 2010. 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
Due from customers		530
Purchases	1,259	
Purchases return	264	
Loan from bank		256
Creditors	528	
Trade expenses	700	
Cash at bank	226	
Bills payable	100	
Salaries and wages	600	
Stock (1.4.2009)		264
Rent and rates	463	
Sales return		98
	5,454	**5,454**

The closing stock on 31st March, 2010 was valued at Rs. 574. Mr. Singhania claims that he has recorded every transaction correctly as the trial balance is prepared. Check the accuracy of the above trial balance.

Solution

Corrected Trial Balance of Mr. Singhania as on 31st March, 2010

Particulars	Dr. (Rs)	Cr. (Rs)
Singhania's Capital		1,556
Singhania's Drawings	564	
Leasehold premises	750	
Sales		2,750
Due from customers	530	
Purchases	1,259	
Purchases return		264
Loan from bank		256
Creditors		528
Trade expenses	700	
Cash at bank	226	
Bills payable		100
Salaries and wages	600	
Stock (1.4.2009)	264	
Rent and rates	463	
Sales return	98	
	5,454	**5,454**

Reasons:

1. Due from customers is an assets, so its balance will be a debit balance.
2. Purchases return account always shows a credit balance because assets go out.
3. Creditor is a liability, so its balance will be a credit balance.
4. Bills Payable represents liabilities, so its balance will be a credit balance.
5. Stock (opening) represents assets, so it will have a debit balance.
6. Sales return account always shows a debit balance because assets come in.

6.10 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 it cannot help in the preparation of the financial statements.

Illustration 4

Given below is a ledger extract relating to the business of X and Co. as on March, 31, 2010. You are required to prepare the Trial Balance by the Total Amount Method.

Cash Account

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
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 Purchases A/c	1,000
		By Capital A/c	500
		By Balance c/d	7,500
	35,500		**35,500**

Furniture Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Cash A/c	3,000	By Balance c/d	3,000
	3,000		**3,000**

Salaries Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Cash A/c	2,500	By Balance c/d	2,500
	2,500		**2,500**

Shyam's Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Cash A/c	21,000	By Purchases A/c (Credit Purchases)	25,000
To Purchase Returns A/c	500		
To Balance c/d	3,500		
	25,000		**25,000**

Purchases Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Cash A/c (Cash Purchases)	1,000	By Balance c/d	26,000
To Sundries as per Purchases Book	25,000		
	26,000		**26,000**

Purchases Returns Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance c/d	500	By Sundries as per Purchases Return Book	500
	500		**500**

Ram's Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
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**

Sales Account

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
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**

Sales Return Account

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
To Sundries as per Sales Returns Book	100	By Balance c/d	100
	100		**100**

Capital Account

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
To Cash A/c	500	By Cash A/c	10,000
To Balance c/d	9,500		
	10,000		**10,000**

Solution:

S. No.	Name of Account	Total of Debit Items Rs.	Total of Credit Items Rs.
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	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 carry forward to the trial balance. This method is used commonly by the accountants and helps in the balances of the ledger accounts.

Illustration 5:

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 31.03.2010

S. No.	Name of Account	Total of Debit Items Rs.	Total of Credit Items Rs.
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. Under this method statement of trial balance contains seven columns instead of five columns. This has been explained with the help of the following example:

Trial Balance of X as at 31.03.2010

S. No.	Name of Account	L.F.	Debit Balance Rs.	Credit Balance Rs.	Debit Balance Rs.	Credit Balance Rs.
1.	Cash A/c		7,500		35,500	28,000
2.	Furniture A/c		3,000		3,000	
3.	Salaries A/c		2,500		2,500	
4.	Shyam's A/c			3,500	21,500	25,000
5.	Purchases A/c		26,000		26,000	
6.	Purchases Returns A/c			500		500
7.	Ram's A/c		4,900		30,000	25,100
8.	Sales A/c			30,500		30,500
9.	Sales Returns A/c		100		100	
10.	Capita			9,500	500	10,000
			44,000	**44,000**	**1,19,100**	**1,19,100**

6.11 Summary

After recording the transactions in the journal, recorded entries are classified and grouped into by preparation of accounts and the book, which contains all set of accounts (viz. personal, real and nominal accounts), is known as Ledger.

A ledger account has two sides-debit (left part of the account) and credit (right part 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

The process of transferring the debit and credit items from journal to classified accounts in the ledger is known as posting.

At the end of the each month or year or any particular day it may be necessary to ascertain the balance in an account.

To ascertain the balance in any account, what is done is to total the sides and ascertain the difference; the difference is the balance.

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 ultimately show balances.

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.

There are various methods for preparing the Trial Balance, these are:

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.

Balance Method: Under this method, every ledger account is balanced and those balances only are carry forward to the trial balance. This method is used commonly by the accountants and helps in the balances of the ledger accounts.

Total and Balance Method: Under this method, the above two explained methods are combined. Under this method statement of trial balance contains seven columns instead of five columns.

6.12 Key Words

Ledger: Recorded entries are classified and grouped into by preparation of accounts and the book, which contains all set of accounts (viz. personal, real and nominal accounts), is known as Ledger.

Posting: The process of transferring the debit and credit items from journal to classified accounts in the ledger is known as posting.

Balancing an Account: At the end of the each month or year or any particular day it may be necessary to ascertain the balance in an account.

Trial Balance: 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.

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.

Balance Method: Under this method, every ledger account is balanced and those balances only are carry forward to the trial balance.

Total and Balance Method: Under this method, the total method and balance methods are combined.

6.13 Self Assessment Questions

1. **Pick up the correct answer from the given choices :**

(i) 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) Rs. 500 cash payment to creditors is debited to creditors for Rs. 50 and credited to cash as Rs. 500.
- (d) None of the above.

(ii) Rs. 1500 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 Rs. 3000 that the credit total.
- (b) The debit total will be greater by Rs. 1500 that the credit total.
- (c) Subject to other entries being correct the total will agree.
- (d) None of the above.

(iii) After the preparation of ledgers, the next step is the preparation of -

(a) trading account (b) trial balance

(c) profit and loss account (d) none of the above.

(iv) After preparing the trial balance the accountant finds that the total of debit side is short by Rs. 1,500. This difference will be

(a) Credited to suspense account

(b) Debited to suspense account

(c) Adjusted to any of the debit balance amount

(d) Adjusted to any of the credit balance amount

(v)

S. No.	Account heads	Debit (Rs.)	Credit (Rs.)
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 (c) wrong placing of miscellaneous expense account

(b) wrong placing of salaries account (d) wrong placing of all accounts

[Ans : (i)-(c), (ii)-(a), (iii)-(b), (iv)-(b), (v)-(b)]

2. An inexperienced bookkeeper has drawn up a Trial Balance for the year ended 30th June, 2010.

	Dr. (Rs.)	Cr. (Rs.)
Provision for Doubtful Debts	200	-
Bank Overdrafts	1,654	-
Capital	-	4,591
Creditors	-	1,637
Debtors	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
Stock	2,418	-
Provision for Depreciation on Furniture	364	-
Total	**24,983**	**25,002**

Required:

(a) Draw up a 'Corrected' Trial Balance, debiting on crediting any residual errors to a Suspense Account.

6.14 Reference Books

1. Fundamentals of Accounting - R.L. Guputa and V.K. Gupta

2. Fundamentals of Accounting - Jain, Khandelwal, Pareek

3. Book-keeping and Accountancy - M.L. Sharma, D.K. Bhardwaj and D.K. Jain

4. Introduction to Accountancy - T.S. Grewal.

Unit - 7 Rectification of Errors

Structure of Unit:

7.0 Objectives

After completing this unit you will be able to:

- Get knowledge about the various types of errors in accounts;
- Understand the process of how to locate errors;
- Learn various methods of rectifying errors;
- Enhance the practical knowledge regarding preparation and use of suspense accounts.

7.1 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 requires 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 two totals do not agree, it is definite that there have been 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.

7.2 Cases of Errors

(a) **Wrong Entries:** Let us start from the first phase in the accounting process. Wrong entry of the value of transactions and events in the subsidiary books, Journal Proper and Cash Book may occur.

Example 1:

Credit purchases Rs. 17,270 are entered in the Purchases Day Book as Rs. 17,720. Credit sales of Rs. 15,000 gross less 1% trade discount are wrongly entered in Sales Day Book at Rs. 15,000. Cheque issued Rs. 19,920 are wrongly entered in the credit of bank column in the Cash Book as Rs. 19,290.

(b) **Wrong positing from subsidiary books:** Subsidiary books are totalled periodically and posted to the appropriate ledger accounts. There may arise totalling errors. Totalling errors may arise due to wrong entry or simply these may be independent errors.

Example 2:

For the month of January, 2010 total of credit sales are Rs. 1,75,700, this is wrongly totalled as Rs. 1,76,700 and posted to sales account as Rs. 1,76,700.

(c) **Wrong casting of subsidiary book:** For example, wrong castings of the Cash Book result in balancing error.

Example 3:

The following cash transactions of M/s Tularam & Co. occurred: 2010
Jan. 1 Balance - cash Rs. 1,200 bank Rs. 16,000;
Jan. 2 Cheque issued to M/s Bholaram & Co., a supplier, for Rs. 22,500;
Jan. 6 Cheque collected from M/s Scindia & Bros. Rs. 42,240 and deposited for clearance;
Jan. 7 Cash sales Rs. 27,200, paid wages Rs. 12,400;
Jan. 8 Cash sales Rs. 37,730, cash deposited to bank Rs. 35,000.

The following Cash Book entries are passed:

Cash Book

Dr. ***Cr.***

Date 2010	*Particulars*	*Cash Rs.*	*Bank Rs.*	*Date 2010*	*Particulars*	*Cash Rs.*	*Bank Rs.*
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	Jan.7	By Wages A/c	12,200	0
Jan. 7	To Sales A/c	27,200		Jan. 8	By Bank A/c	34,500	0
Jan. 8	To Sales A/c	37,370		Jan. 8	By Balance c/d	19,070	71,420
Jan. 8	To Cash A/c		34,500				
		65,770	**92,920**			65,770	**93,920**

Wrong entries and 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 made. In the above example, there are four wrong entries and one wrong casting Bank and cash balances are affected by these errors.

(d) **Wrong casting of ledger balances:** Likewise Cash Book, any ledger account balance may be cast 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 of ledger balances.

Example 4:

The following are the credit purchases of M/s Ballav Bros.: 2010

Jan. 1 Purchases from M/s Saurabh & Co.- gross Rs. 1,00,000 less 1% trade discount.

Jan. 3 Purchases from M/s Netai & Co.- gross Rs. 70,000 less 1% trade discount.
Jan.6 Purchases from M/s Saurabh & Co.- gross Rs. 60,000 less 1% trade discount.

Let us cast M/s Saurabh & Co.'s Account:

M/s Saurabh & Co.'s Account

Dr. ***Cr.***

Date 2010	*Particulars*	*Amount*	*Date 2010*	*Particulars*	*Amount*
Jan. 1	To Balance c/d	1,55,000	Jan. 1 Jan. 6	By Purchases A/c By Purchases A/c	99,000 59,000
		1,55,000			**1,55,000**

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 Rs. 27,030 and from M/s Karnataka Suppliers for Rs. 28,050. The following Day Book is prepared:

Purchases Day Book

Date	*Particulars*	*Amount Rs.*
	M/s Saurabh & Co. M/s Karnataka Suppliers	27,050 28,030
		55,080

In the 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.

Particulars	*Dr.*	*Cr. Rs.*
M/s Saurabh & Co.		27,050
M/s Karnataka Suppliers		28,030
Purchases Account	55,080	
	55,080	55,080

7.3 Types of Errors, Classification of Errors and Locating 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.

(b) Clerical errors: These errors arise because of mistake committed in the ordinary course of the accounting work. 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 an error is cancelled by the effect of some other error, the trial balance will naturally agree. Suppose an amount of Rs. 10 received from A is not credited to his account and the total of the sales book is Rs. 10 in excess. The omission of credit to A's account will be made up by the increased credit to the Sales Account; there will not be any effect on the trial balance.

From another point of view, errors may be divided into two categories:

(a) Those that affect the trial balance - because of the errors that trial balance does not agree; Like:

- (i) Wrong casting of the subsidiary books [see (b) above.]
- (ii) Wrong balancing of an account [see (a) above.]
- (iii) Posting an amount on the wrong side [see (d) above.]
- (iv) Wrong posting, ie., writing the wrong amount [see (d) above.]
- (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 [see (i) above.]
- (ii) Making an entry in the wrong subsidiary book [see (ii) above.]
- (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.

7.4 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 debtors is the example from which Sundry debtors 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; 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 Re. 1, Rs. 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 the cases should be seen; it is possible that an error has been committed. Suppose the sales account for the current year shows a balance of Rs. 32,53,000 whereas it was Rs. 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.

ERRORS

Clerical Errors

Errors of Principle (Treating a revenue expense as capital expenditure or *vice versa* or the sale of a fixed asset as ordinary sale). Trial Balance will agree

Errors of Omission

Errors of Commission

Compensating Errors. Trial Balance will agree.

Omitting an entry completely from the subsidiary books. Trial Balance will agree

Omitting to post the ledger account from the subsidiary books. Trial Balance will not agree

Writing the wrong amount in the subsidiary books. Trial Balance will agree

Wrong casting of subsidiary books.

Posting the wrong amount in the ledger

Posting an amount on the wrong side.

Wrong balancing of an account

Trial Balance will not agree

7.5 Rectification of Errors

Errors should never be corrected by overwriting. If immediately after making an entry it is clear that an error has been committed, it may be corrected by neatly crossing out the wrong entry and making the correct entry. If however the errors are located after some time, the correction should be made by making another suitable entry, called 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.

7.6 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:

Illustration 1

(i) The sales book for November is undercast by Rs. 200. The effect of this error is that the Sales Account has been credited short by Rs. 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 Rs. 200 on the credit side: "By undercasting of Sales Book for November Rs. 200".

(ii) While posting the discount column on the debit side of the cash book the discount of Rs. 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 Rs. 10. This should now be done by the entry "By omission of posting of discount - Rs. 10".

(iii) Rs. 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 Rs. 200. Not only is the wrong debit to be removed but also a credit of Rs. 200 is to be given.This can be done now by entering Rs. 400 on the credit side of his account. The entry will be "By Posting on the wrong side - Rs. 400".

(iv) Rs. 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, Rs. 50 has been omitted from the credit side of his account. The rectification will be by the entry. "By Omission of posting Rs. 50"

(v) Rs. 51 paid to Mohan has been posted as Rs. 15 to the debit of his account. Mohan has been debited short by Rs. 36. The rectifying entry is "To mistake in posting of Rs. 36".

(vi) Goods sold to Ram for Rs. 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 by the entry "By wrong posting Rs. 1,000" in the credit of purchases account and also "By omission of posting of - Rs. 1000" in the credit sales account.

(vii) Bills receivable from Mr. A of Rs. 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 by the entry "To wrong posting of Rs. 500" in debit of Bills payable Account and also "To omission of posting of Rs. 500" in the debit of Bills Receivable Account.

(viii) Goods purchased from Vinod for Rs. 1,000 was wrongly credited to Vimal account by Rs. 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 Rs. 100" in the debit of Vimal account and "By omission of posting Rs 1,000" in the credit of Vinod account.

Thus, from the above illustrations we are convinced that the general rule that errors affecting two accounts can always be corrected by a journal entry is not always valid.

Such errors will be rectified as follows:

(a) To correct the wrong balancing of the bank column, an entry will be made on the debit side on first November as follows. "To mistake in balancing Rs. 500".

(b) To correct the excess posting in purchases book the entry will be "By Mistake in totalling the purchases book for October, 2009 Rs 100".

(c) The discount account will be opened and posted as already shown.

(d) In account of G. Norwood we shall first debit Rs. 640 so that the wrong credit of Rs. 320 is converted into the debit of Rs. 320.

The entry will be "To Wrong posting on October 5, Rs. 640." Then to remove the wrong debit of Rs. 312 and give the correct credit of Rs. 320 Rs. 632 will be entered on the credit side by the entry. "By wrong posting on October 16, 2009, Rs. 632. The account of G.Norwood will appear as shown below:

G. Norwood's A/c

Dr. **2009**		**Rs.**	**2009**		**Cr.** **Rs.**
Oct. 16 " 11	To Cash Book To Wrong posting on Oct. 5 (wrong side)	312 640	Oct. 5 " 31	By Sales Book By Wrong posting on Oct. 16 (wrong side, wrong amount)	320 632
		952			952

(e) Rs. 36 has to be debited to the Purchases Account since on the 26th October, Rs. 36 was credited to this account in excess. The entry will be "To Wrong posting on Oct. 26 Rs. 36".

Illustration 2

How would you rectify the following errors in the books of Rama & Co.?

1. The total to the Purchases Book has been undercast by Rs. 100.

2. The Returns Inward Book has been undercast by Rs. 50.

3. A sum of Rs. 250 written off as depreciation on Machinery has not been debited to Depreciation Account.

4. A payment of Rs. 75 for salaries (to Mohan) has been posted twice to Salaries Account.

5. The total of Bills Receivable Book Rs. 1,500 has been posted to the credit of Bills Receivable Account.

6. An amount of Rs. 151 for a credit sale to Hari, although correctly entered in the Sales Book, has been posted as Rs. 115.

7. Discount allowed to Satish Rs. 25 has not been entered in the Discount Column of the Cash Book. It has been posted to his personal account.

Solution

1. The Purchases Account should receive another debit of Rs. 100 since it was debited short previously: "To Undercasting of Purchases Book for the month of - Rs. 100."

2. Due to this error the Returns Inward Account has been posted short by Rs. 50 : the correct entry will be: "To Undercasting of Returns Inward Book for the month of — Rs. 50."

3. The omission of the debit to the Depreciation Account will be rectified by the entry : "To Omission of posting on Rs. 250".

4. The excess debit will be removed by a credit in the Salaries Account by the entry : "By double posting on Rs. 75".

5. Rs. 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 Rs. 3,000 by the entry: "To Wrong posting of B/R received Rs. 3,000"

6. Hari's personal A/c is debited Rs. 36 short the rectification entry will be : "To Wrong posting Rs. 36".

7. Due to this error, the discount account has been debited short by Rs. 25. The required entry is : "To Omission of discount allowed to Satish Rs. 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 in fact that rectifying entry is made directly in the account(s) concerned. 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 Rs. 2,000 has been entered in the purchases book. The effect of the entry is that the account of the supplier has been credited by Rs. 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:

		Rs.	Rs.
Wrong Entry:			
Purchases Account	Dr.	2,000	
To Creditor			2,000
Correct Entry:			
Machinery Account	Dr.	2,000	
To Creditor			2,000
Rectifying Entry:			
Machinery Account	Dr.	2,000	
To Purchases Account			2,000

(ii) Rs. 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 :

Wrong Entry: Rs. Rs.

Cash Account	Dr.	1,000	
To Krishan Kishore			1,000

Correct Entry:

Cash Account	Dr.	1,000	
To Kamal Kishore			1,000

Rectifying Entry:

Krishan Kishore	Dr.	1,000	
To Kamal Kishore			1,000

(iii) The sale of old machinery, Rs. 1,000 has been entered in the sales book. By this entry the account of the buyer has been correctly debited by Rs. 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:

Wrong Entry: Rs. Rs.

Buyer's Account	Dr.	1,000	
To Sales Account			1,000

Correct Entry:

Buyer's Account	Dr.	1,000	
To Machinery Account			1,000

Rectifying Entry:

Sales Account	Dr.	1,000	
To Machinery Account			1,000

Illustration 3

The following errors were found in the books of Ram Prasad & Sons. Give the necessary entries to correct them.

(1) Rs. 500 paid for furniture purchased has been charged to ordinary Purchases Account.
(2) Repairs made were debited to Building Account for Rs. 50.
(3) An amount of Rs. 100 withdrawn by the proprietor for his personal use has been debited to Trade Expenses Account.
(4) Rs. 100 paid for rent debited to Landlord's Account.
(5) Salary Rs. 125 paid to a clerk due to him has been debited to his personal account.
(6) Rs. 100 received from Shah & Co. has been wrongly entered as from Shaw & Co.
(7) Rs. 700 paid in cash for a typewriter was charged to Office Expenses Account.

Solution

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	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
(1)	Furniture A/c Dr.		500	
	To Purchase A/c			500
	(Correction of wrong debit to Purchases A/c for Furniture Purchased)			
(2)	Repairs A/c Dr.		50	
	To Building A/c			50
	(Correction of wrong debit to building A/c for repairs made			

(3)	Drawings A/c Dr. To Trade Expenses A/c (Correction of wrong debit to Trade expenses A/c for cash withdrawn by the proprietor for his personal use)		100	 100
(4)	Rent A/c Dr. To Landlord's Personal A/c (Correction of wrong debit to land-lord's A/c for rent paid)		100	 100
(5)	Salaries A/c Dr. To Clerk's Personal A/c (Correction of wrong debit to Clerk's personal A/c for salaries paid)		125	 125
(6)	Shaw & Co. Dr. To Shah & Co. (Correction of wrong credit to Shaw & Co. instead of Shah & Co.)		100	 100
(7)	Typewriter A/c Dr. To Office Expenses A/c (Correction of wrong debit to Office Expenses A/c. for purchase of typewriter)		100	 100

Illustration 4

Give journal entries to rectify the following :

(1) A purchase of goods from Ram amounting to Rs. 150 has been wrongly entered through the Sales Book.

(2) A Credit sale of goods amounting Rs. 120 to Ramesh has been wrongly passed through the Purchase Book.

(3) On 31st Dec. 2009 goods of the value of Rs. 300 were returned by Hari Saran and were taken into stock on the same date but no entry was passed in the books.

(4) An amount of Rs. 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 Rs. 100 received from Man Mohan was dishonoured and had been posted to the debit of Sales Returns Account.

Solution

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	Particulars	**L.F.**	**Dr. Rs.**	**Cr. Rs.**
(1)	Purchases A/c Dr. Sales A/c Dr. To Ram (Correction of wrong entry in the sales Book for a purchases of goods from Ram)		150 150	 300
(2)	Ramesh Dr. To Purchases A/c To Sales A/c (Correction of wrong entry in the Purchases Book of a credit sale of goods to Ram)		240	 120 120

	Particulars	L.F.	Dr. Rs.	Cr. Rs.
(3)	Returns Inwards A/c Dr. To Hari Saran (Entry of goods returned by him and taken in stock omitted from records)		300	300
(4)	Mahesh Chand Dr. To Bad Debts Recovered A/c (Correction of wrong credit to Personal A/c in respect of recovery of previously written off bad debts)		200	200
(5)	Man Mohan Dr. To Sales Returns A/c (Correction of wrong debit to Sales Returns A/c for dishonour of cheque received from Man Mohan)		100	100

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.

7.7 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 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.

One must note that such agreement of the trial balance will not be 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, 2009 is cast Rs. 100 short; as a consequence the trial balance will not agree. The credit column of the trial balance will be Rs. 100 short and a Suspense Account will be credited by Rs. 100. To rectify the error the Sales Account will be credited (to increase the credit to the right figure. Since now one error remains, the Suspense Account must be closed- it will be debiting the Suspense Account. The entry will be :

Suspense Account	Dr.	100	
To Sales Account			100
(Correction of error of undercasting the sales Book for Nov. 2009)			

Illustration 5

Correct the following errors (i) without opening a Suspense Account and (ii) opening a Suspense Account :

(a) The Sales Book has been totalled Rs. 100 short.

(b) Goods worth Rs. 150 returned by Green & Co. have not been recorded anywhere.

(c) Goods purchased Rs. 250 have been posted to the debit of the supplier Gupta & Co.

(d) Furniture purchased from Gulab & Bros, Rs. 1,000 has been entered in Purchases Day Book.

(e) Discount received from Red & Black Rs. 15 has not been entered in the Discount Column of the Cash Book.

(f) Discount allowed to G. Mohan & Co. Rs. 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 cast Rs. 100 short, the Sales Account has been similarly credited Rs. 100 short. The correcting entry is to credit the Sales Account by Rs. 100 as "By wrong totalling of the Sales Book Rs. 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 Rs. 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 Rs. 500".

(d) By this error Purchases Account has to be debited by Rs. 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 purchases A/c was debited instead of the Furniture Account)			

(e) The discount of Rs. 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 Rs. 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 Rs. 18."

If a Suspense Account is opened :

	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
(a)	Suspense A/c Dr. To Sales A/c (Being the correction arising from under-casting of Sales Day Book)		100	 100
(b)	Return Inward Account Dr. To Green & Co. (Being the recording of unrecorded returns)		150	 150
(c)	Suspense A/c Dr. To Gupta & Co. (Being the correction of the error by which Gupta & Co. was debited instead of being credited by Rs. 250).		500	 500
(d)	Furniture Account Dr. To Purchases Account (Being the correction of recording purchase of furniture as ordinary purchases)		1,000	 1,000
(e)	Red & Black Dr. To Discount Account (Being the recording of discount omitted to be recorded)		15	 15
(f)	Discount Account Dr. 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. **Cr.**

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
	To Sales A/c To Gupta & Co.	100 500		By Difference in Trial Balance By Discount A/c	582 18
		600			600

Note :

(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 6

Correct the following errors found in the books of Mr. Dutt. The Trial Balance was out by Rs. 493 excess credit. The difference thus has been posted to a Suspense Account.

(a) An amount of Rs. 100 was received from D. Das on 31st December, 2009 but has been entered in the Cash Book on 3rd January, 2010.

(b) The total of Returns Inward Book for December has been cast Rs. 100 short.

(c) The purchase of an office table costing Rs. 300 has been passed through the Purchases Day Book.

(d) Rs. 375 paid for Wages to workmen for making show-cases had been charged to "Wages Account".

(e) A purchase of Rs. 67 had been posted to the creditors' account as Rs. 60.

(f) A cheque for Rs. 200 received from P. C. Joshi had been dishonoured and was passed to the debit of "Allowances Account".

(g) Rs. 1000 paid for the purchase of a motor cycle for Mr. Dutt had been charged to "Miscellaneous Expenses Account".

(h) Goods amounting to Rs. 100 had been returned by customer and were taken in to stock, but no entry in respect thereof, was made into the books,

(i) A sale of Rs. 200 to Singh & Co. was wrongly credited to their account.

Solution

(a) The following entry should be passed on 31st December, 2009:

Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
Bank Account Dr. To D. Das (Being the amount received)		100	100

The entry already passed in the Cash Book on 3rd January, 2010 will be reversed by entering on the credit side of the Cash Book : "By D. Das Rs. 100" (to reverse entry wrongly passed on January 3).

	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
(b)	Returns Inward Account Dr. To Suspense Account (Being the mistake in totalling the Returns Inward Book corrected)		100	100
(c)	Furniture Account Dr. To Purchases Account (Being the rectification of mistake by which purchase of furniture was entered in Purchases book and hence debited to Purchases Account)		300	300
(d)	Furniture Account Dr. To Wages Account (Being the wages paid to workmen for making show-cases which should be capitalised and not to be charged to Wages Account)		375	375
(e)	Suspense Account Dr. To Creditor's (personal) Account (Being the mistake in crediting the Creditors Account less by Rs. 7, now corrected)		7	7
(f)	P.C. Joshi Dr. To Allowances Account (Being the cheque of P.C. Joshi dishonoured, previously debited to Allowances Account)		200	200

	Particulars	L.F.	Dr. Rs.	Cr. Rs.
(g)	Drawings Account Dr. To Miscellaneous Expenses (Being the motor cycle purchased for Mr. Dutt debited to his Drawings Account instead of Miscellaneous Expenses Account as previously done by mistake)		1,000	1,000
(h)	Returns Inward Account Dr. To Customer's (Personal) Account (Correction of the omission to record return of goods by customers)		100	100
(i)	Singh & Co. Dr. To Suspense Account (Being the correction of mistake by which the account of Singh & Co. was credited by Rs. 200 instead of being debited)		400	400

Suspense Account

Dr. **Cr.**

Date 2009	**Particulars**	**Amount Rs.**	**Date 2009**	**Particulars**	**Amount Rs.**
Dec.31	To Difference in Trial Balance	493	Dec. 31	By Returns Inwards A/c	100
" "	To Creditor's A/c	7	" "	By Singh & Co.	400
		500			500

Illustration 7

The following errors, affecting the account for the year 2009 were detected in the books of Jain Brothers, Delhi:

(1) Sale of old Furniture Rs. 150 treated as sale of goods.

(2) Receipt of Rs. 500 from Ram Mohan credited to Shyam Sunder.

(3) Goods worth Rs. 100 brought from Mohan Narain have remained unrecorded so far.

(4) A return of Rs. 120 from Mukesh posted to his debit.

(5) A return of Rs. 90 to Shyam Sunder posted as Rs. 9 in his account.

(6) Rent of proprietor's residence, Rs. 600 debited to rent A/c.

(7) A payment of Rs. 215 to Mohammad Sadiq posted to his credit as Rs. 125.

(8) Sales Book added Rs. 900 short.

(9) The total of Bills Receivable Book Rs. 1,500 left un posted.

You are required to pass the necessary rectifying entries and show how the trial balance would be affected by the errors.

Solution

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	Particulars	**L.F.**	**Dr. Rs.**	**Cr. Rs.**
(1)	Sales Account Dr. To Furniture Account (Rectification of sales of furniture treated as sales of goods)		150	150

	Particulars	L.F.	Dr. Rs.	Cr. Rs.
(2)	Shyam Sunder Dr.		500	
	To Ram 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)			
(4)	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 Rs. 240.
(5) Debit the account of Shyam Sunder by Rs. 81.
(7) Debit the account of Mohammad Sadiq by Rs. 340.
(8) Credit Sales Account by Rs. 900.
(9) Debit Bills Receivable Account with Rs. 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 Rs. 240.
5. Trial Balance debit total short by Rs. 81.
6. No effect
7. Trial Balance debit total short by Rs. 340.
8. Trial Balance credit total short by Rs. 900.
9. Trial Balance debit total short by Rs. 1,500.

Illustration 8

The trial balance of Mr. W & H failed to agree and the difference Rs. 20,570 was put into suspense pending investigation which disclosed that:

(i) Purchase returns day book had been correctly entered and totalled at Rs. 6,160, but had been posted to the ledger.

(ii) Discounts received Rs. 1,320 had been debited to discounts allowed.

(iii) The Sales account had been under added by Rs. 10,000.

(iv) A credit sale of Rs. 1,470 had been debited to a cutomer account at Rs. 1,740.

(v) A vehicle bought originally for Rs. 7,000 four years ago and depreciated to Rs. 1,200 had been sold for Rs. 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 Rs. 560 for telephone charges had been completely omitted.

(vii) A bad debt of Rs. 1,560 had not been written off and provision for doubtful debts should have been maintained at 10% of debtors which are shown in the trial balance at Rs. 23,390 with a credit provision for bad debts at Rs. 2,320.

(viii) Tools bought for Rs. 1,200 had been inadvertently debited to purchases.

(ix) The proprietor had withdrawn, for personal use, goods worth Rs. 1,960. No entries had been made in the books.

Required:

(i) Pass rectification entries without narration to correct the above errors before preparing annual accounts.

(ii) Prepare a statement showing effect of rectification on the reported net profit before correction of these errors.

Solution

	Particulars		**L.F.**	**Dr. (Rs.)**	**Cr.(Rs.)**
(i)	Suspense Account	Dr.		6,160	
	To Return Outward A/c				6,160
(ii)	Suspense Account	Dr.		2,640	
	To Discount Allowed Account				1,320
	To Discount Received Account				1,320
(iii)	Suspense Account	Dr.		10,000	
	To Sale Account				10,000
(iv)	Suspense Account	Dr.		270	
	To Customer Account				270
(v)	Suspense Account	Dr.		1,500	
	To Vehicle Account				1,200
	To Profit on Sale of Vehicle Account				300
(vi)	Telephone Charges Account	Dr.		560	
	To Outstanding Expenses Account				560
(vii)	Bad Debts Account	Dr.		1,560[1]	
	To Sundry Debtors Account				1,560
	Provision for Doubtful Debts Account	Dr.		164[2]	
	To Profit and Loss Account				164
(viii)	Loose Tools Account	Dr.		1,200	
	To Purchases Account				1,200
(ix)	Drawing Account	Dr.		1,200	
	To Purchases				1,200

[1] Bad debts account will be debited in the profit and loss account.

[2] Provision @ 10% ofRs. 2,156; Excess provision Rs. 164.

Working Notes :

			(Rs.)
(i)	Sundry Debtors as per books		23,390
	Deduction vide item (iv)	270	
	Bad Debts	1,560	1,830
			21,560

(ii) **Suspense Account**

Particulars	Rs.	Particulars	Rs.
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	10,000		
To Customers	270		
To Vehicles	1,200		
To Profit on Sale of Vehicle Account	300		
	20,570		20,570

Illustration 9

On going through the Trial balance of Ball Bearings Co. Ltd. you find that the debit is in excess by Rs. 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 cast in excess by Rs. 50

(2) The "Sales Account" has been totalled in short by Rs. 100.

(3) One item of purchase of Rs. 25 has been posted from the day book to ledger as Rs. 250.

(4) The sales return of Rs. 100 from a party has not been posted to that account though the Party's account has been credited.

(5) A cheque of Rs. 500 issued to the Suppliers' account (shown under Sundry Creditors) towards his dues has been wrongly debited to the purchases.

(6) A credit sale of Rs. 50 has been credited to the Sales and also to the Sundry Debtors Account.

- (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.

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	Particulars	L.F.	Dr. (Rs.)	Cr.(Rs.)
	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's Account 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)			

Particulars		L.F.	Dr. (Rs.)	Cr.(Rs.)
Sundry Creditors	Dr.		500	
To Purchases Account				500
(Being the payments made to supplier wrongly posted to purchases now rectified)				
Sundry Debtors		Dr.		100
To Suspense Account				100
(Being the sales wrongly credited to Customer's Account now rectified)				

* It is assumed that the day-book is the Purchase Day Book in which case only the supplier's account would be posted wrongly (creditor of Rs. 250 instead of Rs. 25). If however, by day-book is meant a book in which all transactions are recorded and posted at the ledger there from, it would mean that both the Supplier's Account and Purchases Account are wrongly posted.

Dr. **Suspense Account** **Cr.**

	Rs.		Rs.
To Expenses Account	50	By Difference in Trial Balance	150
To Sales Account	100	By Sundry Creditors	225
To Balance c/d	425	By Sales Returns Account	100
		By Sundry Debtors	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 Rs.	Decreased by Rs.
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 Rs. 550.

Illustration 10

The Trial balance of Messrs. A, B and C did not agree. A Suspense Account was opened with the amount of the difference. The following errors were discovered on scrutiny:

(1) The addition of the Analysis Column of the Tabular Purchase Journal posted to Goods Purchased for Resale Account was found to be short by Rs. 150 though the addition of the total column was correct.

(2) A dishonoured B/R for Rs. 400 returned to the firm by bank had been credited to Bank Account for collection of bills and debited to B/R Account. A cheque was later received from the customer for Rs. 400 and was duly paid into the firm's bank account.

(3) An amount of Rs. 450 treated as paid in advance on account of insurance in the previous year was not brought forward.

(4) Sales on approval amounting to Rs. 2,000 were included in the Sales Account. Half of these were returned but no entries were passed in respect of these goods. However, the returned goods have been included in the closing stock at their cost price of Rs. 500.

(5) Of the total amount of Rs. 38,356 shown as Sundry Debtors, Rs. 1,260 represent credit given to customers when the payments against sales invoices were received. However, these invoices themselves were not entered in the books. A discount of 10% is allowed on the selling price in all such invoices.

You are required to pass rectifying entries making use, of the Suspense Account, wherever necessary.

Solution

Journal of M/s A, B and C

	Particulars	L.F.	Dr. Rs.	Cr. Rs.
1.	Purchase for Resale A/c Dr.		150	
	To Suspense Account			150
	(Short debit to 'purchases for Resale Account' on account of undercasting on now corrected)			
2.	Customers A/c Dr.		400	
	To Bills Receivable A/c			400
	(Amount of dishonoured bill receivable previously debited to Bills Receivable Account, error now rectified)			
3.	Insurance Account Dr.		450	
	To Suspense Account			450
	(Prepaid insurance in the previous year not brought forward now debited to the Insurance Account)			
4.	Sales Account Dr.		1,000	
	To Customer's Account			1,000
	(Goods worth Rs. 1,000 returned by a customer on sale or return basis, previously omitted to be recorded; error now rectified)			
5.	Discount Account Dr.		140	
	Customers Account Dr.		1,260	
	To sales Account			1,400
	(Credit sales of Rs. 1,400 previously omitted from the books, error now corrected)			

Note: Payment being equal to 90% of the gross sale is Rs. 1,400, i.e., 1,260 x 100/90. 1/10 of this amount is discount.

Since the discount of 10% is allowed in all cases, it would be better to treat the sale to be Rs. 1,260 and not Rs. 1,400, the discount is trade discount for which no account is opened, the sales being recorded, at the net amount.

7.8 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 Rs. 1,000 in December, 2009 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 2010 will be Rs. 1,000 more than the amount relating to year 2010 and thus the profit that year 2010 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 "Profits and Loss Adjustment Account". The balance in the account should be transferred to the Profits and Loss Account. However, these Prior Period Items should be charged after deriving net 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 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 profit or loss can be perceived.

Illustration 11

Mr. A closed his books of account on September 30, 2009 inspite of a difference in the trial balance. The difference was Rs. 830 the credits being short; it was carried forward in a Suspense Account. In 2010 following errors were located :

(i) A sale of Rs. 2,300 to Mr. Lala was posted to the credit of Mrs. Mala.

(ii) The total of the Returns Inward Book for July, 2007 Rs. 1,240 was not posted in the ledger.

(iii) Freight paid on a machine Rs. 5,600 was posted to the Freight Account as Rs. 6,500.

(iv) While carrying forward the total in the Purchases Account to the next page, Rs. 65,590 was written instead of Rs. 56,950.

(v) A sale of machine on credit to Mr. Mehta for Rs. 9,000 was not entered in the books at all. The book value of the machine was Rs. 7,500. The firm has the practice of writing off depreciation @ 10% on the balance at the end of the year.

Solution

Journal of Mr. 'A'

Date 2010	Particulars		L.F.	Dr. Rs.	Cr.Rs.
(i)	Mrs. Mala	Dr.		2,300	
	Mr. Lala	Dr.		2,300	
	To Suspense A/c				4,600
	(Correction of error by which a sale of Rs. 2,300 to Mr. Lala was posted to the Credit of Mrs. Mala)				
(ii)	Profit and Loss Adjustment A/c	Dr.		1,240	
	To Suspense A/c				1,240
	(Rectification of omission to post the total of Returns Inward Book for July, 2009)				
(iii)	(a) Machinery A/c	Dr.		5,600	
	Suspense A/c	Dr.		900	
	To Profit & Loss Adjustment A/c				6,500
	(Correction of error by which freight paid for a machine Rs. 5,600 was posted to Freight Account at Rs. 6,500 instead of capitalising it)				
	(b) Profit & Loss Adjustment A/c	Dr.		560	
	To Plant and Machinery A/c				560
	(Depreciation @ 10% charged on freight paid on a machine capitalised)				

Date 2010	Particulars	L.F.	Dr. Rs.	Cr.Rs.
(iv)	Suspense A/c Dr.		8,640	
	To Profit & Loss Adjustment A/c			8,640
	(Correction of wrong carry forward of total in the purchase Account to the next page Rs. 65,950 instead of Rs. 56,950)			
(v)	Mr. Mehta Dr.		9,000	
	To Plant and Machinery A/c			6,750
	To Profit & Loss Adjustment A/c			2,250
	(Correction of omission of a sale of machine on credit to Mr. Mehta for Rs. 9,000 with a book value of Rs. 7,500 on which depreciation @ 10% has been charged in 2009)			

Comments

The Suspense Account will now appear as shown below:

Suspense Account

Dr. Cr.

Date 2010	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
	To Profit and Loss Adjustment A/c	900	2009	By Balance b/d	830
	To Profit and Loss Adjustment A/c	8,640	Oct.1	By Mrs. Mala	2300
				By Mrs. lala	2300
				By Profit & 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)

Dr. Cr.

Date 2010	Particulars	Amount Rs.	Date 2010	Particulars	Amount Rs.
	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

7.9 Suspense Accounts

A. Introduction

Even if the trial balance does not tally due to the existence of one sided errors, accountant has to carry forward his accounting process prepare financial statements. The accountant tallies this trial balance by putting the difference on shorter side as 'suspense account'.

B. Process of rectification

The process of rectification using suspense account can be understood with the help of the following example:

C. Practical Example

(a)Credit sales of Mohan Rs. 10,000 were not posted to his account. This is an error of partial omission committed while posting entries of the sales book.

Wrong effect has been:

Mohan's A/c	Dr.	Nil	
To Sales A/c			10,000

Correct effect should have been:

Mohan's A/c	Dr.	10,000	
To Sales A/c			10,000

The rectification entry will be:

Mohan's A/c	Dr.	10,000	
To Suspense A/c			10,000

(b) Credit sales to Mohan Rs. 10,000 were posted to his account as Rs. 7,000 an error of commission. Mohan's account has been debited with Rs. 7,000 of Rs. 10,000 resulting in short debit of Rs. 3,000.

Wrong effect has been:

Mohan's A/c	Dr.	7,000	
To Sales A/c			10,000

Correct effect should have been:

Mohan's A/c	Dr.	10,000	
To Sales A/c			10,000

The rectification entry will be:

Mohan's A/c	Dr.	3,000	
To Suspense A/c			3,000

(c) Credit sales to Mohan Rs. 10,000 were posted to his account as Rs. 12,000. This is an error of commission.

The Wrong effect has been:

Mohan's A/c	Dr.	12,000	
To Sales A/c			10,000

Correct effect should have been:

Mohan's A/c	Dr.	10,000	
To Sales A/c			10,000

The rectification entry will be:

Suspense A/c	Dr.	2,000	
To Mohan's A/c			2,000

(d) Purchases book overcast by Rs. 1,000. Errors in casting of subsidiary by affect only those accounts where totals of the subsidiary books involved are posted. The accounts of individual parties are not affected. Consider the following example.

Purchases (Journal) Book

Date	Invoice No.	Name of suppliers (Accounts to be credited)	L.F.	Amount Rs.
		Dheru		8,000
		Chandraprakash		7,000
		Sachin		6,000
				21,000
		Wrong total due to overcasting		22,000

Dheru's Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
					By Purchases		8,000

Chandraprakash's Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
					By Purchases		7,000

Sachin's Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
					By Purchases		6,000

Purchases Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
	To Sundries		22,000				

As you can notice that there is no error in accounts of Dheeru, Chanderprakash and Sachin. Only purchases account has been debited with Rs. 1,000 extra. Hence, rectification entry will be :

Suspense A/c	Dr.	1,000	
To Purchases A/c			1,000

D. Summary

If the trial balance does not tally due to the existence of one sided errors, accountant has to carry forward his accounting process and prepare financial statements. The accountant tallies this trial balance by putting the difference on shorter side as 'suspense account'.

7.10 Summary

To check the arithmetic accuracy of the journal and ledger accounts, trial balance is prepared. 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 two totals do not agree, it is definite that there have been some errors.

There are various types of errors, which is illustrated by the flowchart.

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. So there are some steps for solving it or remove errors.

Errors should never be corrected by overwriting. If immediately after making an entry it is clear that an error has been committed, it may be corrected by neatly crossing out the wrong entry and making the correct entry.

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.

Rectification of errors often 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.

7.11 Key Words

Trial Balance: 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.

Rectification of Errors: Errors should never be corrected by overwriting. If immediately after making an entry it is clear that an error has been committed, it may be corrected by neatly crossing out the wrong entry and making the correct entry.

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.

Wrong Entry: Wrong entry of the value of transactions and events in the subsidiary books, Journal Proper and Cash Book may occur.

Wrong Posting from Subsidiary Books: Subsidiary books are totalled periodically and posted to the appropriate ledger accounts. There may arise totalling errors. Totalling errors may arise due to wrong entry or simply these may be independent errors.

Wrong Casting of Subsidiary Book: For example, wrong castings of the Cash Book result in balancing error.

Wrong Casting of Ledger Balances: Likewise Cash Book, any ledger account balance may be cast wrongly. Obviously wrong postings make the balance wrong; but that is not wrong casting of balances.

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.

Clerical Errors: These errors arise because of mistake committed in the ordinary course of the accounting work. These are of three types:

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,

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."

Compensating Errors: If the effect of errors committed cancel out, the errors will be called compensating errors. The trial balance will agree.

7.12 Self Assessment Questions

I. Pick up the correct answer from the given choices:

1. (i) Goods purchased from A for Rs. 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. (d) Either (a) or (b).

(ii) If a purchase return of Rs. 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 Rs. 1,000 more than the credit
(b) trial balance would show the credit side to be Rs. 1,000 more than the debit
(c) the debit side of the trial balance will be Rs. 2,000 more than the credit side.
(d) the credit side of the trial balance will be Rs. 2,000 more than the debit side.

(iii) 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. (d) compensating error.

(iv) If a purchase return of Rs. 84 has been wrongly posted to the debit of the sales return a/c, but had been correctly entered in the suppliers account, the total of the trial balance would show :

(a) the credit side to be Rs. 84 more than debit side.
(b) the debit side to be Rs. 84 more than credit side.
(c) the credit side to be Rs. 168 more than debit side.
(d) the debit side to be Rs. 168 more than credit side.

Ans. 1 [(i)-(a); (ii)-(c); (iii)-(b); (iv)-(d)]

2. **State which statements complete correctly the sentences given below:**

(i) Rs. 200 paid as wages for erecting a machine should be debited to

(a) Repair account (b) Machine account
(c) Capital account (d) Furniture account

(ii) On purchase of old furniture, the amount of Rs. 1,000 spent on its repair should be debited to

(a) Repair account (b) Furniture account
(c) Cash account (d) Bank account

(iii) Goods worth Rs. 50 given as charity should be credited to

(a) Charity account; (b) Sales account
(c) Purchases account (d) Expenses account.

(iv) Goods worth Rs. 100 taken by proprietor for domestic use should be credited to

(a) Sales account; (b) Proprietor's personal exp. account
(c) Purchases account (d) Expenses account

(v) Errors of commission do not permit;

(a) Correct totalling of the balance sheet; (b) Correct totalling of the trial balance;
(c) The trial balance to agree (d) None of the above

(vi) The preparation of a trial balance is for :

(a) Locating errors of commission (b) Locating errors of principle
(c) Locating clerical errors (d) All of the above.

(vii) Rs. 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 (d) Bad debts account

(viii) Purchase of office furniture Rs. 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 (d) Compensating error

(ix) Goods destroyed by fire should be credited to

(a) Goods lost by fire account; (b) Sales account
(c) Purchase Account (d) Cash Account

[Ans. 2 : (i)-(b); (ii)-(b); (iii)-(c); (iv)-(c); (v)-(c); (vi)-(c); (vii)-(a); (viii)-(b); (ix)-(a); (x)-(b)]

II. From the given information, choose the most appropriate answer.

1. Classify the following errors under (a) Errors of omission; (b) Errors of commission; (c) Errors of principle; and (d) Compensating errors.

(i) The total of sales book was not posted to the ledger.
(ii) Sales to Heena Rs. 143 was posted to Meena as Rs. 143.
(iii) Goods taken away by the proprietor for personal use not recorded anywhere.
(iv) The total of a folio in the sales book Rs. 1,000 was carried forward as Rs. 100.
(v) Repairs of newly purchased second-had machinery debited to repairs accounts.

[Ans. 1: (i)-b); (ii)-(b); (iii)-(a); (iv)-(b); (v)-(c)]

2. Point out the type of the errors given below : (put 1 against errors of omission, 2 against errors of commission, 3 against errors of principle, 4 if it is not an error).

(a) Sale of Rs. 120 was written in the purchases book.
(b) Salary paid to Ram, has been debited to his account.
(c) Purchase of furniture has been entered in the purchases book.
(d) Rs. 120 received from Ganesh has been debited to his account.
(e) Freight paid on machinery has been debited to the freight account.
(f) The discount columns of the cash book have not been posted.
(g) Repairs to buildings have been debited to the buildings account.
(h) The total of the Sales Book is Rs. 100 short.
(i) The sale of worth Rs. 337 has been posted as Rs. 373.
(j) The amount of a dishonoured bill has been debited to general expenses account.

[Ans. 2: - 1:(f); 2:(a) (d) (h) (i); 3: (b) (c) (e) (g) (j)]

III. Given below are the questions containing multiple answers. Choose the correct answer(s).

1. Below some errors are mentioned. State which of these will not be revealed by the Trial Balance: (a) compensating errors; (b) errors of principle;

(c) wrong balancing of an account (d) wrong totalling of an account.

[Ans. : 1 : (a) and (b) will not be revealed]

2. Below some errors are mentioned. State which of these will be revealed by the Trial Balance:

(a) compensating errors; (b) errors of principle;
(c) wrong balancing of an account (d) wrong totalling of an account.

[Ans. : (c) and (d) will be revealed]

7.13 Reference Books

1. Fundamentals of Accounting - R.L. Guputa and V.K. Gupta

2. Fundamentals of Accounting - Jain, Khandelwal, Pareek

3. Book-keeping and Accountancy - M.L. Sharma, D.K. Bhardwaj and D.K. Jain

4. Introduction to Accountancy - T.S. Grewal.

Unit - 8 Bank Reconciliation Statement

Structure of Unit:

8.0 Objectives

After Completing this unit, you will be able to:

- Define Bank Reconciliation Statement;
- Analyze the need and importance of Bank Reconciliation Statement;
- Prepare Bank Reconciliation Statement;
- Prepare Bank Reconciliation Statement from adjusted cash book.

8.1 Introduction and Meaning

Usually all business enterprises open a current account with Bank. it is customary for a bank to send to its customers regularly a statement containing information of his account.

At the same time businessmen also maintain cash book to record transactions with bank. However, often there is a difference even if there is no mistake.

Thus, to know the position and to ensure that there is no mistake, a statement is prepared to explain causes of differences between the balances of bank statement i.e. pass book and balances of cash book. It is known as bank reconciliation statement.

It may be defined as under:

"Bank Reconciliation statement is a statement prepared mainly to reconcile the difference between the Bank Balance shown by Cash Book and Bank Pass Book."

Thus we can say that Bank Reconciliation Statement is a statement which reconciles the balance as per cash book and the balance as per pass book showing all causes of difference between them.

8.2 Causes of Difference

The causes of difference between the balance as per Cash Book and Pass Book are as under:

1. Cheque issued but not yet presented for payment: Where cheque has issued to the party it is credited in the cash book and shows the less bank balance, however if it is not presented into bank by the party the pass book shows an excess balance. Thus, there exist differences.

2. Cheque deposited into the bank but not yet collected: Sometimes, cheque deposited into bank for collection, and debited to the cash book but until it is collected by bank the pass book shows a short balance.

3. Bank Charges: Bank Charges fees and commission on the services provided by them. These charges are entered in the pass book but not in the cash book, and it creates difference between the balance of these books.

4. Interest allowed by bank: The customer gets interest on the amount deposited in their account. But until the customers get informed, There arises difference.

5. Direct deposit by customer: Where a customer directly deposit in the bank, it is recorded in the pass book but not in the cash book, thus, creates a difference.

6. Dishonour of bill discounted: Bills discounted with the bank and later on dishonoured at maturity are debited by bank in the Pass Book but not recorded in Cash Book.

7. Standing Order: When a bank met a pay order, as per standing orders or instructions such as Premium of insurance policy, water and electricity bills etc. Similarly if bank collected dividend on shares and interest on debentures and entered in the Pass Book but it has not included in the cash book. Thus, it shows a difference between the books.

8. Omission: The difference may be occur due to omission for example cheque drawn but not recorded or due to error in casting balances.

8.3 Need and Importance

Bank reconciliation statement is necessary due to the following reasons:

1. **Detection of Errors:** It is helpful in detecting the errors which arises due to omission of a transaction or due to wrong recording of transactions.

2. **To avoid undue delays in collection:** Comparison of the cash book with the pass book shows the position of collection of cheque, bills etc. thus with the help of bank reconciliation statement debtors may be pursued to pay on time and unnecessary delays in collection may be avoided.

3. **Accuracy of transaction:** Reconciliation is helpful to check the accuracy of the transactions entered in the cash book or pass book. Periodic comparison of Cash book and Pass book is helpful to trace the cheque which may have been sent to bank for collection.

4. **Reduces chances of Fraud:** Due to fear of detection of fraud by periodic comparison, the chances of fraud and embezzlement reduces.

5. **Completion of Cash Book:** While preparing statement businessman comes to know about various charges such as bank charges, direct payment or deposit according to standing instruction. It helps in keeping true balance of method.

8.4 Methods

The Bank Reconciliation statement can be prepared by the following methods:

1. **Taking the balance as per pass Book as Starting point:** Under this method in priority the balance as per bank pass book is taken and then it is compared with the transactions of cash book.

2. **Taking the balance as per cash book as starting point:** Bank Reconciliation may be prepared by using balance of the cash book first and there after the transaction of Pass Book are compared with the cash book.

8.5 Presentation of Bank Reconciliation Statement

Before presenting bank reconciliation following guidelines should be followed:

i) If 'Dr. Balance as per cash book or Cr. Balance as per pass book' is given in a question it means the balance of deposit with the bank or favourable balance as per cash book.

ii) If 'Cr. Balance as per cash book or Dr. Balance as per pass book' is given in a question – It means bank overdraft or unfavourable balance as per cash book.

In other words there may be

- I Dr. balance as per cash book – Favourable balance
- II Cr. balance as per cash book – Unfavourable balance
- III Dr. balance as per pass book – Unfavourable balance
- IV Cr. balance as per pass book – Favourable balance

After entering starting balance in the statement this balance is then adjusted by noting how the balance would have changed if the same entries are mude in the two books i.e. passbook and cash book.

In other words, following steps should be taken to prepare Bank Reconciliation Statement.

Step I – Enter the balances of the books given in the question

Step II – Analyse the reasons given in the question and their impact on the other balance and accordingly add or subtract the amount

Step III – Calculate the final balance. It is the balance of the other book.

In short, the adjustment of various items of differences depend upon the starting base which is summarised in the following chart:

Bank Reconciliation Statement as on......

	Transactions	When Cash Book Balance is Starting Point		When Pass Book Balance is Starting Point	
		Normal Balance (Dr. Bal.)	Overdraft Balance (Cr. Bal.)	Normal Balance (Cr. Bal.)	Normal Balance (Dr. Bal.)
1.	Cheques issued but not yet presented for payment.	Add	Less	Less	Add
2.	Cheques deposited into bank but not yet collected.	Less	Add	Add	Less
3.	Interest allowed by bank but not yet entered in cash book.	Add	Less	Less	Add
4.	Bank charges not yet entered in cash book.	Less	Add	Add	Less
5.	Direct deposit into the bank by a customer.	Add	Less	Less	Add
6.	Direct payments made by bank not yet entered in cash book.	Less	Add	Add	Less
7.	Direct collection made by bank but not yet entered in cash book.	Add	Less	Less	Add
8.	Cheques issued and payment received by the customers but not yet entered in cash book.	Less	Add	Add	Less
9.	Cheqsues paid into bank for collection but ommitted to be entered in cash book.	Add	Less	Less	Add
10.	Dishonour of a cheque for which no entry was passed in cash book.	Less	Add	Add	Less
11.	Cheques entered in cash book but omitted to be banked.	Less	Add	Add	Less

8.6 Illustrations

I. When Debit balance as per cash book is given

Illustration 1.

Prepare a Bank Reconciliation statement from the following particulars on 31-3-2010:

		Rs
1.	Debit balance as per bank column of the cash book	3,72,000
2.	Cheques issued to creditors, but not yet presented to the bank for payment	72,000
3.	Dividend received by the bank, but not entered in the cash book	5,000
4.	Interest allowed by bank	1,250
5.	Cheques deposited into bank for collection, but not collected by the bank upto this date	15,400
6.	Bank charges	200
7.	A cheque deposited into bank was dishonoured, but no intimation was received	320
8.	Bank paid house tax on our behalf, but no information received from bank in this connection	350

Solution:

Bank Reconciliation Statement
as on 31-3-2010

Particulars	Amount in Rs.
Balance as per cash book	3,72,000
Add	
cheques issued but not presented	+72,000
Dividend received by bank not recorded in cash book	+ 5,000
Interest allowed by bank	+ 1,250
Subtract	
Cheques deposited but not yet collected	-15,400
Bank charges	- 200
Dishonour of cheque deposited	- 320
House tax paid by bank	- 350
Balance as per pass book	**4,33,980**

II. When credit balance as per Pass book is given

Illustration 2.

Prepare a Bank Reconciliation statement as on 30th September, 2009 from the following particulars:

		Rs
1.	Bank balance as per the Pass-Book	10,000
2.	Cheques Deposited into the bank, but no entry was passed in the Cash Book	500
3.	Cheque received and entered in the Cash Book but not sent to bank	1,200
4.	Credit side of the Cash Book bank column cast short	200
5.	Insurance Premium paid directly by the bank under the standing advice	600
6.	Bank charges entered twice in the Cash Book	20
7.	Cheque issued, but not presented to the bank for payment	500
8.	Cheque received entered twice in the Cash Book	1,000
9.	Bill discounted dishonoured not recorded in the Cash Book	5,000

Solution :

Bank Reconciliation Statement

As on 30th September, 2009

Particulars	Plus Items Rs.	Minus Items Rs.
Balance as per Pass Book (Cr.) (Favourable)	10000	
Cheque deposited into the bank but not recorded in the Cash book		500
Cheque received and recorded in the Cash Book but not sent to bank	1200	
Credit side of the Cash book bank column cast short	200	
Insurance premium not recorded in the Cash book		600
Bank charges entered twice in the Cash book		20
Cheque issued but not presented for payment	500	
Cheque received entered twice in the Cash book	1000	
Bill discounted dishonoured not recorded in the Cash book	5000	
	17,900	1120
Balance as per Cash Book (Dr.)	**16780**	

III. When Debit balance as per Pass book is given

Illustrations 3:

On 31-3-2010, the bank pass book of a trader showed an overdraft of Rs. 9,000. A comparison of entries in the pass book with those in the cash book revealed the following:

1. Cheques for Rs. 15,000 deposited with the bank on 29-3-2010 were not credited by the bank before 1-4-2010,

2. Rs, 7,000 withdrawn from bank for office were entered in the cash book as Rs. 9000

3. Bank charged Rs. 300 as service charges but the transaction was not recorded in the cash book.

4. Cheques were issued for Rs. 17,700 on 28-3-2010 out of which cheques for Rs. 7,700 were presented to the bank for payment after 31-3-2010.

5. Debit side total of the bank column of the cash book was carried forward as Rs. 1,13,900 instead of Rs. 1,31,900.

Prepare a bank Reconciliation statement as on 31-3-2010.

Solution:

Bank Reconciliation Statement
as on 31-3-2010

Particulars	Plus Item Rs.	Minus Item Rs.
Overdraft as per pass book		9000
Cheques deposited with bank but not yet credited by bank	15000	
Withdrawal from bank overstated in cash book		2000
Bank charges not yet recorded in cash book	300	
Cheques issued but not yet presented for payment		7700
Wrong carry-forward in cash book		18000
	15300	36700
Overdraft as per cash book		**- 21400**

IV. When Credit balance as per cash book is given

Illustration 4:

Prepare a Bank Reconciliation Statement in the books of Snow White Ltd. As on 30th June 2009 from the following information:-

	Rs.
1. Credit Balance (Overdraft) as per Cash Book as on 30th June 2009	1,50,000
2. Cheques deposited but not yet credited by the Bank	85,000
3. Another Cheque deposited but dishonoured	12,000
4. Cheques issued but not yet presented for payment	60,000
5. Interest on overdraft not recorded in Cash Book	7800

6. A cheque of Rs. 24,200 received from a customer, although entered in the Cash Book, was not sent to bank.

Solution:

Bank Reconciliation Statement
As on 30th June 2009

Particulars	Plus Item Rs.	Minus Item Rs.
Credit Balance (Overdraft) as per Cash Book		1,50,000
Cheques deposited but not yet credited by the bank		85,000
Cheque deposited but dishonoured		12,000
Cheques issued but not yet presented for payment	60,000	
Interest on Overdraft charged by bank		7,800
Cheque entered in the Cash Book but not sent to bank		24,200
	60,000	2,79,000
Debit Balance (Overdraft) as per Pass Book		**2,19,000**

8.7 Preparation of a Bank Reconciliation Statement from Adjusted Cash Book Balance

To Prepare Bank Reconciliation Statement by preparing amended Cash Book (Bank column):

Following rules should be followed:

i) If there is wrong entry in Cash Book whether it is related to balancing or totalling should be corrected in the Cash Book. These items are not shown in the reconciliation statement.

ii) Those entries which are entered in Pass Book but not entered in Cash Book should be entered in the Cash Book properly.

iii) Those items which have been shown in the Cash Book but not entered in Pass Book, should be entered in the reconciliation statement.

Thus the Bank Reconciliation Statement will be made by amended Cash Book balance. This amended balance is shown in the Trial Balance and Balance Sheet as bank balance.

Illustration 5:

From the following particulars, find out adjusted bank balance as per cash book and prepare thereafter Bank Reconciliation Statement as on 31-12-2009 of a sole-proprietor:

		Rs.
a)	Bank overdraft as per Cash Book	80,000
b)	Cheque deposited as per bank statement but not entered in Cash Book	3,000
c)	Cheques recorded for collection but not sent to Bank	10,000
d)	Credit side of Bank column cast short	1,000
e)	Premium on Proprietor's LIP paid on standing advice	5,000
f)	Bank charges recorded twice in Cash Book	100
g)	Customer's cheque returned as per Bank statement only	4,000
h)	Cheque issued but dishonoured on technical ground	3,000
i)	Bills collected by Bank directly	20,000
j)	Cheque for Rs. 50,000 deposited but collection per Bank statement	49,980
k)	Cheque received entered twice in Cash Book	5,000

Solution

Cash Book (Amended Bank Column)

Dr. Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
31-12-09	To Customers A/c (b)	3,000	31-12-09	By balance b/d (a)	80,000
	To Bank Charges A/c (f)	100		By suspense A/c (undercasting of bank column)(d)	1,000
	To Customers A/c (i)	20,000		By Drawings A/c (e)	5,000
	To balance c/d	71,900		By Customers A/c (g)	4,000
				By Customers A/c (k)	5,000
		95,000			**95,000**

Bank Reconciliation Statement
as on 31-12-2009

Particulars	Amount (Rs.)
Unfavourable balance as per cash book	-71,900
Subtract Cheque recorded but not sent for collection (c)	-10,000
Add Cheque issued but dishonoured on technical ground (h)	+3,000
Subtract Amount of cheque recorded less by bank (j)	-20
Unfavourable balance as per pass book	**-78,920**

8.8 Summary

1. **Bank Reconciliation Statement** is a statement prepared on a particular date reconciling the bank balance in the Cash Book with the balance as per the Pass Book or Bank Statement showing the causes of differences between the two balances.

2. **Causes of Difference** can be as follows:

(i) Cheques issued but not presented for payment;
(ii) Cheques deposited but not cleared;
(iii) Interest allowed by the bank;
(iv) Interest and expenses charged by the bank;

(v) Interest and dividend collected by the bank;
(vi) Direct payments by the bank;
(vii) Direct payments into the bank by a customer;
(viii) Dishonour of bills discounted with the bank;
(ix) Bills collected by the bank on behalf of a customer; and
(x) Errors committed.

3. **Debit Balance** as per Cash Book and **Credit Balance** as per Pass Book or Bank Statement means a favourable balance.

4. **Credit Balance** as per Cash Book and **Debit Balance** as per Pass Book or Bank Statement means an unfavourable balance.

8.9 Self Assessment Questions

Theoretical Questions

1. What do you mean by bank reconciliation statement? Why it is necessary for business? Explain.

2. What is bank reconciliation statement? When it is prepared? Also write the needs of bank reconciliation statement.

3. Write the procedure of preparation of bank reconciliation statement with imaginary figures.

4. Explain the meaning of bank reconciliation statement, what are the causes of differences between cash book and pass book.

5. "Bank reconciliation statement plays an important role to removing the errors between cash book and pass book." Explain this statement.

Practical Questions

Q.1 On 30th June, 2008, the bank column of the Cash Book showed a balance of Rs. 12,000 but the Pass Book shows a different balance due to the following reasons:

(i) Cheques paid into Bank Rs. 8,000 but out of these only cheques of Rs. 6,500 credited by bankers.
(ii) The receipt column of the Cash Book undercast by Rs. 200.
(iii) On 29th June, a customer deposited Rs. 3,000 direct in the Bank account but it was entered in Pass Book only.
(iv) Cheques Rs. 9,200 were issued of which Rs. 2,200 were presented for payment on 15th July.
(v) Pass Book shows a credit of Rs. 330 as interest and a debit of Rs. 60 as bank charges.

Prepare a Reconciliation Statement as on 30th June, 2008.

Ans.: Balance as per Pass Book - Rs. 16,170

Q.2 On examining the Bank Pass Book of Green Ltd., it is found that the balance shown on 31st March, 2009, the closing of the company's financial year, differs from the bank balance of Rs. 23,650 shown by the Cash Book on that date. From a detailed comparison of the entries it is found that:

(i) Rs. 2,860 is entered in the Cash Book as paid into the bank on 31st March, 2009, but not credited by the bank until the following day.
(ii) Bank charges of Rs. 70 on 31st March, 2009, are not entered in the Cash Book.

(iii) A bill for Rs. 5,500 discounted with the bank is entered in the Cash book without recording the discount charge of Rs. 270.

(iv) Cheques totalling Rs. 16,720 were issued by the company and duly recorded in the Cash Book before 31st March, 2009, but had not been presented at the Bank for payment until upto that date.

(v) On 25th March, 2009, a debtor paid Rs. 1,000 into the Company's Bank in settlement of his account, but no entry was made in the Cash Book by the company in respect of this.

(vi) No entry has been made in the Cash Book to record the dishonour on 15th March, 2009, of a cheque for Rs. 550 received from Ram Babu.

Prepare a Reconciliation Statement as on 31st March, 2009.

Ans: Balance as per Pass Book - Rs. 37,620

Q.3 The pass book of a customer shows a bank balance of Rs. 62,000 on 31st December, 2009. On comparing it with the Cash Book the following discrepancies were noted:

(i) Cheques were deposited into the Bank in December but were credited in January next. P-Rs. 3,500; Q-Rs. 2,500; R-Rs. 2,000.

(ii) Cheques issued in December were credited in January.

X-Rs. 4,000; Q-Rs. 4,500.

(iii) Cheque for Rs. 1,000 received from a customer entered in the Cash Book but was not banked.

(iv) The Pass Book shows a debit of Rs. 1,000 for bank charges and credit of Rs. 2,000 as interest.

(v) Interest on investment Rs. 2,500 collected by the bank appeared in the Pass Book.

Prepare a Bank Reconciliation Statement showing the balance as per Cash Book on 31st December, 2009.

Ans: Balance as per Pass Book - Rs. 59,000

Q.4 Mr. Trehan's Cash Book shows a credit bank balance on 31st December, 2009 as Rs. 40,500 but Pass Book shows a difference due to following reasons:

(i) A post-dated cheque for Rs. 900 has been debited in the bank column of Cash Book but could not have been presented.

(ii) Cheques totalling Rs. 10,200 deposited with the bank have not yet been collected and a cheque for Rs. 4,000 has been dishonoured;

(iii) Insurance premium amounting Rs. 500 paid by bank has not been entered in Cash Book.

(iv) A bill for Rs. 10,000 was retired by the Bank under a rebate of Rs. 150 but the full amount credited in the bank column of Cash Book.

(v) A cheque for Rs. 5,000 drawn in favour of Manohar has not yet presented for payment.

Prepare a Bank Reconciliation Statement as on 31 December, 2009.

Ans: Overdraft as per Pass Book - Rs. 50,950

Q.5 On checking the Bank Pass Book it was found that it showed an overdraft of Rs. 5,220 as on 31st December, 2009, while as per Ledger it was different to bank debit. The following differences were noted:

(i) Cheques deposited but not yet credited by bank Rs. 6,000.

(ii) Cheques dishonoured and debited by bank but not given effect to it in the ledger, Rs. 800.

(iii) Bank charges debited by bank but debit memo not received from bank Rs. 50.

(iv) Interest on overdraft excess credited in the Ledger Rs. 200.

(v) Wrongly credited by bank to account, deposit of some other party Rs. 900.

(vi) Cheques issued but not presented for payment Rs. 400.

Prepare a Reconciliation Statement as on 31st Dec, 2009.

Ans: Overdraft as per Cash Book - Rs. 130

Q.6 From the following particulars find out adjusted Bank balance after rectification of errors in the Cash Book and then prepare Bank Reconciliation Statement of Ram Prasad, a sole trader, on 31st March, 2009:

	Rs.
Bank overdraft as per Cash Book	72,300
Cheques deposited as per Bank Statement but not entered in the Cash Book	2,800
Cheque recorded as sent for collection but not sent to bank	10,000
Credit side of Bank column in the Cash Book shows a short casting of Rs. 120	
Premium on Proprietor's Life Insurance paid by Bank on standing advice as per Bank Statement	5,100
Bank charges recorded twice in the Cash Book	200
Cheque received and collected, entered twice in the Cash Book	5,500
Cheque issued but dishonoured on technical ground as per Bank Statement	3,080
Bills collected by Bank directly as per Bank Statement	20,100
Cheque deposited Rs. 40,000 but collected against it as per Bank Statement	39,900

Ans: Adjusted Cash Book balance (Cr.) - Rs. 63,000:
Bank balance as per Pass Book (Dr.) - 73,100

8.10 Reference Books

1. Advanced Accounting: Dr. Ashok Sehgal and Dr. Deepak Sehgal / Taxmann
2. Advanced Accounts: M.C. Shukla, T.S. Grewal, S.C. Gupta / S. Chand
3. Advanced Accountancy: S.N. Maheshwari / Vikas Publishing House Pvt. Ltd.

Unit - 9 Depreciation, Provisions and Reserves

Structure of Unit:

9.0 Objectives

After completing this unit you will be able to:

- Understand the concept of depreciation;
- Understand objectives and basis of depreciation;
- Prepare depreciation account and asset disposal account;
- Define reserve and provision;
- Compare reserve and provision;
- Know various types of reserves.

9.1 Introduction and Meaning

The word depreciation is derived from a Latin word 'Depletion' which means decline in price or decrease in the value of assets.

Every business has certain fixed assets such as building, plant and machinery, motor vehicles furniture, office equipments etc. Value of these assets decreases with passage of time and its utilisation, this decrease in value of assets is known as depreciation.

Definitions:

Some of the well known definitions of depreciation are as given below.

"Depreciation may be defined as the permanent and continuing diminution in the quality, quantity or the value of an assets." **- William Pickles**

"Depreciation is the gradual and permanent decrease in the value of an asset from any cause." **- R.N. Carter**

"Depreciation may be defined as the measure of the exhaustion of the effective life of an asset from any cause during a period." **- Spices & Pegler**

"Depreciation represents the loss in the value of the capital sunk in building, plant, machinery and other equipment, due to normal and inevitable deterioration during the life of these assets." **- M.J. Wheldean**

Characteristics of Depreciation

1. Depreciation is a constant decrease in the value of assets.
2. It may occur due to physical or functional factors.
3. Depreciation is not a valuation of assets.
4. It is charged against the revenue earned in an accounting year.
5. It decreases the book value of asset but not necessarily the market value.
6. It must be computed in a systematic and rational manner.

9.2 Causes of Depreciation

Depreciation is a rational estimate of a decline in the usefulness of an asset due to consumption, use, technological changes or other causes.

The main causes of depreciation are as follows:

i) Use / Consumption: The value of tangible capital assets fall due to wear and tear on account of constant use.

A machine wears when operated from day to day and this wearing out is in the proportion to the number of hours of use in a day. The wear and tear of the fixed asset is resulted into decrease of price and capacity of the assets.

ii) Obsolescence: Besides normal and abnormal factors, value of an asset may be decline due to technological and market changes. In such cases value of assets declines not due to physical deterioration but due to availability of new products or better technology which makes the existing asset an obsolete.

iii) Depletion: One of the major cause of decrease in value of wasting assets such as coal mines, oil reserves etc. are consumption in the process of production. The quantity of these assets decreases on extraction.

iv) Abnormal Factors: Various abnormal causes such as fire, accident, earth quake may also lead to depreciation of assets.

v) Lapse of time: In case of leasehold properties, patents, copy rights etc. value of assets decreases due to lapse of time.

vi) Exhaustion of Assets: Some assets completely lose their existence after some time due to lapse of their age such as trees, livestock etc.

9.3 Objectives of Charging Depreciation

Every business enterprise needs a suitable policy on depreciation it has following objectives:

i) To ascertain true and fair profit and loss: Depreciation is an important element of the cost of production, though it is not visible and never paid to outsiders as other expenses, but in order to ascertain the true and fair profits and losses it must be calculated and deducted out of the income.

ii) To provide funds for replacement: All fixed assets become commercially unviable after a certain period. To continue a business for a long period, old assets are to be put out of use and replaced by new ones. Thus, the amount conserved in the business through depreciation can be used for replacement of fixed assets.

iii) To reveal true and fair financial position: Every business enterprise prepare balance sheet to find out the financial position. It must reveal the true and fair view, for this, it is important that depreciated value of the asset is calculated and shown on the asset side of the balance sheet.

iv) To calculate correct cost of production: Depreciation is an element of cost of production. If it will not be included is cost of production and charged from profit and loss account, the cost of production will not be correct.

v) To compute tax liability: From the income tax point of view depreciation is a chargeable expense, thus by calculating depreciation as per tax laws and charging it to profit and loss account, taxable income can be calculated.

vi) To avoid payment of dividend from capital: If the company is distributing dividend without charging depreciation from profit it may resulted into payment of dividend out of capital.

vii) To comply with legal requirements: It is obligatory for a company to charge depreciation on fixed assets before declaration of dividend as per section 205 of The Companies Act, 1956.

9.4 Factors or Basis of Charging Depreciation

Calculation of depreciation is based on following factors:

i) Cost: Cost of an asset includes invoice price and other costs which are necessary to put asset in operation, includes cost of transportation, transit insurance, installation and registration etc. In case of purchase of a second hand asset cost of initial repair and overhauling is also included.

However the cost does not include the interest paid and financing charge to purchase an asset.

Thus, cost of depreciable asset represents cost of acquisition, installation and commissioning, in other words:

Cost of Assets = Price + Freight + Installation Charges

ii) Net Residual Value: Residual value of an asset refers to estimated net realisable value of an asset at the end of its useful life. It is also known as scrap value of salvage value.

It is calculated on the basis of estimated gross realisable value after deducting cost of disposal.

The depreciable cost is a difference of cost of the asset and the residual value of the asset while determining the amount of depreciation. The organisation has to consider that the depreciable cost must be recovered with the working life of the asset.

iii) Estimated useful life of the asset : Calculation of depreciation is also based on the estimated useful life of an asset. If the useful life is shorter than the amount of depreciation will be higher, however, if the useful life is higher than the amount of depreciation will be lower.

iv) Legal Provisions: There are various laws which should be considered while deciding depreciation. It is applicable as per the nature of company such as Company Law, Income Tax Laws etc.

v) Possibilities of Invention: Where the asset becomes obsolete due to change in technology or due to new invention. The amount of depreciation depends upon the expected period of new invention.

9.5 Methods of Calculation of Depreciation

Following are the methods for providing depreciation :

a) Straight Line/ Fixed Instalment Method

b) Written Down Value Method / Diminishing Balance Method
c) Annuity Method
d) Depreciation Fund Method
e) Insurance Policy Method
f) Depletion Method
g) Revaluation Method

a) Straight Line Method / Fixed Instalment Method: Under this method amount of depreciation is calculated by dividing depreciable cost by the estimated life of the asset. For this purpose following formula is used:

$$Depreciation = \frac{Cost - Scrap\ \ Value}{Estimated\ \ Life}$$

Thus a fixed proportion of the cost of asset is written off each year. Generally the rate of depreciation is given in the percentage.

Note: This rate may be given per annum or not. If 'per annum' words are given with the rate then depreciation will be calculated for the period of use in accounting year. If 'per annum' is not given then full year's depreciation will be charged irrespective of the date of purchase and depreciation will not be calculated in the year of sale.

Merits:

i) This method is very easy to understand.

ii) The value of asset can be reduced up to zero.

iii) The burden of calculation is not for every year, as the amount of depreciation remains the same.

iv) It makes comparison of income for different accounting year easy as the amount charged for depreciation remains the same.

Demerits:

i) It is based on wrong assumption that assets is utilised in same proportion for every year, as efficiency of an asset reduces with passing of time.

ii) It does not consider the loss of interest on the invested amount.

iii) Many times, even after the value of an asset becomes zero in the books, the asset continues to be used in actual practice.

iv) In reality the charges increase every year, though the depreciation remains the same. It is due to the maintenance cost increases every year.

v) It becomes difficult to calculate the depreciation on additions made during the year.

Illustration 1

A company purchased one machinery costing Rs. 3,00,000 as on 1st April 2008. It purchased further machinery on 1st October, 2008, costing Rs. 2,00,000 and on 1st July, 2009, costing Rs. 1,00,000.

On 1st January, 2010, one-third of the machinery which was installed on 1st April, 2008 became obsolete and was sold for Rs. 30,000.

Show how the machinery account would appear in the books of the company, if depreciation is charged Fixed Instalment at 10 percent p.a.

The accounting period of the company is calendar year.

Solution:

Machinery Account

Date 2008	Particular	Amount (Rs.)	Date 2008	Particular	Amount (Rs.)
April 1	To Bank A/c (i)	3,00,000	Dec. 31	By Depreciation A/c	
Oct. 1	To Bank A/c (ii)	2,00,000		(i) 22,500	
				(ii) 5,000	27,500
			Dec. 31	By Balance c/d	
				(i) 2,77,500	
				(ii) 1,95,000	4,72,500
		5,00,000			5,00,000
2009			2009		
Jan. 1	To Balance b/d		Dec. 31	By Depreciation A/c	
	(i) 2,77,500			(i) 30,000	
	(ii) 1,95,000	4,72,500		(ii) 20,000	
July 1	To Bank A/c (iii)	1,00,000		(iii) 5,000	55,000
			Dec. 31	By Balance c/d	
				(i) 2,47,500	
				(ii) 1,75,000	
				(iii) 95,000	5,17,500
		5,72,500			5,72,500
2010					
Jan. 1	To Balance b/d		2010		
	(i) 2,47,500		Jan. 1	By Bank A/c	30,000
	(ii) 1,75,000		Jan. 1	By Profit & Loss A/c	52,500
	(iii) 95,000	5,17,500	Dec. 31	By Depreciation A/c	
				(i) 20,000	
				(10% on Rs. 2,00,000)	
				(ii) 20,000	
				(iii) 10,000	50,000
			Dec. 31	By Balance c/d	
				(i) 1,45,000	
				(ii) 1,55,000	
				(iii) 85,000	3,85,000
		5,17,500			5,17,500
2011					
Jan. 1	To Balance b/d	3,85,000			

Note1. Calculation of Loss on Sale of one-third Machinery:-

Balance of 1st Machinery on 1st January, 2010 = Rs. 2,47,500

Therefore Balance of one third Machinery

on 1st Jan.2010 = Rs. 247500 x 1/3 = 82,500

Less: Selling Price 30,000

Loss 52,500

b) Written Down Value Method:

Under this method, the amount of depreciation charged every year also goes on declining as the value of asset goes on diminishing year after year.

Eg.	Cost of asset	Rs.	1,10,000
	Estimated scrap value	Rs.	10,000
	Cost of asset subjected to depreciation	Rs.	1,00,000
	Rate of depreciation		10%

The amount of depreciation is calculated as shown below:

Year	Balance Cost of Assets Rs.	Depreciation Rs.	Written Down Value Rs.
1	1,00,000	10,000	90,000
2	90,000	9,000	81,000
3	81,000	8,100	72,900
4	72,900	7,290	65,610
5	65,610	6,561	59,049

The rate of depreciation to be charged is calculated according to the following formula.

$$D = 1 - n\sqrt{\frac{R}{C}}$$

Where n = number of years
R = Residual / Scrap Value
C = Cost of the asset

In this method amount of depreciation is higher in initial years in comparison to later years. Thus it is useful to those assets on which the repairs and maintenance cost is increasing and consequently efficiency and revenues in every succeeding period decreasing. This method is recognised as per the Income tax and The Indian Companies Act, 1956.

Merits:

i) It is easy to calculate the depreciation under this method.
ii) In this method total burden on Profit & Loss Account in respect of depreciation and repairs put together remains the same.
iii) Assets balance is never reduced to zero in this method.
iv) This method is permissible by income tax authorities in India.
v) This method also acts as a tax shield.

Demerits:

i) In this method value of asset, never becomes zero thus even if the asset becomes obsolete and useless.
ii) It does not consider the loss of interest on the amount invested in the asset.
iii) It is typical to decide rate of interest.
iv) In this method actual cost of various assets is not shown in Balance Sheet.

Illustration 2

Mitali Limited purchased a machine on January1,2006 at a cost of Rs. 30,000 and spent Rs. 20,000 on its installation. The firm writes off depreciation @10% p.a. by written down value method. The scrap value of the machine at the end of its economic life of 4 years is expected to be Rs. 65,610/-

Show the machine account for 4 years in the books of Mitali Limited. The books are closed on 31 December every year.

Solution:

Machinery Account

Dr. **Cr.**

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2006			2006		
Jan.1	To Bank A/c	80,000	Dec.31	By Depreciation A/c.	
Jan. 1	To Bank A/c (Exp.)	20,000		(10% on 1,00,000)	10,000
				By Balance b/d	90,000
		1,00,000			**1,00,000**
2007			2007		
Jan.1	To Balance b/d	90,000	Dec.31	By Depreciation A/c.	
				(10% on Rs. 90,000)	9,000
			Dec. 31	By Balance c/d	81,000
		90,000			**90,000**
2008			2008		
Jan.1	To Balance b/d	81,000	Dec.31	By Depreciation A/c.	
				(10% on Rs. 81,000)	8,100
			Dec. 31	By Balance c/d	72,900
		81,000			**81,000**
2009			2009		
Jan.1	To Balance b/d	72,900	Dec.31	By Depreciation A/c.	
				(10% on Rs. 72,900)	7,290
			Dec. 31	By Balance c/d	65,610
		72,900			**72,900**
2010					
Jan.1	To Balance b/d	65,610			

Illustration 3

Ajanta Limited purchased on 1st January 2007 a plant for Rs. 8,000. On 1st April, 2008, it purchased additional plant costing Rs. 4,800. On 1st September 2009, the plant purchased on 1st January, 2007 was sold off for Rs. 4,200 and on the same date fresh plant was purchased at the cost of Rs.7,500.

Depreciation is provided at 10% per annum on the Diminishing balance method every year. Accounts are closed each year on 31st December.

Show the Plant account for 3 years.

Solution:

Plant Account

Dr. **Cr.**

Date	Particulars	Amount Rs.	Date	Particulars		Amount Rs.
2007			2007			
Jan.1	To Bank A/c (i)	8,000	Dec.31	By Depreciation A/c.	800	
		8,000		By Balance c/d	7,200	**8,000**

2008			2008		
Jan.1	To Balance b/d	7,200	Dec.31	By Depreciation A/c.	
April 1	To Bank a/c (ii)	4,800		(i) 720	
				(ii) 360	1,080
				(for 9 months)	
				Dec.31 By Balance c/d	
				(i) 6,480	
				(ii) 4,440	10,920
		12,000			**12,000**
2009			2009		
Jan.1	To Balance b/d		Sept.1	By Bank A/c	4,200
	(i) 6,480		Sept. I	By Depreciation A/c	
	(ii) 4,440	10,920		(10% on Rs. 6,480 for	
				eight months)	432
Sept. I	To Bank A/c	7,500	Sept. I	By P&L A/c	
				(Loss on Sale of Plant	
				Rs. 6480-4200-432)	1,848
			Dec. 31	By Depreciation A/c	
				i) 444	
				ii) 250	694
			Dec. 31	By Balance c/d	
				i) 3996	
				ii) 7250	11,246
		18,420			**18,420**
2010					
Jan. 1	To Balance b/d	11,246			

c) Annuity Method

This method is based on the assumption that if the amount of asset is invested else where it would earn some interest. Thus, amount of interest at the specified rate is added to the book value of the asset and then the amount of depreciation is calculated with the help of annuity table.

A specimen of such a table in given below:

Annuity Table

Years	3%	3 ½ %	4%	4 ½ %	5%
3	.35353	.35693	.36035	.36377	.36721
4	.30903	.27225	.27549	.27874	.28201
5	.21836	.22148	.29463	.22729	.23098
6	.18460	.18767	.19076	.19388	.19702
7	.16051	.16354	.16661	.16970	.17282
8	.14246	.14584	.14853	.15161	.15472
9	.12843	.13145	.13449	.13757	.14039
10	.11723	.12024	.12329	.12638	.12951

Following Journal Entries are made :

1. For charging interest on asset A/c :

Asset A/c Dr.
To Interest A/c
(For interest charged on capital sunk in asset)

2. For charging depreciation on asset :

Depreciation A/c Dr.
To Asset A/c
(Being depreciation charged)

3. For transferring depreciation to Profit & loss A/c :

Profit & loss A/c Dr.
To Depreciation A/c
(Dep. transferred to P& L A/c)

4. For transferring interest to Profit & Loss a/c

Interest A/c Dr.
To Profit and loss A/c
(Interest transferred to P & L A/c)

Illustration 4:

A firm acquired a 4 years lease of premises for Rs. 60,000/- on 1st April, 2006. It was decided to write off depreciation by Annuity Method calculating interest at 4 ½ % p.a.

The Annuity Table shows that annual depreciation on Re. 1 at 4 ½ interest for 4 year will be Re.0.278743. Show the Leasehold Property Account for 4 years.

Solution :

Annual Depreciation for Re.1 = Re. 0.278743
So writting off Rs. 60,000 as depreciation = 0.278743 x 60,000
= Rs.16,724.58

Leasehold Property Account

Dr. **Cr.**

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2006			2007		
Apr.1	To Bank A/c	60,000	Mar. 31	By Depreciation A/c.	16,724.58
2007			Mar.31	By Balance c/d	45,975.42
Mar.31	To Interest A/c	2,700			
		62,700			**62,700**
2007			2008		
Apr. I	To Balance b/d	45,975,.42	Mar. 31	By Depreciation A/c	16,724.58
2008			Mar. 31	By Balance c/d	31,319.73
Mar. 31	To Interest A/c	2,068.89			
		48,044.31			**48,044.31**
2008			2009		
Apr. I	To Balance b/d	31,319.73	Mar. 31	By Depreciation a/c	16,724.58
2009			Mar. 31	By Balance c/d	16,004.54
Mar. 31	To Interest a/c	1,409.39			
		32,729.12			**32,729.12**

2009 Apr. I 2010 Mar. 31	To Balance b/d To Interest A/c	16,004.54 720,.04	2010 Mar. 31	By Depreciation A/c	16,724.58
		16,742.58			**16,724.58**

d) Depreciation fund method / Sinking Fund method:

Depreciation fund method, besides recovering the depreciable cost, aims to provide liquid assets by investing the amount of annual depreciation outside the business.

Thus, in this method a fixed amount is provided as depreciation and debited to P&L A/c each year and a corresponding amount invested every year in securities and at the time of replacement the securities are sold and the cash realised is used to buy the asset.

Following journal Entries are passed under this method.

At the end of 1st year:

(i) Profit and loss A/c Dr.
To Depreciation Fund A/c
(Being amount of annual depreciation provided.)

(ii) Depreciation Fund Investment A/c Dr.
To Bank A/c
(Being amount of Depreciation Fund invested)

In the subsequent years.

(i) Bank A/c Dr.
To Depreciation Fund A/c
(Being interest received on Depreciation Fund Investments)

(ii) Profit and Loss A/c Dr.
To Depreciation Fund A/c
(Being amount of annual depreciation provided)

(iii) Depreciation Fund Investment A/c Dr.
To Bank A/c
(Being amount of Depreciation Fund invested)

In Replacement year or Last year :

(i) Bank A/c Dr.
To Depreciation Fund A/c
(Being interest received on Depreciation Fund Investments)

(ii) Profit and Loss A/c Dr.
To Depreciation Fund A/c
(Being amount of annual depreciation provided)

(iii) Bank A/c Dr.
To Depreciation fund investment A/c
(Being Depreciation fund investment sold)

(iv) Depreciation fund investment A/c Dr.
To Depreciation fund A/c
(Profit on sale of Depreciation fund investment transferred)

Or

Depreciation Fund A/c Dr.
To Depreciation fund investment A/c
(Loss on sale of Depreciation fund investment transferred)

(v) Depreciation Fund A/c Dr.
To Old Asset A/c
(Old Assets written off)

(vi) New Asset A/c Dr.
To Bank A/c
(New Asset purchased)

(vii) Depreciation Fund A/c Dr.
To Profit and Loss A/c
(Balance transferred)

Or

Profit and Loss A/c Dr.
To Depreciation Fund A/c
(Balance transferred)

This method is appropriate for replacement of highly priced assets.

e) Insurance Policy Method:

In this method company takes insurance policy of the amount which is equal to the cost price of Replacement Value of the asset. The amount of annual depreciation is used in payment of the premium. This method is beneficial as the amount is easily recovered on the maturity of the period. In this method amount of depreciation is utilised to pay insurance premium instead of purchasing securities. For this purpose following entries will passed.

(i) On payment of Policy Premium

Depreciation Fund Policy A/c Dr.
To Bank A/c
(Premium paid.)

(ii) While charging depreciation (equal to premium)

Profit & Loss A/c Dr.
To Depreciation Fund A/c
(Premium charged against profits)

(iii) When amount of policy is received

Bank A/c Dr.
To Depreciation Fund Policy A/c
(Policy money received on maturity)

(iv) Transferring balance of policy A/c

Depreciation Fund Policy A/c Dr.
To Depreciation Fund A/c
(Balance transferred.)

(v) Writing off Asset

Depreciation Fund A/c Dr.
To Asset A/c
(Asset written off.)

(vi) Purchase of New Asset

Asset A/c Dr.

To Bank A/c

(New Asset purchased)

f) Depletion Method

When life of an asset is expressed in number of units. It is favourable to provide depreciation by depletion method. The amount of depreciation in an accounting period under this method is calculated with the help of following formula

Depreciation of an accounting period =

$$\frac{\text{Cost of the asset (Less Salvage Value) x output of the accounting year}}{\text{Estimated total output during the estimated useful life of the asset.}}$$

Illustration 5:

A mine estimated to contain 1,00,000 ton of minerals is leased at a cost of Rs. 15,00,000 and was expected to be worked for 10 years. The production for the first two years of operations was 6,000 tons and 15,000 tons respectively.

Prepare the relevant accounts for the 2 years using 'Depletion method' assuming accumulated depreciation account is not maintained.

Lease A/c

Dr. **Cr.**

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
Year I	To Bank A/c	15,00,000	Year I	By Depreciation A/c (15,00,000x6,000/1,00,000)	90,000
				By Balance c/d	14,10,000
		15,00,000			15,00,000
Year II	To Balance b/d	14,10,000	Year II	By Depreciation A/c (15,00,000x15,000/1,00,000)	2,25,000
				By Balance c/d	11,85,000
		14,10,000			14,10,000

Extract of Profit and Loss A/c

Dr. **Cr.**

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
Year I	To Depreciation A/c	90,000			
Year II	To Depreciation A/c	2,25,000			

Extract of Balance Sheet

Liabilities	Amount (Rs.)	Date	Assets	Amount (Rs.)
		Year I	Lease A/c	14,10,000
		Year II	Lease A/c	11,85,000

g) Revaluation Method:

Under this method the value of the asset is determined at the end of the year. It is useful for some specific assets such as Patents, Trade Marks, Live Stock etc.

In the end of the year the asset is revaluated and whatever amount is reduced is shown as depreciation to P&L A/c of that year.

9.6 Methods of Recording Depreciation

i) By charging to Asset account without maintaining Depreciation A/c.

In this method "Provision for depreciation account is not maintained by the enterprise, thus amount of depreciation is directly credited to the Asset A/c.

ii) By maintaining provision for Depreciation A/c

When the businessman wishes to show the asset on original value in the balance sheet, separate A/c for charging depreciation is prepared by him. The balance on the credit side of 'Provision for Depreciation A/c' shows the total amount of depreciation accumulated to date. However, when the asset is sold, the total accumulated depreciation for the asset is transferred to the credit side of the 'Asset A/c'.

Illustration 6

On April 1, 2001 a firm purchased a machinery for Rs. 20,00,000. On August 1, 2004 the machinery became obsolete and was auctioned for Rs. 9,00,000. The firm provides depreciation on its machinery @ 10% per annum on written down value method. The books are closed on 31st March of every year.

Show the necessary Ledger Accounts assuming that :

(a) 'Provision for Depreciation Account' is not maintained, and
(b) 'Provision for Depreciation Account' is maintained.

Solution:

(a) When 'Provision for Depreciation Account' is not maintained:

Machinery Account

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2001			2002		
Apr. 1	To Bank A/c	20,00,000	Mar. 31	By Depreciation A/c	2,00,000
			Mar. 31	By Balance c/d	18,00,000
		20,00,000			**20,00,000**
2002			2003		
Apr. I	To Balance b/d	18,00,000	Mar. 31	By Depreciation A/c	1,80,000
			Mar. 31	By Balance c/d	16,20,000
		18,00,000			**18,00,000**
2003			2004		
Apr. I	To Balance b/d	16,20,000	Mar. 31	By Depreciation A/c	1,62,000
			Mar. 31	By Balance c/d	14,58,000
		16,20,000			**16,20,000**

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2004			2004		
Apr. I	To Balance b/d	14,58,000	Aug 1	By Bank A/c	9,00,000
			Aug. 1	By Depreciation A/c (On Rs. 14,58,000 for 4 months)	48,600
			Aug. 1	By Profit & Loss A/c (Balancing figure)	5,09,400
		14,58,000			**14,58,000**

(b) When 'Provision for Depreciation Account' is maintained:

Machinery Account

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2001 Apr. 1	To Bank A/c	20,00,000	2002 Mar. 31	By Balance c/d	20,00,000
2002 Apr. 1	To Balance b/d	20,00,000	2003 Mar. 31	By Balance c/d	20,00,000
2003 Apr. 1	To Balance b/d	20,00,000	2004 Mar. 31	By Balance c/d	20,00,000
2004 Apr. 1	To Balance b/d	20,00,000	2004 Aug 1	By Bank A/c	9,00,000
			Aug. 1	By Provision for Depreciation A/c	5,90,600
			Aug. 1	By Profit & Loss A/c (Balancing figure)	5,09,400
		20,00,000			**20,00,000**

Provision for Depreciation A/c

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2002 Mar. 31	To Balance c/d	2,00,000	2002 Mar. 31	By Depreciation	2,00,000
2003 Mar. 31	To Balance c/d	3,80,000	2002 Apr. 1	By Balance b/d	2,00,000
			2003 Mar. 31	By Depreciation A/c	1,80,000
		3,80,000			**3,80,000**

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2004			2003		
Mar. 31	To Balance c/d	5,42,000	Apr. 1	By Balance b/d	3,80,000
			2004		
			Mar. 31	By Depreciation A/c	1,62,000
		5,42,000			5,42,000
2004			2004		
Aug. I	To Machinery A/c (Transfer to Machinery A/c)	5,90,600	Apr. 1	By Balance b/d	5,42,000
			Aug. 1	By Depreciation A/c (on Rs. 14,58,000 for 4 months)	48,600
		5,90,600			**5,90,600**

9.7 Preparation of Asset Disposal Account

In the event of an asset being sold, a new account titled, 'Asset Disposal Account' is opened in the ledger for the purpose of calculating profit or loss on the sale of an asset.

Accounting treatment

(i) The gross value of the asset being sold is transferred to the debit of this account by passing the following entry:

Asset Disposal A/c Dr. [For original cost of the asset sold]
To Asset A/c

(ii) Similarly, the amount of accumulated depreciation is transferred to this account by passing the following entry:

Provision for Depreciation A/c Dr. [For transferring accumulated depreciation]
To Asset Disposal A/c

(iii) Amount of Sale Proceeds:

Cash/Bank A/c Dr. [For sale value of the asset]
To Asset Disposal A/c

Illustration 7:

On 1st January, 2008, M/s. Atul and Bros. purchased 5 washing machines for Rs. 15,000 each. They sold on January 1, 2009 one machine for Rs. 12,500. They decided to write off depreciation @ 10% on the Straight Line Method. Prepare Washing Machine Account, Washing Machine Disposal Account and Provision for Depreciation Account for two years. Accounts are closed on 31st December every year.

Solution:

Washing Machine Account

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2008			2008		
Jan. 1	To Bank a/c (5xRs. 15,000)	75,000	Dec. 31	By Balance c/d	75,000
		75,000			**75,000**

2009 Jan. 1	To Balance b/d	75,000	2009 Jan. 1 Dec. 31	By Machinery Disposal A/c By Balance c/d	15,000 60,000
		75,000			**75,000**

Provision for Depreciation Account

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2008 Dec.31	To Balance c/d	7,500	2008 Dec. 31	By Depreciation A/c	7,500
2009 Jan. 1	To Washing Machine Disposal A/c	1,500	2009 Jan. 1	By Balance b/d	7,500
Dec.31	To Balance c/d	12,000	Dec. 31	By Depreciation A/c	6,000
		13,500			**13,500**

Washing Machine Disposal Account

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2009 Jan. 1	To Washing Machine A/c	15,000	2009 Jan. 1	By Provision for Depreciation A/c	1,500
			Jan. 1	By Bank A/c	12,500
				By Profit and Loss A/c (Loss on Sale)	1,000
		15,000			**15,000**

Notes:

1. Book value of one machine (January 1, 2009) = Rs. 13,500
   [Cost: Rs. 15,000 - Depreciation: Rs. 1,500 (for 2008)]

2. Loss on sale of machine = Rs. 13,500 - Rs. 12,500 = Rs. 1,000

3. Depreciation for 4 machines (for 2009) = Rs. 6,000
   (Rs. 60,000 x 10/100 = Rs. 6,000)

9.8 Meaning of Reserves

Reserves mean amount set aside out of profits to meet future uncertainties.

According to **William Pickles**, "Reserves mean the amounts set aside out of profits and other surpluses, which are not earmarked in any way to meet any particular liability, known to exist on the date of the Balance Sheet."

Examples of Reserve

1. General Reserve
2. Dividends Reserve
3. Contingency Reserve
4. Reserve for Expansion etc.

9.9 Importance of Reserves

1. Reserves are necessary to maintain to meet a contingent liability which is not specifically mentioned.

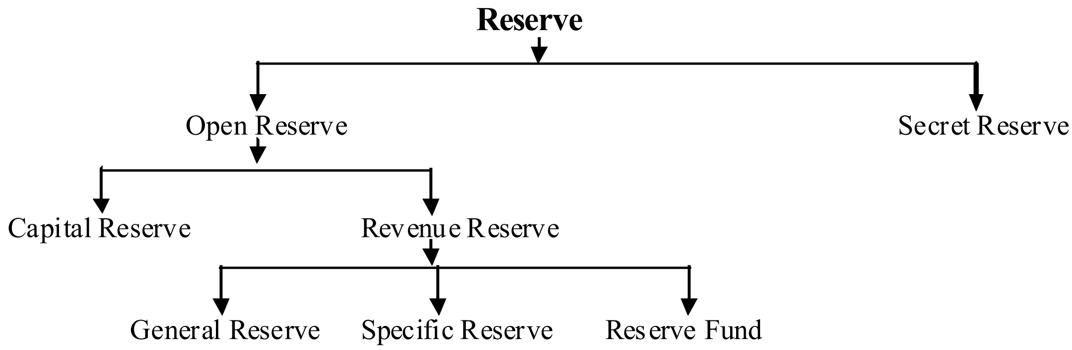
2. It is provided for meeting the prospective losses or liabilities, it strengthen the business and its financial position by increase in working capital.

3. Some reserves such as 'Dividend Equalisation Reserve' are helpful to maintain a uniform dividend rate from year to year. It increases goodwill of the organisation.

4. Reserve may be created to meet out a particular liability such as Debenture Redemption Reserve, by it the amount is made available at the time of redemption.

9.10 Types of Reserves

Types of Reserves



1. **Open Reserve**: Open reserves are those reserves which are shown in liabilities side of Balance Sheet under various heads. These are of two types:- (a) Capital Reserve (b) Revenue Reserve.

(a) Capital Reserves: These reserves are created out of capital profits and generally, are not available for distribution as cash dividend among the shareholders of a company. Profits received from the following sources are termed as capital profits:

1. Profits on the sale of fixed assets.
2. Profits on the revaluation of fixed assets and liabilities.
3. Premiums received on issue of shares or debentures.
4. Profit on the purchase of a running business.
5. Profit prior to the incorporation of a company.
6. Profit from the reissue of forfeited shares.
7. Profit on redemption of debentures.

All above profits should be treated as Capital Reserves.

Capital reserves are used to write off capital losses and for the issue of fully paid bonus shares. Usually, the capital reserves are not available for distribution as dividends. Some capital reserves can however be utilized to distribute dividends subject to fullfilment of the following conditions:

1. Articles of the company must not prohibit such dividend.
2. Capital profits must have realised in cash.
3. Such profit remains after a fair revaluation of assets and liabilities.

All the same, it would be prudent policy on the part of the management not to distribute such profits. They should be kept in business to strengthen its financial position.

Share premium, Capital redemption reserves etc. can be utilised for using fully paid up bonus shares or writing off of underwriting commission or cost of issue of shares/debentures, preliminary expenses, or for paying the premium on redemption of debentures and preference shares.

(b) Revenue Reserve: These are the reserves created out of revenue profits of the business. They are of following types:

General Reserve: Usually, the businessmen do not withdraw the entire profits from the business but retain a part of it in the business to meet unforeseen future uncertainties. Profits so retained in the business for 'a rainy day' are known as 'General Reserve'. Similarly, companies also do not distribute the entire profits as dividends but keep aside a part of it in the form of General Reserve. Such reserves are also termed as 'Contingency Reserves' or 'Free Reserves' because these are not created for any specific purposes and can be freely used for any purpose.

2. Secret Reserves: Secret reserves are reserves the existence of which does not appear on the face of Balance Sheet. In such a situation, net assets position of the business is stronger than the disclosed by the Balance Sheet. Secret reserves are created by:

(a) Writing down the assets much below their cost or market value.
(b) Providing more reserves than necessary for bad and doubtful debts or discount on debtors.
(c) Writing down the goodwill to a nominal value.
(d) Not writing up the value of an asset whose price has permanently gone up.
(e) Providing excessive depreciation on fixed assets.
(f) Omitting some of the assets altogether from the Balance Sheet.
(g) Charging capital expenditure to revenue account.

9.11 Meaning of Provision

Business involves risk and uncertainty. Thus, it is essential to create reserves and provisions to remove these risks and uncertainties.

According to companies Act, 1956 Provision usually means any amount written of for retained by the way of providing depreciation renewals 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."

Examples of Provision:

1. Provision for Bad & Doubtful debts
2. Provision for Repairs and Renewals.
3. Provision for Depreciation
4. Provision for Income Tax

9.12 Importance of Provision

1. A provision is an amount set aside out of current earning considered necessary to provide for all losses.
2. It is an endeavour to retain future operating performance.
3. Provisions are needed for proper allocation of expenses.
4. The Balance Sheet shows a true and fair position of business only when proper provisions are made in the books.

9.13 Distinction between Reserve and Provision

S. No.	Basis	Reserve	Provision
1.	Meaning	Reserve is created to meet an unknown liability	It is created to meet a known liability.
2.	Object	The object of reserve us to strengthen the financial position of business	Provisions are created to provide for depreciation, doubtful debts and other specific liabilities.
3.	Necessity	Creation of reserves is discretionary. It can be created only if adequate profits have been earned.	It is a necessity to provide for provision.
4.	Mode of creation	It is created through P&L Appropriation A/c.	It is created by debiting to P&L A/c.
5.	Utilisation of dividends	It can be utilised for distribution as dividends among shareholders	It cannot be utilised for distribution of dividends.
6.	Presentation in balance sheet	It is shown at liabilities side	It is shown either on assets side by way of deducting from the particular assets or shown in liabilities side.
7.	Investment	It may be invested outside the business	Provisions are never invested outside the business.

9.14 Summary

For the purpose of correct valuation of assets, depreciation is charged on the cost of acquisition of assets as shown in the Financial Statements. Depreciation is a permanent, continuous and gradual reduction in the book value of fixed asset. Depreciation accounting is necessary so as not to show the assets at an overstated amount. There are various methods available for calculating the amount of depreciation to be charged to. It is required for correct valuation of asset and to calculate proper profit and loss for the year.

1 **Causes of Depreciation** are (i) wear and tear, (ii) efflux of time, (iii) obsolescence, and (iv) accident.

2 **Normally depreciation** can be recorded either by (i) crediting the respective asset, or (ii) crediting 'Provision for Depreciation Account'.

3 **Depreciation** can be computed either as a (i) fixed percentage on original cost, known as Straight Line Method, or (ii) fixed percentage on diminishing balance, known as Written Down Value Method.

4 **Asset Disposal Account**. An account to which the balance of asset account is transferred. Also, the amount received on sale is credited to the account and the resultant profit or loss is transferred to the Profit and Loss Account.

Thus provisions and Reserves are essential to remove uncertainties and risk. There may be various types of reserves such as capital reserve and general reserve.

9.15 Self Assessment Questions

I. Theoretical Questions

1. What do you understand by depreciation? Why is it necessary to charge?
2. Mention names of different methods of charging depreciation.
3. Write short note on:
   i) Revaluation Method
   ii) Annuity Method

4. Explain depreciation also write its causes and importance to depreciate an asset.

5. Write short note on -

a) Straight line method b) Reserve

c) Provision d) Types of Reserve

e) Scrap Value

II. Practical Questions

Q.1 A Maruti Van was purchased on 1.1.2007 for Rs. 60,000 and Rs. 5,000 was spent on its repair and registration. On 1.7.2008 another van was purchased for Rs. 70,000. On 1.1.2009, the first van was sold for Rs. 45,000 and a new van costing Rs. 1,70,000 was purchased on the same date. Show the Maruti Van account from 2007 to 2009 on the basis of straight line method, if the rate of depreciation charged is 10% p.a. Assume that books are closed on 31st December every year.

Ans: Balance of Maruti Van A/c: Rs. 2,12,500 (Maruti Van II: Rs. 59,500+ Maruti Van III: Rs. 1,53,000); Loss on Sale of Van I- Rs. 7,000

Q.2 A company whose accounting year is a calendar year, purchased on 1st April, 2006 a machinery costing Rs. 30,000.

It purchased further machinery on 1st October, 2006 costing Rs. 20,000 and on 1st July, 2007 costing Rs. 10,000.

On 1st January, 2008 one third of the machinery installed on 1st April, 2006 became obsolete and was sold for Rs. 3,000.

Show how machinery account would appear in the books of the company. It being given that machinery was depreciated by fixed instalment method at 10% p.a. Waht would be the value of Machinery Account on 1st January, 2009?

Ans.: Loss on Sale of Machinery - Rs. 5,250; on Ist January, 2009: Balance of Machinery I (2/3) - Rs. 14,500 and Machinery II - Rs. 15,500 and Machinery III - Rs. 8,500

Q.3 A Company purchased a machinery for Rs. 50,000 on 1st July, 2007. Another machinery costing Rs. 10,000 was purchased on 1st September, 2008. On 31st December, 2009; the machinery purchased in 2007 was sold at a loss of Rs. 5,000. The company charges depreciation at the rate of 15% on diminishing balance method. Accounts are closed on 31st December every year.

Prepare Machinery Account for 3 years.
[Balance of Machinery A/c (Mach. II) - Rs. 8,075]

Q.4 A firm purchased on 1st January, 2007 certain machinery for Rs. 5,82,000 and spent Rs. 18,000 on its erection. On 1st July, 2007 additional machinery costing Rs. 2,00,000 was purchased. On 1st July, 2009, the machinery purchased on 1st January, 2007 was auctioned for Rs. 2,86,000 and a fresh machinery for Rs. 4,00,000 was purchased on the same date. Depreciation was provided annually on 31st December at the rate of 10% on the written down value method. Prepare Machinery Account from 2007 to 2009.

Ans.: Balance of Machinery A/c - Rs. 5,33,000; Loss on Sale of Machine - Rs. 1,75,700

Q.5 An asset was purchased for Rs. 50,000 on 1st April 2006 What would be its book value three years after if it was depreciated by both the methods - (i) Straight Line Method; and (ii) Written Down Value Method at the rate of 10% per annum. Show your answer by a tabular ledger account. Accounts are closed on 31st March, every year.

Ans.: Straight Line Method Rs. 35,000; Written Down Value Method Rs. 36,450.

Q.6 Bindal Traders Ltd. which depreciates its machinery at 20% p.a. on diminishing balance method, purchased a machine for Rs. 15,00,000 on 1st July, 2007. It closes its books on 31st December every year. On Ist October, 2008, it purchased another machine for Rs. 3,75,000. On 1st September, 2009, one third of the machinery purchased on 1st July, 2007 was sold for Rs. 2,00,000. You are required to prepare Machinery Account and Provision of Depreciation Account for the relevant years.

Ans. Balance of Machinery Account on 31st Dec., 2009 Rs. 13,75,000: Balance of Provision for Depreciation A/c on that date Rs. 5,14,000; Loss on sale of Machinery Rs. 1,12,000.

Q.7 On 1st April, 2007 ABC Limited purchased a machinery for Rs. 3,00,000. Depreciation is provided @ 20% p.a. on the original cost of the machinery and books are closed on 31st December each year. On 28th February, 2009 a part of the machine purchased on 1st April, 2007 for Rs. 72,000 was sold for Rs. 48,000 and on the same date new machinery was purchased for Rs. 84,000. You are required to prepare (a) Machinery Account (b) Provision for Depreciation and (c) Machinery Disposal Account.

Ans.: Balance of Machinery Account on 31st December, 2009 Rs. 3,12,000; Balance of provision for depreciation A/c on that date Rs. 1,39,400; Gain on Sale of Machinery Rs. 3,600.

9.16 Reference Books

1. Advanced Accounting : Dr. Ashok Sehgal and Dr. Deepak Sehgal / Taxmann
2. Advanced Accounts : M.C. Shukla, T.S. Grewal, S.C. Gupta / S. Chand
3. Advanced Accountancy : S.N. Maheshwari / Vikas Publishing House Pvt. Ltd.

Unit - 10 Preparation of Final Accounts [Without Adjustments]

Structure of Unit:

10.0 Objectives

After completing this unit you will be able to:

- Discuss the nature and purpose of the Final Accounts which include Profit & Loss Account and Balance Sheet;
- Prepare a Profit & Loss Account from relevant financial figures.
- Prepare a Balance Sheet and understand the related information;
- Understand the key accounting practices and conventions related to Balance Sheet;
- Understand the limitations of Final Accounts.

10.1 Introduction

In this unit, we consider an over view of the Final Accounts which are prepared by the business entity at the end of its accounting year. The Final Accounts include majorly two documents viz. [1] Profit & Loss Account, and [2] Balance Sheet, which one more account is prepared in case of manufacturing business concern i.e. a manufacturing account. The Profit & Loss Account contributes towards performance of a business while Balance Sheet indicates the financial position of the business on the date of preparation. We will also understand that how Final Accounts are prepared and what are the principles under which these statements are prepared. Following the principle or concept of accounting period, every business has an accounting period of twelve months and known as accounting year. Ultimately, at the end of each accounting year, every business prepares Profit & Loss Account, and Balance Sheet, therefore these are considered as Final Accounts. However, the Profit & Loss Account is prepared following the double entry system but the Balance Sheet is prepared as a sheet showing the financial position of the business but putting in the package of the Final Accounts. In simple words, the Balance Sheet is not an account but traditionally include in the term of 'Final Accounts'.

10.2 Nature and Purpose of Final Accounts

In order to understand the performance in view of profit generated by the business during the financial year or accounting year, generally Profit & Loss Accounts are prepared at the end of the financial year, and the Balance Sheet is prepared to know the financial position in view of what to be discharged the liabilities of the business against what the assets having by the business at the end of the financial year [on a particular date]. The Final Accounts are indispensable parts of the annual report issued by the business entity regardless any forms of business. The Profit & Loss Account answering the question that how much profit/wealth has been generated by the business during a particular period of time i.e. in the year for which the Profit & Loss Account has been prepared, and the Balance Sheet answering the question that what is the financial position in term of the accumulated wealth of the business like what are the assets available against the liabilities to be discharged at the end of or on the particular date, on which the Balance Sheet is prepared . Considering together, these Final Accounts highlight an overall picture of the financial health of the business.

Generally the Final Accounts are prepared on the basis of trial balance made balancing the different accounts opened in the ledger. The Profit & Loss Account is refers as income statement while the Balance Sheet as financial position statement.

10.3 Significance of Final Accounts

As you know that Final Accounts are important documents for the owners or managers for policy decision making, even these are very significant documents for the related parties and users including investors, financiers, bankers, government, tax authorities, researchers, even policy makers etc. Final Accounts properly known as financial statements and these are prepared at the end of the accounting year or financial year therefore also called as annual accounts. Annual accounts become parts of the annual report which is published by the business so also called as published accounts. In simple words the Final Accounts are also known either as financial accounts, annual accounts, or published accounts. These accounts when audited then also called as audited accounts. However, the Final Accounts are the by-product as well as output of the financial procedures. Therefore these are considered as a primary source of data, figures, facts, and information on which a number on decisions are taken by the different users in accordance with their objectives.

Considering the practical use of the annual report, most of the popular companies publish cash flow statement, funds flow statement, retained earnings statement, working capital statement, value added statement besides Profit & Loss Account, and Balance Sheet including various schedules, review of accounts, accounting policies and auditor’s reports . These related statements also add the utility and significance of the basic Final Accounts; the Profit & Loss Account and Balance Sheet. Owners in general and share holders in case of companies can understand about the managerial performance and financial health and financial soundness of the business by the help of these final accounts. Whether business is growing or not, if not growing, what are the reasons behind this phenomenon. Preparation of Final Accounts as well as publication of these accounts is a must legally for the companies registered under the companies act, 1956.

These accounts are very important in view of employees, creditors and other third party dealing with business. The trade unions behave with the employer demanding bonus and an increase in their salary and other benefits on the basis of profit and performance reflected by the Final Accounts. The creditors, money lenders and other party also take their dealing decisions on the basic of result produced by Profit & Loss Account and financial position reflected by the Balance Sheet. Income tax, sales tax and other tax levied departments assess, taxation keeping the Final Accounts in their views. Investors analyze the earning power and financial soundness of the business on the basis of the audited Final Accounts before taking their decision for investing money. Similarly the government, researchers and other users analyze the financial condition of the business on the basic of financial accounts. The business or the managers also considers the Final Accounts as significant documents for taking their policy decisions. In fact the Final Accounts are the mirror of the business.

10.4 Profit & Loss Account

Profit & Loss Account is a significant statement in the preparation of the Final Accounts of a business entity. Profit & Loss Account is prepared for the year but at the end of the accounting year in order to know the results of the business operations done in the whole accounting year. The result is known in terms of either profit or loss. The traditional Profit & Loss Account is more popular now a day in the form of Income Statement.

10.5 Meaning and Definition of Profit & Loss Account

Profit & Loss Account or income statement is an indispensible statement in order to know the result of business operations done throughout the year. Profit & Loss Account is generally prepared horizontally while income statement is prepared vertically. The nominal accounts opened in the ledger are transferred / posted in the Profit & Loss Account making closing entries in order to complete the double entry system, as well for closing the books of accounts as financial or accounting year is being ended. The result of Profit & Loss Account is shown in the Balance Sheet particularly preparing Profit & Loss Appropriation Account. Being an account Profit & Loss Account is also prepared as other accounts are prepared in the ledger through drawing eight columns as four for debit side and another four for credit side. A few definitions of Profit & Loss Account are given below:

According to R.N. Anthony and J.S. Reece, "The accounting report that summarizes the revenues and the expenses of an accounting period is called either profit and loss statement, or income statement, or statement earning, or statement of operations."

According to John N. Myer, "The income statement provides a review of the factors directly concerned with the determination of the net income."

According to Howard and Upton, "The profit and loss statement is a summary of changes in the owner's claim or equity resulting from operations over a given period of time."

According to Schwartzman and Ball, "Income statement is a basic financial document showing the gain or loss achieved by the firm during a stated period, generally a year and also called a profit and loss statement."

The different learners considered Profit & Loss Account as an important and basic document in the parlance of financial accounts. This resulted in the terms of either profit or loss against business transactions and operations done throughout the accounting and financial year by the business entities. In order to understand the factors affecting profit or loss the statement is the direct means and source. Profit & Loss Account is an important dimension of the accounting process which presents in a summary form to the number of expenses spent and revenues generated through different sources during the year. The profit and loss gives result in term of gross profit against the direct trading activities i.e. purchase and sales done in the financial year while in term of net profit against overall business transactions or activities happened during the accounting or financial year. Generally Profit & Loss Account includes trading, Profit & Loss Account, and Profit & Loss Appropriation Account, while one more manufacturing account in case of manufacturing business entity. The Profit & Loss Appropriation Account indicates that how profit earned is appropriated or planned.

10.6 Nature and Significance of Profit & Loss Account

Profit & Loss Account is prepared at the end of financial year to understand the general and trading activities done by the business in the year besides to close all the revenues and nominal accounts opened in the ledger. Undoubtedly the Profit & Loss Account is a statement of trading, operating and financial activities reflecting the operating as well as business results. The users, readers and interested parties become able to analyze the business activities to reach on the conclusion that whether the business is running in the profitable manner with expected growth and development, as well as whether business is able to earn sufficient return on the invested capital. Without preparation of Profit & Loss Account no business can prepare its Balance Sheet. In fact, Profit & Loss Account is the mirror of business activities in a summarized form. An analyst can easily understand financial irregularities and managerial performance simply applying certain techniques of financial analysis such as ratio analysis, common size or comparative financial statement techniques. Profit & Loss Account is more significant than Balance Sheet in order to achieve general purpose of relative parties. R. N. Anthony & J. S. Reece, therefore truly say that 'In a technical sense the income statement [i.e. Profit & Loss Account] is subordinate to the Balance Sheet but the information on the income statement is usually much more important than information on the Balance Sheet'. Generally, owner's equity and related earning [i.e. surplus, reserves, funds etc.] are shown on the Balance Sheet but much more explained on the Profit & Loss Account, in this way, Profit & Loss Account is subordinate to the Balance Sheet. Profit & Loss Account is also clearly indicate the reasons that what and why differences occurred on the two Balance Sheets during the one accounting year. Profit & Loss Account reported the result of the business activity in the profitability sense indicating degree of sufficiency with cause and effect, therefore, Profit & Loss Account is more informative than Balance Sheet and therefore more significant to the investors, share holders and the other parties related to the business. Even the quality of Balance Sheet depends upon that how Profit & Loss Account is prepared using personal judgment and setting accounting process. Really Profit & Loss Account is an important and much significant document or statement. Considering the significance and details as given in above pages, the nature of Profit & Loss Account may be summarized in the following points as given below:

1 Profit & Loss Account s prepared at the end of the financial year but for the year as the result is given for the activities done during the financial or accounting year;

2 Profit & Loss Account includes trading account, Profit & Loss Account, and profit & loss appropriation account, therefore it may be considered as 'three-in-one ' account;

3 Profit & Loss Account is not merely as an account like the accounts prepared in the ledger but in fact, this is a financial statement showing all business activities;

4 Profit & Loss Account is an important and indispensable step of the accounting process or accounting system;

5 Profit & Loss Account indicates different sources of revenues and different expenses in the appropriate titled in the summarized form;

6 Profit & Loss Account generally presents 'true and fair' records of revenues and expenses of the business;

7 Profit & Loss Account reflects changes [with reasons] occurred on the significant items of the Balance Sheet during the accounting period of one year;

8 Profit & Loss Account generally affected by the personal accounting judgments;

9 Profit & Loss Account is authorized by the responsible authorities and audited by the auditors;

10 Profit & Loss Account highlights upon managerial performance, profitability and operating aspects of the business but keep mum on the financial position of the business;

11 Profit & Loss Account depicts quantitative aspect of the business but not the qualitative aspect, and;

12 Profit & Loss Account remained as historical document of the business stating the present facts.

Activity A:

Rearrange the above given points in order of their significance indicating appropriate nature of Profit & Loss Account.

10.7 Forms of Profit & Loss Account

Profit & Loss Account being an account would be prepared as accounts being prepared in the ledger but traditionally Profit & Loss Account is prepared in the 'T' from or as ' T- account' and this form is popularly known as 'Horizontal Form'. Profit & Loss Account is also prepared in the "Vertical –form' which generally called income statement. Profit & Loss Account in its form may be prepared either 'single step form' or 'multiple step form'. In brief, following are the two popular forms of Profit & Loss Account.

- Horizontal Form,
- Vertical form:
  - Single Step form, and
  - Multi- step form

Horizontal form of Profit & Loss Account:

One of the popular forms of the Profit & Loss Account is horizontal form which known as traditional form of Profit & Loss Account. When Profit & Loss Account is prepared in its horizontal-form then the account shows three outputs or results:

(1) Gross Profit,
(2) Net Profit, and
(3) Net Surplus or Retained Earnings, which is carried to the Balance Sheet.

The Horizontal Profit & Loss Account includes Trading Account, Profit & Loss Account and Profit & Loss Appropriation Account indicating separate three parts or compartments respectively. Trading account generally show the items related to the trading transactions which indicates result of trading i.e. selling and purchasing activities and this compartment \ part gives the result in terms of gross profit. In the second part other activities related to the business expenses and the sources of unearned revenues are considered. Generally unearned revenues or profits are generated as rent, interest, dividend, commissions etc. The second compartment as Profit & Loss Account (main part) provides result of business in terms of net profit. This net profit is planned or appropriated in the third part\compartment i.e. profit & loss appropriation account. The horizontal form may be more clearly understood with the following Profit & Loss Account:

Profit & Loss Account in Horizontal form:

Trading and Profit & Loss Account of XYZ Ltd.
for the Year Ending March 31, 2010

Dr. **Cr.**

Particulars	Amount	Particulars	Amount
To Opening Stock	xxx	By Sales xxx	
To Purchases xxx		Less Return xx	xxx
Less Return xx	xxx	By Stock (Closing)	xxx
To Wages	xxx	[By Gross Loss (if any) c\d]	-
To Carriage Inward	xxx		
To Other Direct Charges	xxx		
To Gross Profit c\d	xxx		
Total	**xxxx**	**Total**	**xxxx**

To Gross Loss b\d (if any)		By Gross Profit b\d	xxx
To Salary & Wages	xxx	By Interest Received	xxx
To Rent, Rates & Taxes	xxx	By Rent Received	xxx
To Depreciation	xxx	By Discount Received	xxx
To Repairs & Maintenance	xxx	By Commission Received	xxx
To Carriage Outwards	xxx	By Dividend Received	xxx
To Printing & Stationary	xxx	By Investment Income	xxx
To Postage & Telegrams	xxx	By Profit On Sale of Assets	xxx
To Gen. Expenses	xxx	By Income From any Source	xxx
To Establishment Exp.	xxx	By Miscellaneous Receipts	xxx
To Selling & Distribution Expenses:		By Net Loss (If any)	—
●Advertisement	xxx		
●Agent Commission	xxx		
●Discount Allowed	xxx		
●Bad debts	xxx		
●Other Charges	xxx		
To Provisions	xxx		
To Legal Charges	xxx		
To Loss By Fire or Theft	xxx		
To Interest on Loan	xxx		
To Audit Fees	xxx		
To Other Expenses	xxx		
To Net Profit (Transferred to P&L Appropriation A\C)	xxx		
Total	**xxxx**	**Total**	**xxxx**

Vertical Form of Profit & Loss Account:

Vertical form of Profit & Loss Account is more popular than traditionally prepared Profit & Loss Account in the horizontal-form. Particularly in new of analysis and accounting, managerial decision making now-a-days , the horizontal-form of Profit & Loss Account is becoming obsolete. The vertical-form is becoming more and more popular in practices as no prescribed form of Profit & Loss Account has been specified in the companies act, 1956. Most of companies in the world consider their Final Accounts including Profit & Loss Account and Balance Sheet to prepare in the vertical-form in view of analysis and accounting decision makes. Vertical-form is easier than horizontal form of Profit & Loss Account. Particularly in the vertical-form, it is easier to understand the different sources of income and reserves along with the fact responsible to increase or decrease in the revenue or incomes. Especially in the form of single step vertical Profit & Loss Account, the total of the various sources of revenues deducting total of the different items of expenses resulted in terms of profit earned or loss incurred during the financial year. The multi-step form of Profit & Loss Account depicts the following results:

1. Gross profit; deducting total operating expenses
2. Operating profit
3. Net profit before income tax.
4. Net profit after income tax.
5. Net profit of the business.

Profit is also appropriated by extending the multi-step Profit & Loss Account if prepared in the vertical form, the account is popularly known as ‘Income Statement’. The title is also put as income statement in place of Profit & Loss Account. Besides in title no word\terms other then ‘Income

Statement' is used. The title always remains as 'Income Statement' in practice. The single step and multi step income statement are being illustrated as given below:

Single Step Vertical Form of Income Statement:

Income Statement of XYZ Co.
for the Year ending at March 31, 2010

Particulars	Amount
• **Sources of Revenue Receipts:**	
• Sales after return	xxx
• Rent and interest received	xxx
• Commission received	xxx
• Profit on sales of assets	xxx
• Interest on securities	xxx
• Dividend received	xxx
• Miscellaneous receipts	xxx
(A) Total Receipts	xxxx
• **Deduction from Revenues:**	
• Cost of goods sold	xxx
• General expenses	xxx
• Establishment expenses	xxx
• Selling & distribution expenses	xxx
• Loss on sales of assets	xxx
• Provisions	xxx
• Interest paid	xxx
• Discount on debentures	xxx
• Write-off of fictitious assets	xxx
• Other deductions from revenues	xxx
(B) Total Disbursement	xxxx
• **Net Income or Profit for the year [(A) - (B)]**	**xxxx**

Activity B:

Which form of Profit & Loss Account covers maximum subject matter and why? Suggest any new form of Profit & Loss Account which can help in quick decision making by the users.

Multi-Step Vertical form of Income Statement:

Income Statement of XYZ Co.
For the year ending at March 31, 2010

Particulars	Amount
• **Net Sales**	xxx
Less: Cost of Goods sales	(-) xxx
(A)	**xxxx**
• **Gross Profit**	
Less: Operating Expenses:	
(a) Establishment & Administration	
• Salary and wages	xxx

• Rent, Rates and taxes		xxx
• Printing and Stationary		xxx
• Postage and telegrams		xxx
• Insurance Premium		xxx
• Depreciation		xxx
• Sundry Taxes		xxx
• Other Expenses		xxx
	(a)	**xxx**
(b) Selling & Distribution:		
• Salary and wages		xxx
• Advertisement expenses		xxx
• Discount allowed		xxx
• Travelling expenses		xxx
• Freight and delivery expenses		xxx
• Bad debts		xxx
• Commission allowed		xxx
• Depreciation		xxx
• Store rent		xxx
• Other expenses		xxx
	(b)	**xxxx**
• **Operating Profit [A-(a+b)]**		xxxx
Add: Revenue		
• Rent Received	xxx	
• Interest on Debentures	xxx	
• Commission Received etc.	xxx	(+) xxx
Less: Expenses:		
• Interest paid	xxx	
• Legal charges	xxx	
• Auditors fees	xxx	(-) xxx
• **Net profit before Income Tax**		**xxxx**
• Less Provision for Income Tax paid		xxxx
• **Net profit after Income Tax**		**xxxx**
• Add: Gain or Profit on Investment		(+) xxxx
• **Net Profit for the year**		**xxxx**

10.8 Balance Sheet: Meaning and Definition

Balance Sheet is an important and indispensable document as well as one of the significant financial statements. Balance Sheet shows the financial position of the business on a particular date on which it is prepared; therefore it is also called as financial position statement in practice. Balance Sheet helps in comparison between assets and liabilities of the business, setting the balance between them and therefore called as Balance Sheet. As we know that the nominal account opened in the ledger are transferred by closing in to the Profit & Loss Account but the personal accounts and real accounts are balanced and shown in the Balance Sheet.

Now the statement clearly indicates the nature, condition and value of assets as well as in comparison to liabilities of the business but on a particular date a statement which shows true and fair view of the financial position of the company may be called as financial position statement or traditionally the Balance Sheet. Balance Sheet is also the product of accounting process based on Double Entry

System of the book keeping. Balance Sheet sets out financial position of a business on a specific date, and now in the computer age, at a particular moment of time. Balance Sheet reveals the form of wealth is held along with how much wealth is held in each form. Assets of the business are shown on the one side, and the claims against the assets of business on the other side. Remember that the Balance Sheet is not an account, however put in the set of Final Accounts. Balance Sheet is financial position statement expressing financial status of the business, but the position of business changes with every transaction. The Balance Sheet has been defined on the different learned persons and dignities in the field of accounting and finance, out of which a few are given below:

According to J. L. Henson, "Balance Sheet is a statement showing the assets and liabilities of a business at a certain date."

According to C. T. Horne Green, "Balance Sheet is a statement of financial status at an instant of time."

According to S. D. Schwartzman and Richard E. Ball, "Balance Sheet is a basic financial document that shows the balance between firm's assets and its liabilities plus stock holders equity at the end of a stated period, generally a year. Undoubted the Balance Sheet is a financial statement being an important document for the annual report."

10.9 Nature and Significance of Balance Sheet

Accounting remains incomplete and analysis becomes impossible without Balance Sheet. Balance Sheet is considered as first hand source of financial information about a business. Balance Sheet is a decision making document for the parties related with the business such as banks, insurance companies, investors, money lenders, debenture holders, shareholders, creditors, government departments, income tax department, and management. The personal and real accounts opened in the ledger are depicted, summarized with final outstanding balances in the Balance Sheet.

Every type of reserve, provision fund are shown in this statement. Balance Sheet reflects both the capital structure and assets structure of the business. A comparative financial position between the past and current accounting year is also presented with the true and fair views by the Balance Sheet. The related parties take decision on the basis of information provided by the Balance Sheet by applying certain analytical techniques. The nature, condition and value of assets are shown against the charges their on in the Balance Sheet. Balance Sheet is a historical record or document of the concerned business.

Balance Sheet is an important output of accounting process which shows financial position of the business on a particular date. Balance Sheet is a statement showing assets, liabilities and capital but it is not an account. The nature and significance of the Balance Sheet may be expressed in the following points in brief:

1. Balance Sheet shows the financial position of the business on a particular date;

2. Balance Sheet shows company's assets, liabilities and capital (may be said equity) in a form of statement;

3. Balance Sheet put in the package of Final Accounts but it is not an account, it is simple a statement;

4. Balance Sheet reflects 'static condition' but not dynamic;

5. Balance Sheet depicts 'quantitative aspects' of the business, but not the 'qualitative aspect';

6. Balance Sheet shows items in term of 'book value' but not in form of 'economic value' or 'market value' or resale value;

7. Balance Sheet is prepared keeping 'true and fair concept' in the views;

8. Balance Sheet is a function of personal judgement, principles, postulates, rules, concepts, tradition and recorded facts;

9. Balance Sheet reveals historical facts but not current or future aspects and;

10. Balance Sheet is a final product of financial accounting process.

Activity C
Take \ collect Annual report and match the nature as explained above with published Balance Sheet of any corporate entity of your choice.

10.10 Subject Matter of Balance Sheet

Balance Sheet is a statement showing assets and liabilities of a particular form of business of business on a specific date, generally on the last day of the financial year. Assets may be classified in to four groups viz.

1. Fixed Assets or Non-Current Assets,
2. Current Assets or Floating Assets,
3. Investments,
4. Other Assets.

Assets may also be classified taking dichotomy such as:

1. Tangible and Intangible
2. Current and Non-Current
3. Real and Fictitious Assets

The above four classifications are more popular in view of preparation of the Balance Sheet. **Fixed assets** have long term span of life and these are shown after deducting depreciation (based on appropriate method of depreciation such as WDV, SLM or any other).The fixed assets are purchased in order to keep these assets for running business operations smoothly but not for sale. Undoubtedly unused assets are sold at salvage value. These assets contribute in way of increasing earning-power. Generally, land and building, plant and machineries, furniture, fixtures & fittings, live stock, goodwill, trade mark, patents, copy rights, designs etc. are a few assets which considered fixed assets. It is to state that any change in policy regarding assets or depreciation, revaluation of assets or any other important or significant matter must be shown at the 'Foot Note' of Balance Sheet.

Current assets are converted into cash during an operating cycle of a period of one year. Cash or bank balance is an original form of current assets. Generally, cash in hand, balance at banks, sundry debtors, bills receivable, inventories, etc. are the nature of current assets. In some way, sundry debtors and bills receivables together are known as accounts receivable, while inventory in narrow sense is known as stock of goods and in broader sense (in case of production, or manufacturing or service rendering concerns) it includes four elements such as:

1. Raw material;
2. Work in Process;
3. Finished Goods;
4. Spare and Tools.

It is better to keep minimum duration of operating cycle as well as low inventory. Zero-inventory concept is coined in the global market. Current assets become liquid if inventory is kept aside. Similarly, cash in hand and balance at bank is considered as 'second line of defence' in order to pay or purchase. Marketable-securities are typical current assets. Debtors are converted either in cash, bank or bills receivables. Bills-receivables are negotiable instruments and which can be discounted generally from Banks if cash or liquidity is required. One more, consumable store is also included in current assets. As per companies act, 1956 and notification of central government, loans and advances are also included in the current assets. Inventory is shown in the Balance Sheet at market price or cost, whichever is less, while for sundry debtors provision for bad and doubtful debts is made, and rest current assets at par or keeping their face-value.

Investments are a form of assets shown in the assets-side. Generally, long term investments in shares, securities including bonds and debentures of other companies are shown separately under the caption of 'Investment' in the Balance Sheet. These investments are done in order to seek power and control on the companies besides earnings. The costs of investments are considered while preparation of the Balance Sheet, as investments is shown at cost price in the Balance Sheet while the market price of the investments is shown in inner column of Balance Sheet. Secondly, excess or surplus cash or bank balances are invested for a short period in the banks, FDR's, government-securities or in any similar marketable-securities but these type of short-period investments are not included in the investments and therefore shown as a current assets.

The other assets are those assets which cannot be considered either as fixed assets, currents assets or investment. There are number of assets in the business by the virtue of nature, size and form of business and due to accounting process considered as fictitious assets:

1. Capital Loss or Expenses
2. Deferred Revenue Expenditures
3. Prepaid Insurance Premium
4. Underwriting Commission
5. Preliminary Expenses
6. Debit Balance of Profit & Loss Account
7. Prepaid Expenses

Ultimately, these other assets are to be written off out of the profit earned. However till the time these assets are not written-off, will be shown in Balance Sheet.

In the left hand side of Balance Sheet 'Liabilities' are shown. Liabilities may be shown either 'order of urgency of payment' or 'order of reverse of urgency', as assets are shown in the Balance Sheet in 'order of liquidity' or in 'order of permanency', however consistency of order between assets and liabilities be aware while showing in the Balance Sheet. Payments are to be made to the outsiders by the business is called as 'liabilities'. Capital is also a liability of business towards owners, as there is a concept of 'separate entity'. Generally liabilities arise due to exercise the sources of finance and taking credit or purchasing on credit.

There are three types of sources of finance or capital in the company viz.

1. Long Term
2. Medium Term
3. Short Term

The long term sources are in the form of share capital, debentures and bonds. Share create capital while bonds and debentures create loans. Loans for long term (five or more year) are taken from banks other financial institutions. Medium term loans are of duration between three to five years. Term loans (less than three years) for working capital are taken from banks or financial institutions besides bank overdrafts, outstanding payments, bills payables and creditors. Medium term loans include loans from banks, insurance companies, financial institutions, public deposits and mortgage loans on fixed assets. Business also creates reserves, surplus and funds making appropriations of profit and these are shown in the liabilities resulted by the accounting- process. In brief liabilities are majorly classified in to three groups:

1. Owners Equity
2. Long Term Liabilities
3. Current Liabilities

We have discussed liabilities as above but these three groups may be explained in brief as given below.

Owners' Equity includes share capital and retained earnings. After distribution of profit (i.e. dividend) the remaining part (i.e. profit earned but not distributed among share holders) is called retained earnings and this is kept in the forms of surplus, reserves and funds of different categories. Generally businesses retain profit in order to reinvest for growth, development and for future safety. Owner's equity is a liability toward share holders i.e. owners in the eyes of law but this is severe less liability. Owner's equity may or may not include preference share capital. If there is preference share capital, then it should be shown clearly in the Balance Sheet. It is better to show separately both equity share capital and preference share capital in the liabilities side of the Balance Sheet.

The long terms loans include all liabilities towards lenders (who provide loans for more than one year). However loans may be shown separately as long term loans and medium term loans. The long term loans include debentures, bonds, mortgage, loans, and loans from banks / financial institutions. If loans are secures against assets then they will be called secured loans otherwise unsecured loans. Long term loans are matured at pre determined date or may be paid in instalments as per agreed terms and conditions. A part of due amount of loans in the forthcoming year may be shown under the heading of current liabilities. Facts regarding nature, maturity, interest and other significant information must be given either in the 'foot-note' or schedules of the Balance Sheet.

The current liabilities are shown in the liabilities side of Balance Sheet. These liabilities are such liabilities which are likely to be paid in forthcoming financial years. An effort has been done to pay current liabilities in time in order to avoid 'technical insolvency' and maintain goodwill of the business. Current liabilities include bank overdrafts, outstanding expenses, deferred revenue, income proposed, income tax, declared dividends, bills payables, sundry creditors, outstanding interest, and dues etc. Different provisions, surplus, funds are also part of the current liabilities.

It is always better to pay current liabilities out of current assets. Therefore net working capital is considered as excess of current assets over current liabilities. However contingent liabilities or any expected gains (if any) are shown in 'foot notes' of the Balance Sheet. As stated above, if any long term liability, which is likely to be paid in the next financial year, may also be shown under the heading current liabilities in the Balance Sheet.

10.11 Forms of Balance Sheet

In order to prepare Balance Sheet, an understanding about the different forms of Balance Sheet is must. In preparation of the Balance Sheet, the name of the business is written at the top of Balance Sheet. There are two ways to put title of the Balance Sheet such as:

1. Balance Sheet as on 31st March 2010 (i.e. the last day of the current financial year or accounting period of one year) and similarly
2. Balance Sheet as at 31st March 2010.

But the title as suggested in the part I of schedule VI of the Companies Act 1956, for the form of Balance Sheet is as given below:

"Balance Sheet of _ _ _ _ _ _ _ (here enter the name of the company) as on _ _ _ _ _ _ _ _ _ _ _ _ _ _ _ _ (Here enter the date as at which the Balance Sheet is made out)".

Now it is clear that 'as on' is more correct than 'as at'. However, it is certain that the Balance Sheet is prepared on a particular date which is the last day of accounting year related to the business. But under the special circumstances the Balance Sheet may be prepared on any specific date. In case of interim accounts being prepared, the date would be last day of that period e.g. quarterly or half yearly. There are two forms of Balance Sheet as given below:

1. Horizontal Form of Balance Sheet
2. Vertical Form of Balance Sheet

The horizontal form of Balance Sheet is just like an account form and which is generally called as T-form of the Balance Sheet. It is not an account but Balance Sheet is prepared as statement of financial position. The horizontal form of the Balance Sheet is also specified as per the part I of the schedule VI of the company act, 1956. The form keeps owners, equity and liabilities of the business at the left hand side while assets at the right hand side. But in USA and supporting countries in the world, assets kept in the left hand side and owners' equity & liabilities kept in the right hand side while preparing the Balance Sheet. According to company act Balance Sheet follow the order of permanence to the assets, while the order of reverse of urgency to the liabilities. Here specimen forms of Balance Sheet in horizontal form as well as in T-form are being given as under:

Performa of Balance Sheet in Horizontal Form:

Balance Sheet of PQR Ltd as on 31st March 2010

Fig. of Last Year	Liabilities	Fig. of Current Year	Fig. of Last Year	Assets	Fig. of Current Year
	Share Capital			**Fixed Assets:**	
xxx	Authorised	xxx	xxx	Goodwill	xxx
xxx	Issued & Subscribed xx		xxx	Land & Building	xxx
	Less : Calls Unpaid xx		xxx	Lease holds	xxx
	Add: Forfeited Shares xx	xxx	xxx	Railway Sidings	xxx
	Reserve & Surplus		xxx	Plant & Machinery	xxx
xxx	Capital Reserves	xxx	xxx	Furniture & Fittings	xxx
xxx	Capital Redemption Reserve	xxx	xxx	Development & Property	xxx
xxx	Securities Premium A/c	xxx	xxx	Patents, Trademarks & design	xxx
xxx	Other Reserves	xxx	xxx	Livestock	xxx
xxx	General Reserve	xxx	xxx	Vehicles etc.	xxx
xxx	Surplus	xxx		**Investments**:	
xxx	Proposed Addition to Reserve	xxx	xxx	Investment in Govt. or Trust Securities	xxx
xxx	Sinking Found	xxx	xxx		
				Investment in Shares, Debentures or Bonds	xxx
	Secured Loans:				
xxx	Debentures	xxx	xxx	Immovable Properties	xxx
xxx	Loans & Advances	xxx	xxx	Other Investments	xxx
	Unsecured Loans:			**Current Assets, Loans & Advances**	
xxx	Fixed Deposit	xxx		**(A) Current Assets**	
	(A) Current Liabilities		xxx	Interest accrued on Investment	xxx
xxx	Acceptance (B/Ps)	xxx	xxx	Stores & spare-parts	xxx
xxx	Sundry Creditors	xxx	xxx	Loose tools	xxx
xxx	Outstanding Payments	xxx	xxx	Stock-in-trade	xxx
xxx	Unclaimed Dividend	xxx	xxx	Work in progress	xxx
xxx	Interest Accrued	xxx	xxx	Sundry Debtors xx	
xxx	Other Liabilities	xxx		Less : Provisions xx	xxx

	(B) Provision:		xxx	Cash Balance in Hand	xxx
xxx	Provision for taxation	xxx	xxx	Bank Balance	xxx
xxx	Proposed dividend	xxx		**(B) Loans & Advances**	
xxx	Provision for contingency	xxx	xxx	Advances & Loans to	xxx
xxx	Provision for PF Scheme	xxx		subsidiaries	
xxx	Provision for Insurance	xxx	xxx	Other advances	xxx
	Pension & Others		xxx	Recoverable Advance	xxx
	benefit Schemes		xxx	Balance with Customs,	xxx
xxx	Other Provisions	xxx	xxx	Trust etc.	
				Miscellaneous Expenditure:	
				Preliminary expenses	xxx
				Commission, Brokerage	xxx
				Underwriting etc.	
				Discount Allowed on issue of	xxx
				shares or and debentures	
				Interest paid out of capital	xxx
				during construction	
				Development expenses not adjusted	xxx
				Otherwise	
				Profit & Loss A/c (Balance if any)	xxx
xxxx	**Total**	**xxxx**	**xxxx**	**Total**	**xxxx**

<u>Performa of Balance Sheet in T-Form:</u>

Balance Sheet of XYZ Ltd as on 31st March 2010

Liabilities	Amount	Assets	Amount
Owners Equity		**Fixed Assets:**	
1. Share capital	xxx	1. Tangible	
2. Reserves & Surplus	xxx	Land & Buildings	xxx
Long Term Liabilities		Furniture	xxx
1. Debentures	xxx	Plant & Machinery	xxx
2. Loans:		Others Assets	xxx
Secured	xxx	2. Intangible	
Unsecured	xxx	Goodwill	xxx
Current Liabilities & Provisions		Patents	xxx
1. Sundry Creditors	xxx	Trade Marks	xxx
2. Bills Payable	xxx	Other Assets	xxx
3. Other Liabilities	xxx	**Investments**	xxx
4. Provision	xxx	**Current Assets:**	
		Inventories	xxx
		Raw Material	xxx
		Work in Progress	xxx
		Bills Receivables	xxx
		Sundry Debtors	xxx
		Others	xxx
		Cash at Bank	xxx
		Cash in Hand	xxx
Total	**xxx**	**Total**	**xxx**

The Vertical Form

The vertical form of the Balance Sheet is based on the modern concept of objectivity under which the Balance Sheet follows the concepts of time saving and personal judgment. Vertical form also helps in analysis of Final Accounts including the Balance Sheet. Therefore the vertical-form of Balance Sheet is also called as analytical-form or statement form. It may also be call as single-column form of Balance Sheet.

The subject matter, facts and information are twisted while preparation of the Balance Sheet in accordance of their choice and requirements. By the way, this form may also be called as flexible-form of the Balance Sheet. The vertical form of Balance Sheet therefore is very popular in practice, while having no formal approval of any of the acts or laws. However this form of the Balance Sheet may be used by the companies getting prior approval of the central government of India. The unique features of the vertical-form of the Balance Sheet are that the form easily depicts the sources and use or application of the funds. A specimen form of the vertical-form of the Balance Sheet is given below:

The companies are expected that they have to prepare their Final Accounts either in the horizontal-form or vertical-form and as once decided has to follow for consistency and comparability as option given, as per notification issued on Dec. 23 1978 by the Central Government.

Performa of Balance Sheet in Vertical Form

Balance Sheet of ABC Co. Ltd. as on 31st March 2010

Particulars	Schedule No.	Current Year Amount	Previous Year Amount
I. Source of Funds			
1. Shareholders' fund:			
Capital		xxx	xxx
Reserves and Surplus		xxx	xxx
2. Loan Funds:			
Secured Loans		xxx	xxx
Unsecured Loans		xxx	xxx
Total		xxx	xxx
II Application of Funds:			
1. Fixed Assets			
Gross Block		xxx	xxx
Less: Depreciation		xxx	xxx
Net Block		xxx	xxx
Capital Work in Progress		xxx	xxx
2. Investments		xxx	xxx
3. Current Assets, Loans & Advances			
Inventories		xxx	xxx
Sundry Debtors		xxx	xxx
Cash & Bank Balance		xxx	xxx
Other Current Assets		xxx	xxx
Less: Current Liabilities & Provision			
Current Liabilities		(-) xxx	(-) xxx
Provisions		(-) xxx	(-) xxx
Net Current Assets		xxxx	xxxx
4. Others:			
Miscellaneous Expenditure		xxx	xxx
Profit & Loss A\C (Dr)		xxx	xxx
Total		xxxx	xxxx

Activity D:-

Bring annual report of any corporate body of your choice and convert its Balance Sheet in to horizontal-form, if it is publish in vertical-form or vice versa.

10.12 Summary

In order to know the result of business operations done in the financial year and financial position, the business entity prepares trading, Profit & Loss Account and Balance Sheet at the end of the financial year. The Profit & Loss Account and the Balance Sheet both are significant, important and even indispensable statements. Final Accounts are the products of accounting process based on the Double Entry System of book keeping. Business itself and the government and the third parties need the Final Accounts in order to take their certain decisions. Ultimately the Final Accounts become part of annual report which is must to publish by the companies as per legal requirement and under the Companies Act, 1956. However, the Profit & Loss Account and the Balance Sheet should be based on the concept of the 'true and fair' view.

This unit covers the nature and purpose, significance of Final Accounts as well as meaning and definitions of the Profit & Loss Account and Balance Sheet, besides synonymous names. The unit also highlighted the subject matter of Profit & Loss Account and Balance Sheet. Forms of Profit & Loss Account and Balance Sheet; horizontal and vertical both clearly explain the ways of preparation and subject matter as well as purpose of preparations of the Final Accounts. For simplicity and easy to understand, the unit itself contains certain illustrations regarding preparation of trading, Profit & Loss Account and Balance Sheet.

10.13 Illustrations

Now, with the help of certain illustrations, the Final Accounts; Profit & Loss Account, and Balance Sheet are being prepared so that we can easily learn that how these accounts and Balance Sheets are prepared in the practical life of business. Certain adjustments, while preparing Final Accounts are supposed to be done. These adjustments will be explained in the next unit.

Illustration: 1

The following trial balance was related with the books of Agarwal & Sons as on 31st March, 2010

Particulars	Dr (Rs.)	Cr (Rs.)
Apprentice Premium		25,000
Bank Overdraft		60,000
Cash in hand	25,000	
Commission Received		10,000
Debtors and Creditors	2,00,000	1,50,000
Drawing and Capital	25,000	5,00,000
Furniture	45,000	
Heating and Lighting Office	10,000	
Lease hold Property	4,00,000	
Opening Stock	1,50,000	
Printing & Stationery	5,000	
Provision for doubtful debts		20,000
Purchase and Sales	3,40,000	6,00,000
Returns Inwards	15,000	
Salaries	85,000	
Traveling expenses	15,000	
Wages & freight	50,000	
Total	13,65,000	13,65,000

Prepare trading, Profit & Loss Account for the year ending 31st March, 2010 and Balance Sheet as on that date. Closing stock for the year was 75,000/-

Solution:

M/S Agarwal & Sons

Trading and Profit & Loss Account for the year ending 31st March, 2010

Dr. Particulars	Amount (Rs.)	Particulars	Cr. Amount (Rs.)
To Opening Stock	1,50,000	By Sales 6,00,000	
To Purchases	3,40,000	Less Returns B/W 15,000	5,85,000
To Wages & freight	50,000	By closing stock	75,000
To Gross Profit c/d	1,20,000		
	6,60,000		**6,60,000**
To Salaries	85,000	By Gross profit b/d	1,20,000
To Heating & lighting	10,000	By Commission received	10,000
To Traveling expenses	15,000	By Apprentice premium	25,000
To Print & stationery	5,000		
To Net profit transferred to capital a/c	40,000		
	1,55,000		**1,55,000**

Agrawal & Sons

Balance Sheet as on 31st March, 2010

Liabilities		Amount	Assets		Amount
Capital	5,00,000		Lease hold property		4,00,000
Add : Net Profit	40,000		Furniture		45,000
	5,40,000		Stock in Trade		75,000
Less : Drawings	- 25,000	5,15,000	Debtors	2,00,000	
Bank overdraft		60,000	Less : Provision	20,000	1,80,000
Creditors		1,50,000	Cash in hand		25,000
		7,25,000			**7,25,000**

Illustration: 2

From the following Trial balance of Swastika ltd. as on 31st March, 2010, prepare trading and Profit & Loss Account for the year ended 31st March, 2010 and a Balance Sheet as at that date, closing sock for the year was valued at Rs. 36,500.

Solution:

Particulars	Dr. (Rs.)	Cr. (Rs.)
Capital		2,00,000
Carriage outward	1,250	
Cash at Bank	51,250	
Cash in hand	15,500	
Discount		2,000
Drawings	15,000	
Freight & duties	5,000	
Furniture & fixtures	12,500	
Insurance charges	1,750	
Plant & Machinery 1.4.2009	50,000	
Plant & Machinery 1.10.2009	12,500	
Postage & Telegram	2,000	
Printing & stationary	2,000	
Provision for doubtful debts		1,000
Purchases	2,05,000	
Rates & taxes	11,500	
Rent of permises sublet		3,000
Returns inward	5,000	
Returns outward		2,500
Sales		3,00,000
Salaries & wages	53,250	
Stock on 1.4.2009	37,500	
Sundry debtors	51,500	
Sundry creditors		25,000
Trade expenses	1000	
Total	5,33,500	5,33,500

M/S Swastika Ltd.
Trading and Profit & Loss Account for the year ending 31st March, 2010

Particulars	Amount	Particulars	Amount
To Opening stock	37,500	By Sales 300000	
To Purchases 205000		Less: Returns outwards	
Less Retunes I/W 2500	202,500	5000	2,95,000
To freight & Duty	5,000	By closing stock	36,500
To gross profit c/d	86,500		
	3,31,500		**3,31,500**
To Carriage outward	1250	By Gross profit b/d	86,500
To Rates and taxes	11500	By Rent received	3,000
To Printing & stationary	2,000	By Discount	2,000
To Trade expenses	1,000		
To Postage & Telegram	2000		
To Insurance	1,750		
To Salaries & wages	53,250		
To Net profit transferred to capital a/c	18,750		
Total	**91,500**		**91,500**

Balance Sheet as on 31st March, 2010

Liabilities		Amount (Rs.)	Assets		Amount (Rs.)
Capital	2,00,000		Plant & Machinery	50,000	
Add : Net profit	18,750		as on 1.4.2009		
	2,18,750		Addition	12,500	62,500
Less Drawings	– 15000	2,03,750	Furniture & fixture		12,500
Sundry creditors		25,000	Closing stock		36,500
			Debtors	51,500	
			Less : Provision	1,000	50,500
			Cash in hand		15,500
			Cash at bank		51,250
Total		2,28,750			2,28,750

10.14 Self Assessment Questions

1. Explain the significance and nature of Final Accounts.
2. "Profit & Loss Account and Balance Sheet are indispensable statements". Do you agree with the statement? Give your Comments.
3. Explain in brief, the subject matter of Profit & Loss Account and Balance Sheet.
4. "Practically, vertical form of Final Accounts is more popular than horizontal form". Critically examine the statement.
5. Write short notes:
   (i) Income Statement
   (ii) Horizontal Form of Balance Sheet, and
   (iii) Vertical Form of Income Statement
6. Take the annual report of any business entity and study the Final Accounts published in that report.

10.15 Reference Books

1. Jain, Khandelwal and Pareek : Financial Accounting.
2. Shukla and Grewal : Financial Accounting.
3. R. L. Gupta and R. Gupta : Financial Accounting.
4. Peter Atrill and Eddie Melaney : Accounting and Finance for Non specialists.
5. T.P. Ghosh : Financial Accounting for managers.

Unit - 11 Preparation of Final Accounts [With Adjustments]

Structure of Unit:

11.0 Objectives

After completing this unit you will be able -

- To know that after preparation of preliminary trial balance certain expenses, incomes and provisions remain to be taken care of and adjust in books of accounts.
- To incorporate expenses and incomes related to current year but not accounted for in books due to non payment or non receipts.
- To eliminate expenses and incomes related to next year but accounted for due to their payment or receipt in current year.
- To incorporate provisions and reserves generally made at the year end.
- To prepare adjusted trial balance after incorporating the above expenses, incomes and provisions suitably.
- To prepare the trading profit and loss account on the basis of adjusted trial balance or after incorporating the above adjustments.
- Prepare the balance sheet after incorporating the above adjustments.

11.1 Introduction

In this unit we will discuss about the expenses and incomes which require adjustments while preparing the final accounts. This will result in eliminating the effect of expenses and incomes which are related to next year's but accounted for in current year. It will also be made clear in this unit how these adjustments should have the double effect in final accounts so that the basic principle of double entry system of book keeping is followed resulting into tally of both sides of balance sheet i.e. assets and liabilities. Thus in this unit we will know how profit and loss account and balance sheet are prepared after incorporating the adjustments regarding expenses, incomes and provisions.

11.2 Meaning of Adjustments

In the last unit the importance of final accounts and its ingredients have been explained in detail. The businessman wants to know the operational results of a particular period and the position of the assets and liabilities. Normally this period is an accounting year which may be a calendar year, a financial year or any other period may be Deepawali to Deepawali etc.

As has been explained the income statement or P & L Account when prepared on the basis of the balances appearing in the Trial balance, there is an underlying assumption that all expenses relating to that accounting year have been accounted for, similarly all incomes have been received pertaining to that year.

In real practice it does not happen and hence even after preparation of trial balance certain transactions remain to be taken care of, the amounts of which is important to arrive at the correct figure of profit/loss and position of assets and liabilities. The accounting process by which such transactions are properly incorporated is known as adjustment.

11.3 Need of Adjustments

While preparing the income statement and the balance sheet the adjustment is properly done for the transactions of that particular period whether the same have been accounted for or not on account of non payment or non receipt of these expenses and incomes respectively. Also it is important to give effect of the value of stock lying in business at the end of the period. In other words the adjustments are made for the transactions pertaining to that period have not been made or might have not been made correctly. Thus entries made for correcting the wrong entries already made also becomes the part of adjustments.

As a result of the adjustment the balances appearing in the trial balance prepared on the basis of books will change and some new accounts will be opened. If after making such adjustments a new trial balance is prepared it is called adjusted, final or new trial balance.

11.4 Items of Adjustments

The adjustments which are necessary at the end of the financial year mainly pertain to the following:-

i. Outstanding expenses
ii. Prepaid expenses
iii. Accrued income
iv. Unearned income
v. Depreciation
vi. Interest on capital
vii. Interest on drawings
viii. Closing stock
ix. Manager’s Commission on profits
x. Accidental losses
xi. Provision for doubtful debts

xii. Provision for discount on debtors and reserve on creditors
xiii. Deferred revenue expenses
xiv. Contingent liabilities
xv. Adjustments for rectification of mistake

11.5 Outstanding Expenses

In a business there are certain expenses the benefits of which have been taken but the payment of the same is yet to be made. Such expenses are known as outstanding expenses. Normally the salaries, wages, rent and power bill are paid after close of the period i.e. the wages for the month of April is paid by 7th May. Similarly the power bill payment is made by 15th or 20th of the next month. As the accounts are prepared on accrual basis to know the correct figure of wages, salaries, rent and power expenses etc. It is essential that such expenses pertaining to the month of March 2010 though paid in April 2010 is also taken care of in the income statement prepared for the period ending on 31st March 2010 and balance sheet as on 31th March 2010. It can be summed up that if such expenses are not included in the preliminary trial balance they should be incorporated while preparing the final trial balance to show the true and fair view.

Adjustment in Books of Accounts and Presentation in Final Accounts

For incorporating, the particular expenses account should be debited and the outstanding expenses account to be credited.

For example

Salaries for the period from April to February Rs. 1,10,000 have been paid and accounted for. The payment of March 2010 amounting to Rs. 10,000 has been made on 4th April 2010.

The adjustment journal entry will be –

31st March 2010	Salaries a/c Dr.	10,000	
	To Outstanding Salaries a/c		10,000
	(Outstanding salaries for March 2010)		

Posting in ledger

Salaries a/c

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
Various Dates	To cash a/c	110,000	31/3	By P&L a/c	120,000
31/3/10	To outstanding Salary a/c	10,000			
		120,000			120,000

While preparing the final accounts in the income statement Rs. 10,000 will be added in the salary and in Balance sheet the outstanding salary will be shown in the liabilities side.

Extract of Profit and loss a/c

Particulars		Amount (Rs.)	Particulars	Amount (Rs.)
To salaries a/c	110,000			
Add : Outstanding salary	10,000	120,000		

Extract of Balance Sheet
As on 31st March, 2010

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Outstanding salaries	10,000		

Reverse entry in the beginning of next year

In the beginning of next year the above entry will be reversed as under:

Outstanding salaries a/c	Dr.	10,000
To Salaries a/c		10,000

Or alternatively while recording the payment of salary in next year instead of salary the outstanding salary may be debited. The effect of both the entries will be same.

Similar entries may be passed for all outstanding expenses i. e. rent, interest on loan, power bill etc.

Besides a combined entry for all such expenses may be made and the outstanding liability for expenses may be shown in balance sheet for total amount at the end of the year.

11.6 Prepaid Expenses

If the payment of expenses pertaining to the next accounting year is made and accounted for in books of accounts such expenses are known as prepaid expenses. Normally this happens in cases where expenses are paid in yearly or half yearly instalments. For instance the rent for the business is paid on half yearly basis i.e. in June and December every year.

In such a situation the rent for April, May and June will be treated as advance or prepaid rent while preparing the final accounts i. e. income statement for the year ending 31st March, 2010 and balance sheet as on 31st March, 2010.

For example:

The insurance premium for the year is paid in instalments on half yearly basis ie 30th June and 31st December , Rs. 60,000/- each. The journal adjustment entry for the year ending 31st march 2010 will be made as under –

Journal

Date	Particulars	L/F	Amount (Rs.)Dr.	Amount (Rs.) Cr.
31/3/10	Prepaid insurance a/c Dr. To insurance premium a/c		30,000 -	- 30,000

The insurance premium shown in the books will be reduced by Rs. 30,000/- and the reduced amount will be shown in the profit and loss a/c and prepaid insurance will be shown in assets side of the balance sheet.

Extract of Profit and loss a/c
For the year ended 31st March, 2010

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
31/3	To insurance premium 60,000 Less: Prepaid insurance 30,000	30,000			

Extract of Balance sheet
As on 31st March, 2010

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
		Prepaid insurance premium	30,000

Reverse entry in the beginning of the next year

A reverse entry will be made in the beginning of the next year i. e. insurance premium a/c will be debited and prepaid insurance premium a/c will be credited as under :-

1st April 2010 Insurance premium a/c Dr. 30,000
To prepaid insurance premium a/c 30,000

Activity – A: Take balance sheet of a company and make a list of outstanding and prepaid expenses along with the amounts thereof.

11.7 Accrued Income

In the business it happens that certain incomes are earned in a particular year but a part of which is not received up to the end of the year. Such income is known as accrued income. For example when FD is made on 1st October, 2009 for one year. The interest thereon for 6 months earned on 31st March 2010 but will be received after completion of one year ie on 30th September. Hence on 31st March 2010 the interest for the period from 1st October 2009 to 31st March 2010 will be treated as accrued income.

In other words the income earned but not received is known as accrued income.

This accrued income needs to be incorporated in the final accounts for the year ending 31st March 2010.

Example

Mr. Johnson has made a fixed deposit of Rs. 1 lac with Dena Bank at an effective interest rate of 8% for one year on 1st January 2010. As the interest for the period from 1st January 2010 to 31st March 2010 Rs. 2000/- is to be received along with interest of one full year on 31st Dec 2010. The interest for three months will be treated as accrued income. This will be incorporated through adjustment in final accounts as under –

Journal

31/3/2010	Accrued interest a/c	Dr.	2000	
	To interest a/c			2000
	(Interest accrued for three months)			

Final Accounts

The interest account is a nominal a/c and it represents incomes, it will be shown in credit side of the profit and loss a/c. The accrued interest is a personal account and represents some one as a debtor to the business. It will be shown in assets side with other current assets.

Extract of Profit and loss a/c
For the year ending 31st March, 2010

Date	Particulars	Amount	Date	Particulars	Amount
			31/3/10	By Interest a/c	2000

Extract of Balance sheet
As on 31st March, 2010

Liabilities	Amount	Assets	Amount
		Accrued interest	2000

The similar entries may be passed for such other incomes i. e. interest on debentures, Commission and rent if any to be received.

Reverse entry

In the journal the entry made at the end of the year will be reversed so that the accrued interest a/c will get closed and will not appear in new year in balance sheet. Interest account shall show a debit entity to offset the interest received in the next year.

11.8 Unearned income or income received in advance

Sometimes it may happen that the income pertaining to the next year is received in advance in current year such income is known as unearned income. Normally it happens when some business property is given on rent and the rent for one year is received in advance. Since the rent received may be partly for current year and partly for next year. To show the true and fair view of the profit and loss and also assets and liabilities the adjustment entry is required to be made. For this related income head is debited and unearned income is credited in books. This will result in reducing the related income in profit and loss a/c and creating a liability in balance sheet for the party from whom receipt has been made in advance.

Example

On 1st October, 2010 Jacob has given his business godown on monthly rent of Rs. 10,000/- and received Rs. 1,20,000 as advance rent for one year. While preparing the final accounts on 31st March, 2010 only rent for six months i. e. 60,000/- pertains to current year and remaining Rs. 60,000/- for the next year. Hence to show the true and fair view of this income, the following adjustment is required to be made:

Journal

31/3/2010	Rent a/c	Dr.	60,000	-
	To unearned rent a/c		-	60,000
	(Being rent received in advance for 6 months)			

POSTING IN LEDGER

Rent a/c

Date	Particulars	Amount	Date	Particulars	Amount
31/3/10	To unearned rent a/c To P&L a/c	60,000 60,000	1/10/09	By cash a/c	120,000
		120,000			120,000

Unearned rent a/c

Date	Particulars	Amount	Date	Particulars	Amount
31/3/10	To balance c/d	60,000	31/3/10	By rent a/c	60,000
		60,000			60,000

Presentation in Final Accounts

The rent account is a nominal account and represents income. It will be reduced by Rs. 60,000/- in credit side. In balance sheet, unearned rent will be shown as liability as the business owes to the party from whom rent has been received in advance.

Extract of Profit and loss a/c
For the year ending 31st March, 2010

Particular	Amount	Particular	Amount
		By rent a/c 120,000 Less : unearned rent – 60,000	60,000

Extract of Balance sheet
As on 31st March, 2010

Liabilities	Amount	Assets	Amount
Unearned rent	60,000		

Reverse entry at the beginning of the next year

The entry in next year will be just reverse to what has been passed at the end of the year as is in case of other adjustments –

Journal

01/04/2010	Unearned rent a/c	Dr.	60,000	-
	To rent a/c		-	60,000
	(entry reversed in the beginning of the year)			

From the above it can be summarized that certain expenses either remains to be paid or paid in advance at the year end, adjustment for the same is required. Similarly certain incomes remain to be received and others received in advance. In other words adjustment entries are made for such expenses and incomes to arrive at the true and fair view of the profit and loss for the period and the assets and liabilities as on a particular date.

Activity – B: Make a list of incomes which are of accrued and unearned nature from the balance sheet of a company. Examine whether treatment of the same is correct.

Besides above certain items of adjustments are known but made at the year end only. A few examples of such adjustments are depreciation, closing stock, provision and reserve etc. These are explained here under:

11.9 Depreciation

Due to wear and tear of the fixed asset or due to passage of time or due to change taking place in market condition the value of asset is reduced. This reduction in value is known as depreciation. The depreciation is also an expense hence journal entry is passed debiting the depreciation account and crediting the asset concerned. In profit and loss account it is shown in debit side and in balance sheet the amount is reduced from the value of the fixed asset. Thus the fixed asset is shown at the reduced value.

Example

A machine is purchased on 1st April 2009 at a cost of Rs.10,00,000. At the year end i.e. on 31st March 2010 it is decided to charge depreciation @10% per annum. For this the accounting treatment is given as under –

Journal

31/3/2010	Depreciation a/c	Dr.	100,000	-
	To machinery a/c		-	100,000
	(Being depreciation on machinery written off)			

POSTING IN LEDGER

Depreciation a/c

Date	Particulars	Amount	Date	Particulars	Amount
31/3/10	To machinery a/c	100,000	31/3/10	By P&L a/c	100,000
		100,000			100,000

Machinery a/c

Date	Particulars	Amount	Date	Particulars	Amount
1/4/09	To bank a/c	10,00,000	31/3/10	By depreciation a/c By balance c/d	100,000 900,000
		10,00,000			10,00,000

Extract of Profit and loss a/c
For the year ending 31st March, 2010

Particulars	Amount	Particulars	Amount
To depreciation on machinery	100,000		

Extract of Balance sheet
As on 31st March, 2010

Liabilities	Amount	Assets		Amount
		Machinery Less : Depreciation	10,00,000 1,00,000	9,00,000

It is important to note that it does not have any effect on the profit and loss account / balance sheet of the next year hence in the beginning of the next year no entry is required to be passed.

11.10 Interest on Capital

The owner and the business is considered to be separate entities. Hence for the capital brought by the owner in the business the owner charges interest as return on capital. The interest on capital is also a trading loss hence profit and loss account is affected.

Example

Mr. Johan started business with a capital of Rs. 10,00,000 on 1st April, 2009. At the year end i. e. on March 31st, 2010 it is decided to charge interest on capital @9% per annum.

The accounting treatment of the same is as under –

Journal

31/3/2010	Interest on capital a/c	Dr.	90,000	-
	To capital a/c		-	90,000
	(Being interest provided)			

Presentation in final accounts

The interest on capital is a nominal account hence charged to profit and loss account. In the balance sheet it is shown by adding to capital account in liabilities side as capital is a personal account. For closing the account of interest on capital a closing entry is passed.

Journal

31/3/2010	Profit and loss a/c	Dr.	90,000	-
	To interest on capital a/c		-	90,000
	(Being amount of interest transferred from profit and loss a/c)			

Extract of Profit and loss a/c
For the year ending 31st March, 2010

Particulars	Amount	Particulars	Amount
To interest on capital a/c	90,000		

Extract of Balance sheet
As on 31st March, 2010

Liabilities		Amount	Assets	Amount
Capital	10,00,000			
Add : Interest on capital	90,000	10,90,000		

11.11 Interest on Drawings

As already narrated owner and business are two separate entities hence similar to that of interest on capital, interest is also charged on drawings of the owner from the business. The interest paid by the owner on drawings is profit to the business (expenses to owner) the drawings account is debited and interest on drawings is credited.

Example

Mr. Johan withdraws Rs. 50,000 from the business on 1st October, 2009. The interest on drawings to be charged @ 6% per annum.

In the above the accounting treatment to be given is as under –

Journal

31/3/2010	Drawings a/c	Dr.	3000	-
	To interest on drawings a/c		-	3000
	(Being interest charged on drawings)			

Final accounts

The interest on drawings being an income is shown in the credit side of the profit and loss account and in the balance sheet it is added to the drawings and then deducted from capital in the liabilities side.

Extract of Profit and loss a/c
For the year ending 31st March, 2010

Particulars	Amount	Particulars	Amount
		By Interest on drawings	3000

Extract of Balance sheet
As on 31st March, 2010

Liabilities	Amount	Assets	Amount
Capital 10,00,000 Less: Drawings (50,000+3000) 53,000 Including interest on drawings	9,47,000		

> **Activity – C:** From the balance sheet of a public limited company examine method of depreciation adopted. Also examine whether provision made for depreciation is sufficient.

11.12 Closing Stock

In running the business the normal activity is to purchase and sell the goods. At the end of the year generally out of the goods purchased some goods remain unsold. The value of the unsold goods lying in the business is called Closing Stock. To arrive at the profit / loss it is essential to correctly ascertain the value of closing stock and show it in the profit and loss account.

The adjustment entry for closing stock is –

Stock a/c Dr.
  To trading a/c
(Closing stock taken in to books)

The closing stock is shown in the credit side of the trading a/c and in balance sheet in assets side.

If the closing stock is given in the trial balance it means the trading a/c has already been prepared and gross profit shown. In such a situation the stock is not to be shown in profit and loss account, only it is to be shown in the assets side in balance sheet.

Valuation of closing stock

The valuation of closing stock is made by following two methods –

i. Actual stock taking and
ii. Stock taking by approximation.

1. Actual stock taking

In this method the list of goods lying unsold in business is prepared along with the measured or counted quantity and value thereof. While preparing the list the following points need to be taken care of –

i. The list should be comprehensive and inclusive in all respects. Even small value items should not be left.
ii. Measurement and counting should be correct.
iii. Goods lying unsold with consignment agent should be included.
iv. Goods purchased and entered but delivery not taken should be included.
v. Goods sold and entered in books but lying undelivered should not be considered in stock.
vi. Goods sold on approval but consent to be received from buyer should be considered in stock.

vii. Goods returned from customer and entered as sales return to be included.

viii. Other parties goods lying in business not to be included.

ix. Fixed assets not to be taken i. e. only business stock to be taken.

x. The damaged goods having nil realisable value should not be included.

After including all items in stock the value should be given to every item. Generally for valuation following two types of prices are considered.

Cost price – The purchase price including expense incurred is cost price.

Market price – The price realisable in the market is market price.

The general rule is cost or market price whichever is lower to be taken. This is based on concept of conservation. That is unrealized profit should not become the part of profit of current year. Besides the expected loss or expenses if any should be taken care of while arriving at the profit / loss of the period.

Stock taking by approximation

When the goods are destroyed in fire or due to flood or earthquake, the quantity and value of such goods cannot be determined as usual. In such a situation the value may be ascertained by preparing a memorandum trading account. For this the gross profit ratio for the last year is calculated and applied for the period for current year. Also the purchases, sales, purchase returns and sales returns are properly valued.

Example

Opening stock on 01/04/2009	Rs. 90,000
Net purchases from 01/04/2009 to 31/08/2009	Rs. 4,50,000
Net sales from 01/04/2009 to 31/08/2009	Rs. 3,69,000

Sales price is fixed by adding 20% on cost. The value of stock will be calculated by preparing the memorandum trading a/c.

Memorandum trading a/c
From 01/04/2009 to 31/08/2009

Particulars	Amount	Particulars	Amount
To opening stock To net purchases To gross profit (20% on cost or 16.6% on sales)	50,000 4,50,000 73,800	By sales By closing stock (bal.fig.)	3,69,000 2,04,800
	5,73,800		5,73,800

Activity – D: Study the balance sheet of the company and examine how stocks have been Valued? Whether on cost price or market value.

11.13 Manager's Commission on Profits

Some times commission is paid to the manager on profit. Adjustment is done at the year end in final accounts for such commission. This commission may be percentage of profit before charging such commission or may be after charging such commission.

Example

The manager is entitled to commission @ 5% before charging such commission and the net profit is Rs. 10,50,000. The amount of commission will be –

Commission – (5/100)×10,50,000 = 52,500

If the commission is on net profit after charging such commission, then the amount of commission will be –

Commission – (5/105)× 10,50,000 = 50,000

The accounting treatment of the amount of commission payable to the manager will be as under –

Journal

31/3/2010	Managers commission a/c	Dr.	50,000	-
	To outstanding commission a/c		-	50,000
31/3/2010	Profit and loss a/c	Dr.	50,000	
	To managers commission a/c			50,000

Extract of Profit and loss account
For the year ending 31st March, 2010

Dr. Cr.

To manager's commission To net profit	50,000 10,00,000	By net profit before commission	10,50,000
	10,50,000		10,50,000

Extract of Balance Sheet as on 31st March, 2010

Liabilities	Rs.	Assets	Rs.
Outstanding manager's commission	50,000		

11.14 Accidental Losses

Some times in the business accidental losses occur such as goods or assets destroyed by fire, flood, earthquake or other natural calamities. The adjustment of such losses is essential to arrive at true and fair profit and loss of the business. The treatment of such accidental losses in books of accounts is as follows –

1. **Assets (furniture) destroyed by fire**

   Loss by fire a/c Dr.

   To furnitures a/c

   (Furniture burnt by fire)

2. **Goods or stock destroyed by fire**

   Loss by fire a/c Dr.

   To purchases a/c

   (Goods burnt by fire)

3. **If the goods is insured and full claim is accepted by insurance company**

   Insurance company a/c Dr.

   To loss by fire a/c

   (Claim admitted by insurance company in full)

4. **If loss is accepted partly**

   Insurance company a/c Dr. (amount admitted)

   Profit and loss a/c Dr. (amount not admitted)

   To loss by fire a/c

   (Claim partly accepted by insurance company)

When payment is received from insurance company

Bank a/c Dr.

To insurance company's A/c

(Payment of claim received)

5. **If cash is stolen**

Loss by theft a/c Dr.

To cash a/c

(Cash lost by theft)

In the final accounts the loss not accepted by the insurance company is shown in the debit side of the profit and loss account and is reduced from the purchases, so that this loss does not affect trading loss and affects only net loss.

Cash stolen is shown in the debit side of the profit and loss account and cash shown in balance sheet is reduced by that amount.

11.15 Provision for Bad and Doubtful Debts

The businessman normally sells goods on credit to customers. Generally the amount is recovered but sometimes due to poor financial position of the customer, he is unable to pay the same.

The amount so remaining unrecovered is known as bad debts. The amount of bad debts is credited to the debtors a/c and shown in debit side of profit and loss account.

This way the debtors of a business may be categorized as –

Good debts – From whom the total amount is recoverable

Bad debts – No chance of recovery

Doubtful debts – There is an apprehension that some of the debts may not be recovered.

Following the conservative concept provision for non recovery is made on such debts as the same may not be treated as bad debts. Such provision is known as provision for doubtful debts.

This can be done on the basis of experience, or estimation that how much amount is irrecoverable out of such doubtful debts.

The accounting treatment of such provision for doubtful debts will be as under –

Journal

Profit and loss a/c Dr.

To provision for doubtful debts

(Being provision made)

Extract of Profit and loss a/c
For the year ending ________

Particulars	Amount	Particulars	Amount
To bad debts Add : Provision for doubtful debts	— —		

Extract of Balance sheet as at __________

Liabilities	Amount	Assets	Amount
		Sundry debtors Less: Provision for doubtful debts	— —

While making provision for current year the balance if any standing in the books should be considered. For example the balance in provision a/c is Rs. 90,000 and the estimated total provision is Rs. 1,40,000. Then this year Rs. 50,000 (1,40,000 – 90,000) will be required to be provided and debited to profit and loss account.

Illustration

In the trial balance of M/s. ABC Ltd. as on 31st March, 2010 bad debts were given Rs. 10,000. Debtors at Rs. 2,04,000 and the balance of the provision for bad and doubtful debts at Rs. 22,000 as on 1st April, 2009. As per information provided after preparation of trail balance, additional bad debts Rs. 4,000 and it is decided to keep the provision @ 7% on total debtors. Required to pass journal entries and prepare all necessary accounts.

Journal

31/3/2010	Bad debts a/c	Dr.	4,000	
	To debtors a/c			4,000
	(Bad debts written off)			
31/3/2010	Provision for bad and doubtful debts a/c	Dr.	14,000	
	To bad debts a/c			14,000
	(Being bad debts transferred to provision)			
31/3/2010	Profit and loss a/c	Dr.	6,000	
	To provision for bad and doubtful debts a/c			6,000
	(Additional amount debited to profit and loss a/c to maintain the reserve @ 7% of total debtors)			

Debtors A/c

Date	Particulars	Amount	Date	Particulars	Amount
31/03/10	To sundries a/c	2,04,000	31/03/10	By bad debts a/c By balance c/d	4,000 2,00,000
		2,04,000			2,04,000

Bad Debts a/c

Date	Particulars	Amount	Date	Particulars	Amount
31/03/10	To sundries a/c To debtors	10,000 4,000	31/03/10	By provision for doubtful debts	14,000
		14,000			14,000

Provision for bad and doubtful debts

Date	Particulars	Amount	Date	Particulars	Amount
31/03/10	To bad debts a/c	14,000	01/04/10	By balance c/d	22,000
	To balance c/d	14,000	31/03/10	By profit and loss a/c	6,000
		28,000			28,000

Extract of Profit and loss a/c
For the year ending 31st March, 2010

Particulars		Amount	Particulars	Amount
To provision for bad & doubtful debts				
Bad debts as per trial balance	10,000			
Add : Further bad debts	4,000			
	14,000			
Add: New provision	14,000			
	28,000			
Less: Provision already existing	22,000	6,000		

Extract of Balance sheet
As on 31st March, 2010

Liabilities	Amount	Assets		Amount
		Debtors	2,04,000	
		Less: Additional bad debts	4,000	
			2,00,000	
		Less: provision for bad and doubtful debts	14,000	1,86,000

Note: If less provision is required balance amount if any will be credited to P&L a/c.

11.16 Provision for Discount on Debtors and Reserve on Creditors

A businessman wants to speed up its recovery of dues from debtors and cash discount is offered to them for early payment. For this also provision is made this year for the debtors existing as at the end of the year. This provision is made after deducting the doubtful debts as they are not likely to make early payment. The treatment of the provision for discount on debtors is similar to that of provision for doubtful debts.

Similarly the creditors also give discount on early payments. For this a reserve is created and credited to profit and loss account. However under the conservative concept such reserve is not suggested as expenses and losses expected if any should be provided but gains if any may be left out.

Activity – E: From the balance sheet and P & L Account study and discuss how bad debts are treated and also whether provision is made every year for doubtful debts.

11.17 Deferred Revenue Expenses

Earlier we have come across certain expenses which are of revenue in nature but incurred in connection with fixed asset, they are not charged to revenue but are treated as capital expenditure and capitalized with the asset for which they are incurred.

For example part of the salary of a foreman is capitalized along with the installation cost of a machine on the basis of hours spent by him in installation of a new machine.

Also there are certain expenses which are not in relation to an asset but also may not be wholly charged as revenue in one year as the benefit of such expenses is to be received over a period of time, such expenses are known as deferred revenue expenses.

For example sales promotion expenses incurred, the benefit of which the enterprise derives for long time i. e. the whole advantage of the same not taken in one year but for a number of year or in other words the benefit is deferred over a period of time hence known as deferred revenue expenditure.

Accounting treatment

The total amount of such expenditure is not charged to revenue in one year but in several years. The basis may be unit of output or sale or may be a time period i. e. number of years. Generally the amount is charged to revenue in time period i.e. 5 years or at the most 10 years.

Example

A company has made an expenditure of Rs. 5,00,000 for launching a new product in market. he company expects to derive its benefit for next 5 years. In this case Rs. 1,00,000 to be charged to revenue every year and balance to be shown as deferred revenue expenditure in assets side in balance sheet.

> **Activity – F:** Look into the balance sheet and see whether deferred revenue expenses are appearing and if so how they are dealt with in final accounts.

11.18 Contingent Liabilities

There may be certain losses which are not ascertainable at the time of final accounts but are contingent in nature. No accounting treatment is required to be done. However shown by way of footnote only. For example legal suit pending.

11.19 Adjustment for Rectification of Mistakes

Besides above certain adjustment are there which are not in normal course of business but may sometimes require. For example when goods are taken from the business by the owner it is not sale but has to be debited to drawings a/c.

After preparing the trial balance some mistake may be located in posting or wrong heads are debited or credited. In such cases also rectification of entries is done through adjustments.

11.20 Illustrations

Now with the help of certain illustrations the adjustment journal entries and postings thereof will be done and adjusted trial balance, profit and loss account and balance sheet will be prepared. In earlier unit we have prepared trading and profit and loss account and balance sheet without adjustments presuming that all expenses and incomes have been received. Now in this unit illustrations will be with adjustments.

Illustration – 1

Pass necessary entries in journal of a trader for the following adjustments on March 31, 2010.

		Rs.
(i)	Outstanding Rent	1000
(ii)	Outstanding salary	2000
(iii)	Outstanding bill for repairs	400
(iv)	Insurance premium @ Rs. 2400 per annum paid on August 1, 2009.	
(v)	Interest accrued on loan given to Ram for Rs. 10,000 @ 6% per annum for 6 months.	
(vi)	Rs. 3600 received as Commission of which one-third part relates to next year.	
(vii)	Depreciation is to be written off on the following fixed assets:	

Machinery Rs. 2,00,000 @ 10% p.a.
Building Rs.1,00,000 @ 2.5% p.a
Furniture Rs. 20,000 @ 5% p.a.

(viii) Allow interest @ 9% per annum on the capital of Rs. 4,00,000 of the trader.

(ix) Charge interest on drawings of the trader for Rs. 20,000 @ 10% per annum.

Solution

Journal of ___________

Date	Particulars	L/F	Amount Dr.	Amount Cr.
2010				
31/03	Rent a/c Dr.			1000
	Salaries a/c Dr.		2000	
	Repairs a/c Dr.		400	
	To outstanding expenses a/c			3400
	(Rent, salaries and bill for repairs outstanding)			
31/03	Prepaid insurance premium /ac Dr.		800	
	To insurance premium a/c			800
	(Insurance premium prepaid for 4 months)			
31/03	Accrued interest a/c Dr.		300	
	To interest a/c			300
	(Interest on loan to Ram accrued for 6 months)			
31/03	Commission a/c Dr.		1200	
	To unearned commission a/c			1200
	(1/3rd part of commission unearned)			
31/03	Depreciation a/c Dr.		23500	
	To machinery a/c			20000
	To buildings a/c			2500
	To furnitures a/c			1000
	(Depreciation charged)			
31/03	Interest on capital a/c Dr.		36000	
	To capital a/c			36000
	(Interest allowed on capital)			
31/03	Drawings a/c Dr.		2000	
	To interest on drawings a/c			2000
	(Interest charged on drawings)			

Illustration – 2

The following trial balance is prepared from the books of M/s Rahul Marbles as on 31st March, 2010.

	Dr. (Rs.)	Cr. (Rs.)
Capital		3,00,000
Drawings	39,000	
Purchases	2,40,000	

	Dr. (Rs.)	Cr. (Rs.)
Investments	60,000	
Interest on investments		3,000
Wages	1,02,000	
Debtors	2,10,900	
Legal Charges	12,000	
Cash in hand	3,600	
Cash in bank	33,000	
Buildings	1,80,000	
Machinery	60,000	
Bills payable		19,500
Bills receivable	21,000	
Salaries	9,000	
Office expenses	9,000	
Discount	13,500	
Sales		6,60,000
Stock 01.04.2009	13,5000	
Office rent	7,200	
Bad debts	5,100	
Insurance	4,500	
Gas and fuel	8,100	
Carriage	10,500	
Tools	31,500	
Factory power	15,000	
Creditors		2,40,000
Goods returned	9,600	12,000
Furniture	15,000	
Total	12,34,500	12,34,500

Other information:

(i) Value of stock on 31st March, 2010 Rs. 1,50,000

(ii) Outstanding expenses – wages Rs. 7,200; salaries Rs. 1,800 and office rent Rs. 1,200

(iii) Insurance prepaid Rs. 1,350

(iv) Write off depreciation – Buildings 2% p.a., Machinery 10% p.a., and furniture 25% p.a.

(v) Accrued interest on investments Rs. 600

Give adjustment entries on 31st March, 2010 in the books of the Rahul Marbles. Prepare ledger accounts affected by adjustments, and prepare adjusted trial balance.

Solution:

Journal entries (for adjustments)

Date	Particulars		Amount Dr.	Amount Cr.
2010				
31/03	Wages a/c	Dr.	7200	
	Salaries a/c	Dr.	1800	
	Office Rent a/c	Dr.	1200	
	To outstanding expenses a/c			10200
	(Wages, salaries and office rent outstanding at the end of the year)			

Date	Particulars		Amount Dr.	Amount Cr.
31/03	Prepaid insurance a/c	Dr.	1350	
	To insurance a/c			1350
	(Prepaid insurance)			
31/03	Depreciation a/c	Dr.	13350	
	To buildings a/c			3600
	To machinery a/c			6000
	To Furniture a/c			3750
	(Depreciation charged on building machine & furniture)			
31/03	Accrued interest a/c	Dr.	600	
	To interest on investments a/c			600
	(Accrued interest taken)			

Ledger accounts after adjustments :

Wages account

Date	Particular	Amount	Date	Particular	Amount
2010					
31/03	To balance as per trial balance	1,02,000	31/03	By trading a/c	1,09,200
	To outstanding expenses a/c	7,200			
		1,09,200			1,09,200

Salaries account

Date	Particulars	Amount	Date	Particulars	Amount
2010					
31/03	To balance as per trial balance	9,000	31/03	By P&L a/c	10,800
	To outstanding exp. a/c	1,800			
		10,800			10,800

Office rent account

Date	Particulars	Amount	Date	Particulars	Amount
2010					
31/03	To balance as per trial balance	7,200	31/03	By P&L a/c	8,400
	To outstanding expenses a/c	1,200			
		8,400			8,400

Outstanding Expenses account

Date	Particulars	Amount	Date	Particulars	Amount
2010					
31/03	To balance c/d	10,200	31/03	By wages a/c	7,200
			31/03	By salaries a/c	1,800
			31/03	By office rent a/c	1,200
		10,200			10,200

Insurance account

Date	Particulars	Amount	Date	Particulars	Amount
2010					
31/03	To balance as per trial balance	4,500	31/03	By prepaid insurance a/c	1,350
			31/03	By P&L a/c	3,150
		4,500			4,500

Prepaid insurance account

Date	Particulars	Amount	Date	Particulars	Amount
2010					
31/03	To insurance a/c	1,350	31/03	By balance c/d	1,350
		1,350			1,350

Depreciation account

Date	Particulars	Amount	Date	Particulars	Amount
2010					
31/03	To buildings a/c	3,600	31/03	By P&L a/c	13,350
	To machinery a/c	6,000			
	To furniture a/c	3,750			
		13,350			13,350

Buildings account

Date	Particulars	Amount	Date	Particulars	Amount
2010					
31/03	To balance b/d	180,000	31/03	By depreciation a/c	3,600
				By balance c/d	176,400
		180,000			180,000

Machinery account

Date	Particulars	Amount	Date	Particulars	Amount
2010					
31/03	To balance b/d	60,000	31/03	By depreciation a/c	6000
				By balance c/d	54000
		60,000			60,000

Furniture account

Date	Particulars	Amount	Date	Particulars	Amount
2010					
31/03	To balance b/d	15,000	31/03	By depreciation a/c	3750
				By balance c/d	11250
		15,000			15,000

Interest on investments account

Date	Particulars	Amount	Date	Particulars	Amount
2010					
31/03	To P&L a/c	3600	31/03	By cash a/c	3,000
				By accrued interest a/c	600
		3600			3600

Accrued interest account

Date	Particulars	Amount	Date	Particulars	Amount
2010					
31/03	To interest on investments a/c	600	31/03	By balance c/d	600
		600			600

On the basis of accounts already opened in the books of the trader and the above ledger accounts, the adjusted trial balance will be prepared as follows:

Adjusted Trial Balance
As at 31st March, 2010

	Dr. Rs.	Cr. Rs.
Capital		3,00,000
Drawings	39,000	
Purchases	2,40,000	
Investments	60,000	
Interest on investments Rs. (3,000+600)		3,600
Wages Rs. (1,02,000 + 7,200)	1,09,200	
Debtors	2,10,900	
Legal Charges	12,000	
Cash in hand	3,600	
Cash at bank	33,000	
Buildings Rs. (1,80,000 – 3,600)	1,76,400	
Machinery Rs. (60,000 – 6,000)	54,000	
Bills payable		19,500
Bills receivable	21,000	
Salaries Rs. (9,000 + 1,800)	10,800	
Office expenses	9,000	
Discount	13,500	
Sales		6,60,000
Stock 01.04.2009	1,35,000	
Office rent Rs. (7,200 + 1,200)	8,400	
Bad debts	5,100	
Insurance Rs. (4,500 – 1,350)	3,150	
Gas and fuel	8,100	
Carriage	10,500	
Tools	31,500	
Factory power	15,000	
Creditors		2,40,000
Goods returned	9,600	12,000
Furniture Rs. (15,000 – 3,750)	11,250	
Outstanding expenses	10,200	
Prepaid insurance	1,350	
Depreciation	13,350	
Accrued interest	600	
Total	12,45,300	12,45,300

Closing stock Rs. 1,50,000

Illustration – 3

The following balances were ascertained from the account books of Ganesh on 31st December, 2009:

	Dr. (Rs.)	Cr. (Rs.)
Capital	–	1,25,000
Opening stock	25,000	
Discount	1,250	
Goodwill	25,000	
Provision for doubtful debts		7,500
B/R and B/P	7,500	5,000
Cash in hand	2,500	
Wages	22,500	
Purchases & Sales	2,00,000	300000
Returns	5,000	7500
Carriage Inwards	5,000	
Factory rent	3,750	
Commission		5,000
Machinery	50,000	
Furniture	15,000	
Debtors & Creditors	75,000	50,000
Insurance premium	4,500	
Salary – 11 months	11,000	
Loan to Ram on 01/07/2009 at 12% p.a. interest	25,000	
Trademark	22,000	
Total	5,00,000	5,00,000

Taking into consideration the following adjustments, prepare trading and profit and loss account for the year ending 31st December, 2009 and a balance sheet on that date:

1. Closing stock Rs. 75,000
2. Goods costing Rs. 4,500 were sent to a customer on 31st December, 2009 on sale or approval, which was recorded as sales for Rs. 5,000 by mistake.
3. Charge depreciation @10% p.a. on machinery and furniture.
4. Interest on capital 10% p.a. is payable.
5. Write off further bad debts for Rs. 1,250 and increase the provision for doubtful debts by Rs. 3,750.
6. A bill for R. 5,000 was discounted on 20th December, 2009 the due date of which is 23rd January, 2010.
7. ¼ part of the commission relates to next year.

Solution :

Trading and Profit & Loss account
For the year ending 31st December, 2009

Particulars		Amount	Particulars		Amount
To opening stock		25,000	By sales	3,00,000	
To purchases	2,00,000		Less : Goods sent on	5,000	
Less : Returns	7500	1,92,500	approval	2,95,000	
To wages		22,500	Less : Returns	5,000	2,90,000
To carriage inwards		5,000	By closing stock	75,000	
To factory Rent		3,750	Add : Cost of goods sent on		
To gross profit c/d		1,20,750	approval	4,500	79,500
		3,69,500			**3,69,500**
To discount		1,250	By gross profit b/d		1,20,750
To bad debts	1,250		By commission	5,000	
Add : New provision					
	10,000		Less : Unearned	1,250	3,750
	11,250		By interest accrued		
			(for 6 months)		1,500
Less : Old provision	7,500	3,750			
To insurance premium		4,500			
To salaries	11,000				
Add : Outstanding	1,000	12,000			
To depreciation:					
On Machinery	5,000				
On furniture	1,500	6,500			
To interest on capital		12,500			
To net profit transferred to capital a/c		85,500			
		1,26,000			1,26,000

Balance sheet as at 31st December, 2009

Liabilities		Amount	Assets		Amount
B/P		5,000	Cash in hand		2,500
Creditors		50,000	B/R		7,500
Outstanding salary		1,000	Debtors	75,000	
Unearned commission		1,250	Less : Sale on approval	5,000	
Capital	1,25,000			70,000	
Add : Interest on capital	12,500		Less : Further bad debts	1,250	
Add : Net profit	85,500	2,23,000		68,750	
			Less : Provision for bad debts	10,000	58,750
			Loan to Ram	25,000	
			Add : Interest accrued	1,500	26,500
			Stock in hand	75,000	
			Add : Stock with customer	4,500	79,500
			Trade mark		22,000
			Furniture	15,000	
			Less : Depreciation	1,500	13,500
			Machinery	50,000	
			Less: Depreciation	5,000	45,000
			Goodwill		25,000
		2,80,250			2,80,250

Note : Contingent liability for bills discounted and not yet matured is Rs. 5,000

Working notes

(i) The salary for 11 months is Rs. 11,000. Therefore, one month's salary Rs. (11,000/11) = Rs. 1,000 is outstanding.

(ii) The amount of interest for six months on loan of Rs. 25,000 given to Ram @ 12% per annum i.e. Rs. 1,500 is accrued interest.

(iii) The cost of goods sent to customers on approval basis Rs. 4,500 is added to the closing stock. In this adjustment Rs. 5,000 deducted from sales and debtors both.

(iv) The amount of New Provision for bad and doubtful debts is calculated as under :

Balance of old provision a/c	7,500
Less : Bad debts (given in adjustment)	1,250
	6,250
Add : Increase in provision a/c	3,750
Total amount for new provision for bad and doubtful debts	10,000

Illustration – 4

Below given is the trial balance of M/s Raj Brothers. Prepare trading and profit and loss account for the year ending on 31^{st} March 2010 and balance sheet as on that date.

	Dr. (Rs.)	Cr. (Rs.)
Opening stock	1,50,000	——
Purchase and sale	10,90,000	18,00,000
Manufacturing wages	80,000	——
Power fuel and electricity	120,000	——
Salaries	1,10,000	——
Printing and stationery	55,000	——
Loan to X	50,000	——
Interest on loan to X	——	3,000
Apprenticeship premium	——	45,000
Rent	40,000	——
Outstanding rent	——	6,000
Furniture (including furniture purchased on 1^{st} Oct. Rs.10,000) ——		50,000
Plant	720000	
Debtors and creditors	280000	1,30,000
B/R and B/P	60000	16000
Capital		10,00,000
Cash in hand	1,95,000	——
	30,00,000	30,00,000

Additional Information:

1. Closing stock value Rs. 3,00,000.
2. On 28th March goods worth Rs. 50,000 sold but not entered in books.
3. Goods worth Rs. 70,000 purchased and included in closing but no entry made in books.
4. Provide discount @ 2% on debtors.
5. On first April 2009 the apprenticeship premium received for three years.
6. Provide 10% depreciation on furniture.
7. Salary unpaid for the month of March 2010.

Solution:

Trading and Profit & Loss a/c
For the year ending 31st March, 2010

Particulars		Amount Dr.	Particulars		Amount Cr.
To opening stock		150000	By sales	18,00,000	
To Purchases	10,90,000		Add : Left entered	50,000	18,50,000
Add :Left ent.	70,000	11,60,000	By Closing stock		3,00,000
To Manufacturing wages		80,000			
To Power, fuel and electricity		1,20,000			
To profit and loss a/c		6,40,000			
		21,50,000			**21,50,000**
To salaries	1,10,000		By Gross profit		6,40,000
Add: Outstanding	10,000	1,20,000	By apprenticeship premium	45000	
To printing and stationery		55, 000	Less : Advance	30,000	15,000
To rent		40,000	By Interest on loan		3,000
To depreciation		4,500			
To provision for discount on debtors		6,600			
To net profit		4,31,900			
		6,58,000			6,58,000

Balance sheet as on 31st March 2010

Liabilities		Rs.	Assets		Rs.
Capital	10,00,000		Plant		7,20,000
Add : Net profit	4,31,900	14,31,900	Furniture		45,500
Outstanding rent		6,000	Closing stock		3,00,000
Outstanding salary		10,000	Debtors	3,30,000	
Premium received in advance		30,000	Less : Provision	6,600	3,23,400
Creditors		2,00,000	Bills receivable		60,000
Bill payable		16,000	Loan to X		50,000
			Cash in hand		1,95,000
Total		16,93,900	Total		16,93,900

Note : It has been assumed that the goods sold amounting to Rs. 50,000 not entered in books but while taking closing stock the effect has been given.

Working notes

Debtors	Amount	Creditors	Amount
As per trial balance Add :sales not entered	2,80,000 50,000	As per trial balance Add : Purchase not entered	1,30,000 70,000
	3,30,000		200000

11.21 Summary

In order to arrive at the correct as well as true and fair view of the profitability and assets and liabilities of the enterprise at the year end it is important to consider all expenses, incomes and provisions. By making adjustment entries the incomes and expenses are incorporated in final accounts, one has to take all care while incorporating the adjustments as the double entry system of book keeping is to be followed religiously or otherwise the balance sheet will not tally and the assets and liabilities will not show the correct picture.

In this unit the adjustments have been explained in detail with suitable illustration for incorporating such adjustments through journal entries, posting in ledger and giving impact of adjusted balances in final trial balance and profit and loss account and balance sheet.

11.22 Key Words

Adjustments: Incorporation of all expenses whether paid or not but relates to the current year, similarly incomes whether received or not is known as adjustments. The adjustments may also be for excluding the effect of expenses and incomes relating to next year.

Outstanding expenses: Expenses related to this year paid in next year are known as outstanding expenses. Such expenses are taken into account in this year by adjustments.

Prepaid expenses: Expenses related to next year paid in advance are prepaid expenses. Through adjustment they are excluded from this year's final accounts.

Accrued income: Income of this year if not received during the year known as accrued income. Such income is accounted for in current year through adjustment.

Unearned income: Income related to next year received is adjusted in a way that it is excluded from this year's income.

Depreciation: Reduction in value of assets due to use, obsolescence or change in market condition is termed as depreciation. The adjustment is made at the year end.

Deferred revenue expenditure: Expenses the benefit of which accrues over a period of time known as deferred revenue expenditure.

Contingent liability: The liability which cannot be ascertained due to uncertainty of the event to happen is termed as contingent liability. Such liability normally not taken in final accounts. However it may be given as a footnote.

11.23 Self Assessment Questions

1. What is the need of adjustment in final accounts?
2. What do you mean by unearned income? Briefly explain.
3. When is the reverse entry made related to adjustment? Give example for reverse entry for three such adjustments.

4. What treatment for outstanding power bill appearing in the trial balance is done in final accounts?

5. The debtors of a trader are Rs. 10,00,000 as on 31st March, 2010. It has been decided to provide 10% for doubtful debts and 2% for discount on debtors. Give adjustment journal entry for provision for doubtful debts and also discount on debtors.

6. Give journal entries for the following adjustment at the time of closing the books on 31st March, 2010.

   (a) In the year 2009-2010 wages for 11 months paid Rs. 2,20,000.

   (b) On 1st January, 2010 advance rent Rs. 1,20,000 for one year received and accounted for.

   (c) Vehicle expenses Rs. 80,000 shown in the trial balance. The vehicle is used 50% by the son of the owner of business for going to college.

   (d) Fixed deposit made with Dena Bank @ 10% Rs. 12,00,000 on 1st November, 2009. Interest is credited on annual basis.

7. The following balances have been drawn from the account books of Peacock on 31st December, 2009.

Particulars	Amount	Particulars	Amount
Openings stock	6,80,000	Bad debts provision	60,000
Purchases	74,00,000	Stable expenses	1,00,000
Sales	1,10,00,000	B/P	2,40,000
Selling expenses	6,00,000	Bank loan	4,00,000
Capital	50,00,000	B/R	3,60,000
Creditors	12,00,000	Carriage & Horse	1,40,000
Returns inwards	80,000	Fire insurance premium	40,000
Fuel & Power : Factory	3,20,000	Returns outwards	40,000
Salaries & wages	9,40,000	Debtors	17,40,000
Interest on bank loan	40,000	Machinery	20,00,000
Commission received	60,000	Building	28,00,000
Bad debts	40,000	Drawings	6,00,000
		Cash in hand	1,20,000

Other information :

(1) On 31st December, 2009 the stock was of Rs. 9,88,000.
(2) Credit purchases of Rs. 20,000 and credit sales of Rs. 60,000 were not recorded in account books.
(3) Prepaid fire insurance premium Rs. 10,000. Outstanding interest on bank loan Rs. 8,000 and accrued commission Rs. 20,000.
(4) The provision for bad debts on debtors is to be kept at 5%.
(5) Charge depreciation on buildings at 5% p.a. and on machinery at 10% p.a.
(6) Make provision for manager's commission at 10% of net profit, after charging such commission.

Prepare trading account, profit and loss account for the year ending 31st December, 2009 and a balance sheet as on that date.

8. The following trial balance was extracted from the books of Ratanchand & Sons on 31st March, 2010

Particulars	Amount Dr.	Amount Cr.
Drawings and capital	25,000	5,00,000
Purchases and sales	3,40,000	6,00,000
Debtors and creditors	2,00,000	1,50,000
Opening stock	1,50,000	
Returns inward	15,000	
Bank overdraft		60,000
Salaries	85,000	
Heating & Lighting – Office	10,000	
Leasehold property	4,00,000	
Commission received		10,000
Travelling expenses	15,000	
Printing & stationery	5,000	
Furniture	45,000	
Provision for doubtful debts		20,000
Wages & Freight	50,000	
Apprentice premium		25,000
Cash in hand	25,000	
Total	**1365000**	**1365000**

Prepare trading account and profit and loss account for the year ending 31st March, 2010 and a balance sheet as on that date, from the above trial balance and the following adjustments:

(1) Closing stock of Rs. 75,000

(2) Rs. 5,000 for wages is still payable.

(3) 75% of work for commission received has been completed.

(4) Charge depreciation at 5% on leasehold property and at 10% on furniture.

(5) The provision for doubtful debts is to be maintained at 6% on debtors.

(6) A new machine was purchased for Rs. 50,000 and the payment was made by cheque, the entry for this purchase has not been made in the books.

(7) Rs. 10,000 for salaries related to next year.

11.24 Reference Books

1 Financial Accounting by Jain, Khandelwal and Pareek.

2 Financial Accounting by R.L. Gupta and Gupta.

3 Financial Accounting by M.C. Shukla and T.S. Grewal.

4 Financial Accounting for Managers, By T.P. Ghosh.

5 Accounting and Finance for Non Specialists: By Peter Atrill and Eddie Meloney.

Unit - 12 Accounts of Non Profit Organizations - Receipt and Payment Account, Income and Expenditure Account

Structure of Unit:

12.0 Objectives

After completing this unit, you will be able to:

- Know about various books kept by non profit organizations.
- Analyze the need for maintaining books of accounts.
- Evaluate some peculiar items related to non profit organizations.
- Distinction between receipts and payments account and cash book.
- Distinction between income and expenditure account and receipts and payments account.
- Distinction between income and expenditure and profit & loss account.

12.1 Introduction

The non profit organizations like hospitals, clubs for welfare & entertainment, educational institutions, societies etc. differ from the trading concerns in several aspects. There organizations do not indulge in purchase or sales of goods and accepting the bills of exchanges. They are basically charitable institutions which function without any profit motive. The major sources of these organizations income usually are subscriptions from members, donations etc., and the most of their transactions are cash transactions. Hence, these organizations need not maintain as many books of a/c as the trading concerns do. The main objective of keeping records in such organizations is to meet the statutory requirement and exercise control over the utilization of funds. Therefore, there organizations usually maintain a Cash Book to record all receipts & payments.

12.2 Various Books Kept by Non Profit Organizations

Non profit Organizations are usually maintain a Cash Book to record all receipts and payments and other books like Members Register, Minutes Book, Stock Register etc., we are fully conversant with Cash Book. The other books are as follows:-

1. **Member Register**: Most charitable institutions are organized as societies which are registered with the Registrar of Societies. They are required to keep full record of their subscribers. Hence, they maintain members Register which shows their names, address, date of admission etc.

2. **Stock Register**: Every concern possesses fixed assets like furniture, office equipments, computer, printer etc. They have to keep complete record of these items in a 'Stock Register' which shows date of purchases, quantity purchased, the amount at which purchased etc.

3. **Ledger**: The Non trading concerns also maintain a ledger containing the accounts of all incomes, expenses, assets, consumption and their balances. This facilitates the preparation of final accounts at the end of accounting year.

4. **Minutes Books**: The societies function on the basis of decisions taken by the general body of members and their managing committee. They have to keep separate minutes books for recording the proceedings of the meeting of general body and that of the managing committee. Minutes Book is a permanent record of the decisions taken from time to time.

12.3 Need for Maintaining Books of Accounts

Due to the following reasons, non-profit organizations feel that they should maintain the full and complete books of accounts:

(i) They want to know about the excess of their income over expenditure or expenditure over income during an accounting period. Thus they prepare income and expenditure account for the accounting year. Such organization's membership subscription, donations and grants, etc. undertake trading activities in order to earn some profit. Such profit is also used for the furtherance of the goal of the organization.

(ii) To know about their liquid position, they maintain daily cash book. With the help of this cash book they calculate cash balance of every day, and also outstanding subscription of members. It is also helpful in collecting subscription or donations, i.e., they feel deficit of cash.

(iii) By preparing balance sheet or state of affairs, they can assess their assets and liabilities position, and at the end of an accounting period, these undertakings also get knowledge about the increase or decrease in their capital fund. This statement also provides help to take corrective steps or efforts to control continuous decrease in their capital fund. For the comparative study of capital funds and costs, it also proves an effective tool.

12.4 Some Peculiar Items Related to Non-Profit Organizations

Some peculiar items related to non-profit making organizations are given below:

(1) **Sale of an Old Asset**: When some old asset is sold, it is shown in the receipt and payment account. But, it is a capital receipt and is not shown in the income and expenditure account. Only profit or loss from the sale of such an asset is shown in the income and expenditure account.

For Example: A club has furniture of Rs. 600. Out of which some furniture costing Rs. 200 is sold for Rs. 160.

Here (i) Rs. 160 is shown in receipt and payment account on receipt side.

(ii) Loss on sale of furniture amounting to Rs. 200 - 160 = Rs. 40, will be shown in income and expenditure account and on expenditure side.

(iii) In the balance sheet, the furniture will be shown at Rs. 600 - 200 = Rs. 400.

(2) **Sale of Old Newspapers and Periodicals**: It is a revenue receipt. Any amount realised from the sale of old newspapers and periodicals should be treated as income and credited to the income and expenditure account.

(3) **Sale of Old Sports Materials**: The amount realised from the sale of old sports material is treated as revenue receipt, so it is shown in both of the accounts - receipt and payment account as receipt and in the income and expenditure account as income.

(4) **Legacies**: It is the amount which one gets on account of a will. It is generally treated as capital receipt and shown in receipt and payment account and balance sheet. However, if the amount is small it can be treated as income and shown in the income and expenditure account.

(5) **Honorarium**: Payment to non-employees for their services is called honorarium. It is a revenue payment so it is debited to income and expenditure account. In the case of receipts and payments account, it will be shown on the payment side.

(6) **Life Membership Fees**: Certain organizations charge fees for making persons as life members. Such members have to pay the fee only once in their lifetime and they continue to enjoy the benefits of the organization throughout their life.

The amount received as life membership fees can be treated in the accounts of an institution by any of the following methods.

(i) Received amount may be taken as a capital receipt and shown in receipts and payments account and in the balance sheet as liabilities under the head life membership fee.

(ii) Received amount may be credited to the life membership fee account. The amount computed (according to the average life of a member) may annually be transferred from this account to the income and expenditure account as an income.

(iii) Received amount of life membership fee may be credited to life membership fee account. The normal annual subscriptions may be transferred from the life membership fee account to the income and expenditure account and the balance may be carried forward till it is exhausted. In the case of death of a member, the balance, if any, in the life membership fee account may be transferred to the capital fund account.

Note: Generally, the first method is advised to adopt in the absence of any specific instructions in an examination problem.

(7) **Capital Fund**: Excess of assets over liabilities is called capital fund or general fund. It is similar to capital account of commercial organisation.

(8) **Endowment Fund**: According to Kohler, it is a "fund usually of a non-profit institution, arising from request or gift, the income of which is devoted to a specified purpose". It contains assets donated by the donor, with stipulation that income earned by these assets but not the gift itself can be used for principal activities of the organization. it is of capital nature and shown on the liability side of the balance sheet.

(9) **Government Grant**: Schools, colleges, public hospitals, etc. depend upon government grant for their activities. It is treated as revenue receipt, which is credited to income and expenditure account and debited to receipts and payments account as a receipt.

(10) **Entrance Fees**: Fees paid by new members at the time of joining the organization is called Entrance Fees. It is clearly of non-recurring nature because it is paid only once by members. Hence, it should be treated as capital receipt and be shown in the balance sheet as a part of the general fund and in the receipts and payments account as receipt. Some accountants differ on this view and believe that every year new members join and pay entrance fees, so it is a regular income and should be treated as revenue receipt. In examination problem, entrance fees should always be regarded according to the instructions given in the question.

(11) **Donations**: Donations are the amounts which are given to the non-trading concerns as gifts by members of the society. Hence, it is a major source of income. It is treated as capital receipt or revenue receipt depending upon the nature of donation. Donation can be of two types:

(i) **General Donations**: When the donor does not lay down any specific condition for using the amount of donation, then it is known as general donation. it is a receipt, so it is shown in receipts and payments account. But, when this amount is small then it is treated as revenue receipt and is shown on the credit side of income and expenditure account. When the amount is substantial, it is treated as capital receipt and is shown on the liabilities side of the balance sheet under appropriate head. Quantity-wise, the amount is big or small, it totally depends on the nature of an institution.

(ii) **Specific Donations**: Specific donations are given for some specific purposes such as donation for building construction or library or pavillion etc. The amount received as specific donation is treated as capital receipt and is shown on the liabilities side of the balance sheet under appropriate head.

(12) **Subscription**: Subscription is the main source of income for the non-profit making concerns. the amount received as subscription for a particular year is shown in the income and expenditure account of that year. However, the total subscription received during a particular year may not necessarily be for that year. Some part of it may belong to the previous year or the year to come. Amount of subscription for the current year is calculated as follows:

Statement Showing Calculation of Amount of Subscription
Relating to Income and Expenditure Account

Particulars		Amount (Rs.)
	Total subscription received during the year (Previous + Current + Future period)	-
Add:	(i) Accrued subscription of the current year	-
	(ii) Unearned subscription received in advance during previous year	-
		-
Less:	(i) Accrued subscription or subscription received in advance during previous year	-
	(ii) Unearned subscription of the current year	-
Amount of subscription to be recorded on the Credit Side of Income and Expenditure A/c		-

The amount of accrued/outstanding subscription at the end of the year will also be shown on the assets side of closing balance sheet and the accrued/outstanding subscription at the beginning of the year will be shown on the assets side of the opening balance sheet. the amount of unearned subscription at the end of the year will also be shown on the liablities side of closing balance sheet and the unearned subscription at the beginning of the year will be shown on the liabilities side of the opening balance sheet.

Generally three types of Statements are prepared by Non-Profit Organizations:

1. Receipt and Payment Account
2. Income and Expenditure Account and
3. Balance Sheet.

12.5 Receipt and Payment Account

Receipts and Payments Account is a summary of all cash and bank transactions and is prepared with the help of cash book.

In the words of **William Pickles**, “Receipt and Payment Account is nothing more than a summary of the Cash Book (cash and bank transaction) over a certain period, analysed or classified under suitable headings. It is the form of account most commonly adopted by the treasurers of societies, clubs, associations, etc. when preparing the results of the year’s working.”

Thus, according to the above points, Receipt and Payment A/c can be prepared in the following format:

Receipt and Payment Account
for the year ending …..

Receipts	Amount (Rs.)	Payment	Amount (Rs.)
To Balance b/d (opening)		By Bank Overdraft (if any)	
Cash in Hand		By Revenue Payments :	
Cash at Bank		(i) Printing and Stationery	
To Capital Receipts :		(ii) Sundry Expenses	
(i) Legacies		(iii) Electricity Expenses	
(ii) Specific Donation		(iv) Rent and Taxes	
(iii) Life Membership Fees		(v) Entertainment Expenses	
(iv) Entrance Fees		(vi) Secretary’s Honorarium	
(v) Sales of Investments		(vii) Audit Fees	
(vi) Sale of Assets		(viii) Telephone and Telegrams	
(vii) Endowment Fund Receipt		(ix) Charity	
To Revenue Receipts :		(x) Repaires and Renewals	
(i) Subscription		(xi) Newspapers and Periodicals	
(ii) General Donation		(xii) Insurance	
(iii) Sale of Tickets		(xiii) Salaries	
(iv) Sale of Newspapers		By Capital Payments :	
(v) Interest on General Investments		(i) Purchase of Investments	
(vi) Dividend on General Investment		(ii) Purchase of Furniture	
(vii) Government Grant		(iii) Purchase of Books	
(viii) Miscellaneous		(iv) Purchase of Sports Equipments	
		(v) Buildings Constructed	
		By Balance c/d (closing)	
		Cash in Hand	
		Cash at Bank	

The main difference between the cash book and receipt and payment account is that in a cash book all cash transactions are recorded date wise in detail while in receipts and payments account, transactions are recorded at the end of a certain period. The main features of the receipts and payments account are as follows:

(i) It commences with the opening balance of cash in hand or at bank. This is entered naturally on the debit side.

(ii) All cash transactions, like cash receipts or cash payments, will be reflected in this account. Outstanding expenses and incomes earned but not received are not included in this account.

(iii) In this account, all cash payments whether capital or revenue, will be shown on the credit side.

(iv) All cash receipts, both of capital and revenue nature will be recorded on the debit side of this account.

(v) All the capital or revenue, receipts and payments will be shown in this account, whether they relate to current year or next year or previous year.

(vi) The difference between the two sides represents cash in hand or balance at bank, if the debit side exceeds credit. If, however, the credit side exceeds the debit side, it represents the net bank overdraft.

Limitations:

The receipt and payment account has the following limitations:

(i) It does not show the income and expenditure of the current year.

(ii) On the basis of receipts and payments account, balance sheet cannot be prepared.

(iii) It does not show the surplus or deficit during a particular period.

(iv) It does not take into consideration outstanding expenses, prepaid expenses, accrued incomes and incomes received in advance.

12.6 Distinction between Receipt and Payment Account and Cash Book

Receipt and Payment Account prepared with the help of cash book is a summary of cash book not the cash book. Thus, it can be said that cash book and summary of cash book differ on some points with each other, which are given below:

Basic of Difference	Receipt and Payment Account	Cash Book
1. Period	Receipt and payment account is prepared at the end of accounting period.	Cash book is prepared daily or weekly.
2.Date-wise Recording	Receipt and payment are not shown in chronological order in this account.	In cash book, all cash transactions are recorded date-wise.
3. Dependence	It is prepared with the help of cash book.	It is prepared with the help of cash transactions taken place in the concern.
4. Nature	It is a memorandum account.	It is the principal book of accounts.
5. Ledger Folio	There is no ledger folio in this account.	In it, ledger folio column is maintained by cashier.
6. Sides	It is divided in receipts and payments sides.	It maintains debit and credit sides.
7. Applicability	It is prepared by non-trading concerns and professional people.	It is prepared by each and every commercial organisation.

12.7 Income and Expenditure Account

Non-profit making concerns do not carry any trading and hence, do not earn a profit. They do not prepare a trading and profit and loss account. But, these concerns want to know that whether their current incomes are sufficient to meet current expenses and what is their financial position at the end of the accounting period. Thus, they prepare an account, namely, income and expenditure account which shows all incomes on the right hand and all revenue expenses on the left hand side. The comparison of the two sides show whether or not current expenses are being met out of current income. The rules for preparing this account are same as for trading and profit and loss account.

Some important features of Income & Expenditure Account

(i) It is a nominal account. It records all expenses and losses on the debit side and all gains and incomes on the credit side of the account.

(ii) It includes incomes and expenses of current year on accrual basis irrespective of flow of cash. For this purpose, adjustments relating to outstanding expenses, prepaid expenses, accrued income and received in advance income, etc., are made in this account.

(iii) Excess of credit side over debit side is termed as surplus and is called as excess of income over expenditure. However, if debit side exceeds the credit side, there is a deficit and is termed as excess of expenditure over income.

(iv) It is necessary to provide for depreciation and reserve for bad and doubtful debts in this account.

(v) Capital receipts and capital expenditures are not recorded in this account.

Proforma of Income and Expenditure Account

Expenditure	Amount (Rs.)	Income	Amount (Rs.)
To All Revenue Expenses paid	…..	By All Revenue Income received	…..
Add: All Revenue expenses payable (relating to current year)	…...	Add: All Revenue Income receivable (relating to current year)	…..
Less: Revenue expenses paid in advance (for the future)	……	Less: Income received in advance (for the future)	……
Less: Revenue expenses paid for the past.	……	Less: Income received for the past	……
By Excess of Income over Expenditure (Profit)	……	By Excess of Expenditure over Income (Loss)	…..
	……		……

Example -1

From the following information prepare Receipt & Payment Account of Jai Club, for the year ending 31st March, 2009.

Cash in hand (1.4.2008) Rs. 40,250; subscriptions received Rs. 21,500 including Rs. 400 for last year and Rs. 600 for 2009-2010, admission fee Rs. 400, upkeep of grounds Rs. 2,200, salaries Rs. 6,000, drama expenses Rs. 4,500, life membership fee Rs. 1,000, donations received (on 01.11.2008) Rs. 5,000, subscription for tournament-received (01.11.2008) Rs. 15,000, municipal taxes Rs. 400, charity Rs. 3,500, newspapers Rs. 1,500, sale of old newspapers Rs. 450, sale of used sports material Rs. 500, 12% investments purchased on (1.11.2008) Rs. 20,000, tournament expenses Rs. 12,000, sale of old furniture costing Rs. 1,000 for Rs. 600, purchase of sports materials Rs. 7,000, amount drawn from bank Rs. 1,00,000, proceeds of drama tickets Rs. 9,500, deposited into Bank Rs. 1,28,600, interest on investments received Rs. 500, printing and stationery Rs. 1,000, furniture Rs. 2,500, books Rs. 1,000, subscriptions received for annual dinner Rs. 34,500.

Solution :

Receipt & Payment Account of Jai Club

For the Year Ending March 31, 2009

Receipts	Rs.	Payments	Rs.
To Balance b/d	40,250	By Upkeep of Grounds	2,200
To Subscriptions : Rs.		By Salaries	6,000
2007-08 400		By Drama Expenses	4,500
2008-09 20500		By Newspapers	1,500
2009-10 600	21,500	By Books	1,000
To Admission fee	400	By Municipal Taxes	400
To Life membership fee	1,000	By Charity	3,500
To Donations (1.11.2008)	5,000	By 12% Investments (1.11.2008)	20,000
To Subscription for	15,000	By Tournament Exps.	12,000
Tournament (1.11.2008)		By Sports Material	7,000
To Sale of Old Newspapers	450	By Deposited into Bank	1,28,600
To Sale of Used Sports Material	500	By Printing & Stationery	1,000
To Sale of Drama Tickets	9,500	By Furniture	2,500
To Sale of Old Furniture	600	By Balance c/d (Cash Balance)	39,000
To Drawn from Bank	1,00,000		
To Interest on Investments	500		
To Subscription for Annual	34,500		
Dinner			
	2,29,200		**2,29,200**

Example-2

From the following information, prepare Income & Expenditure Account of Siddharth Institute of Modern Management for the year ended 31st December 2009.

Fees collected Rs. 5,80,000 including Rs. 80,000 on account of last year. Fees outstanding for the year 2007 Rs. 10,000. Salary paid Rs. 2,28,000 including Rs. 3,000 for 2008. Salary outstanding at the end of 2009 Rs. 1,000. Entertainment expenses Rs. 3,000, Tournament expenses Rs. 12,000, Meeting expenses Rs. 18,000, Travelling expenses Rs. 6,000, Purchase of Books and Periodicals Rs. 29,000 including Rs. 20,000 for the books only. Rent Rs. 10,000, postage and telegraph Rs. 15,000, printing and stationery Rs. 8,000 were paid. It includes Rs. 4,000 paid for stationery in advance. Donations received Rs. 20,000.

Solution:

Income & Expenditure Account of Siddharth Institute of Modern Management

For the Year Ending December 31, 2009

Dr. **Cr.**

Particulars		Rs.	Particulars		Rs.
To Salary	228000		By Fees	580000	
Less: Last year's	3000		Less: Last year's	80000	
	225000			500000	
Add: Outstanding	1000	2,26,000	Add: Outstanding at		
			the end	10000	5,10,000
To Entertainment Exps.		3,000	By Donations		20,000
To Tournament Exps.		12,000			
To Meeting Exps.		18,000			
To Travelling Exp.		6,000			
To Books & Periodicals	29000				
Less: Books being					
Capital expenditure	20000	9,000			
To Rent		10,000			
To Postage & Telegrams		15,000			
To Printing & Stationery	8000				
Less : Prepaid	4000	4,000			
To Excess of Income over					
Expenditure		2,27,000			
		5,30,000			**5,30,000**

12.8 Difference between Income & Expenditure Account and Receipts & Payments Account

The main points of difference between the two accounts are as under:

S. No.	Basis of Distinction	Income & Expenditure Account	Receipts & Payments Account
1.	Cash or Bank Balance	It has no opening balance.	It starts with opening cash and bank balance.
2.	Sales	Left hand side of this account shows expenses and right hand side shows income.	Left hand side of this account shows receipts and right hand side shows payments.

3.	Credit Transactions	Credit purchase and sale are recorded in this account.	In this account, credit purchase and credit sale are not recorded.
4.	Cash Income and Expenditure	All revenue income and expenses whether cash or credit of the current year are shown in this account.	All those cash incomes, and expenses which are received or paid the current year, whether related to the current year or last year, are shown in this account.
5.	Nature of Account	It is a nominal account.	It is a real account.
6.	Necessity	It is necessary to prepare this account for finding out surplus or deficits.	There is no necessity of preparing this account.
7.	Capital Income or Expenses	Capital Income and Expenditures are not shown in this account.	Capital income or expenses paid or received in cash are shown in this account.
8.	Adjustments	Adjustments relating to incomes and expenses are made.	No adjustments are required to be made at the end of the year.
9.	System of Accounting	It is prepared on the basis of mercantile system.	It is based on cash system of accounting.
10.	Balance Sheet	To show capital items, the balance sheet must be prepared along with this account.	It is not necessary to prepare balance sheet along with this account.

12.9 Distinction between Income & Expenditure Account and Profit and Loss Account

The income and expenditure account serves the same purpose for a non-profit making concern as the profit and loss account for a profit making concern. Still there is a lot of distinction points between income and expenditure and profit and loss account and the important points are given as under:

S. No.	Basis of Distinction	Income & Expenditure Account	Profit & Loss Account
1.	Purpose	It is prepared to know the excess of income over expenditure.	It is prepared to ascertain the net profit or net loss of the business.
2.	Closing Balance	The balancing figure of this account shows surplus or deficit.	Closing balance of this account reveals the net profit or net loss.

3.	Basis	It is prepared on the basis of receipts and payments account and other information.	This account is prepared on the basis of trial balance and other information.
4.	Who Prepares ?	This account is specially maintained by non-profit organizations.	All trading concerns prepare this account.
5.	Sides	In this account, left hand side shows expenses and right hand side shows income.	It is divided in debit and credit sides.

12.10 Preparation of Income & Expenditure Account from Receipt and Payment Account

The following factors should be kept in mind while preparing Income & Expenditure Account from Receipt & Payment Account -

1. Opening and closing cash and bank balances are not shown in Income & Expenditure Account. These are shown in the Balance Sheet.

2. Capital receipts and Capital expenditure shown in Receipts & Payments Account are not shown in Income & Expenditure account. These are shown in the Balance Sheet.

3. Revenue receipts related to current year which were shown on the debit side of Receipts & Payments account are shown on the credit side of Income & Expenditure Account.

4. Revenue expenses related to current year which were shown on the credit side of Receipts & Payments Account are shown on the debit side of Income & Expenditure Account.

5. Income related to current year which has not been received up to the end of year will be credited in Income & Expenditure Account.

6. Expenses of current year which have not been paid up to the end of year will be debited in Income & Expenditure Account.

7. Adjustments in the items of receipts and payments given in Receipts & Payments Account will be made regarding the information given in other information relating to last year's payments or receipts and next year's payments or receipts while preparing Income & Expenditure account.

8. The following items do not appear in Receipts & Payments Account but these will be shown in Income & Expenditure Account -

(i) Depreciation on fixed assets will be shown on the debit side.
(ii) Loss on sale of fixed assets will be shown on the debit side.
(iii) Profit on sale of fixed assets will be shown on the credit side.

9. After showing all the above items the balance of Income & Expenditure Account will be taken. If credit side exceeds debit side it will be surplus or vice versa deficit, which will be adjusted in Capital Fund shown in the Balance Sheet.

From the above description it is clear that while preparing Income & Expenditure account adjustment of some items is essential. Description of these items is as follows:

(i) **Outstanding Expenses of Current Year**:- It will be added to relevant expenditure in Income & Expenditure Account.

(ii) **Prepaid Expenses in Current Year**:- It will be deducted from the relevant expenditure given in Receipts and Payments Account and balance will be shown in Income & Expenditure Account.

(iii) **Expenses of Current year paid in previous year**:- It will be added to expenses of this year in Income & Expenditure Account.

(iv) **Payment of Outstanding Expenses of last year**:- It will be deducted from current year's expenses and the remaining amount will be shown in Income & Expenditure Account.

(v) **Accrued Income of Current year**: It will be added to relevant income received in current year.

(vi) **Next year's Income received in current year**: It will be deducted from relevant income shown in Receipts & Payments Account and the balance will be shown in Income & Expenditure Account.

(vii) **Income of current year received in previous year**: It will be added to current year's income to be shown in Income & Expenditure Account.

(viii) **Income of Previous year received in current year**: It will be deducted from the relevant income received during the year and balance will be shown in Income & Expenditure Account.

12.11 Preparation of Balance Sheet

It is necessary to prepare a Balance Sheet of a concern to know its financial position. Balance Sheet of a non-trading concern is prepared in the same manner as is prepared by trading concern. The following factors are kept in mind while preparing the Balance Sheet of a non-trading concern -

(1) **Capital Fund**: Non-trading concerns are not made with capital but they made capital by savings. This is called Capital fund of these concerns. Excess of assets over liabilities of such concern is known as capital fund. Surplus from Income & Expenditure Account is added and deficit is deducted from Capital Fund in the Balance sheet. If the opening balance of Capital Fund is not given in the question then to find out it operating Balance Sheet is prepared. It is calculated as follows -

Opening Capital Fund = Total Assets in the beginning - Total liabilities in the beginning.
Closing Capital Fund = Opening Capital Fund + Surplus - Deficit.

(2) Outstanding Expenses and Unearned Income is shown on the liabilites side of the Balance Sheet.

(3) Prepaid Expenses and Accrued Incomes are shown on the assets side of the Balance Sheet.

(4) Capital items of Receipts & Payments Accounts are shown in the Balance Sheet.

Performa of Balance Sheet is as follows -

Proforma of Balance Sheet

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capital or General Fund	……..	Fixed Assets	……..
(Opening Balance)		Current Assets	……..
Add : Receipts capitalized	……..	Cash at Bank	……..
Add: Current year's excess of	……..	Cash in Hand	……..
Income over expenditure		Income receivable	……..
		(subscriptions in arrears, interest	
Less: Current year's excess of	……..	accrued, etc.)	
Expenditure over Income		Expenses prepaid	……..
Other Special Funds	……..		
Sundry Creditors	……..		
Outstanding Expenses	……..		
Income received in advance	……..		
(Subscriptions received in			
advance)			
	……..		……..

12.12 Summary

Some organizations are formed not to earn profit but to render service to its members and to the public. Such organizations include clubs, libraries, schools, hospitals, charitable institutions and literary societies etc. These non-profit seeking entities exist with a primary motive of providing service. Such as, a club provides games & sports and a hospital renders medical services, a literary society promotes arts and culture. Though main sources of income as the main aim of these organisations are not to earn profit, they do not prepare Trading and Profit & Loss Account.

Non-profit organizations also prepare their financial statements more or less on the same lines of profit seeking organizations. At the end of accounting period these organisations mainly prepare the following accounts:

(1) Receipt and Payment Account;
(2) The Income and Expenditure Account, and
(3) The Balance Sheet.

12.13 Key Words

1. General Donations - General donation is that amount of donation which is not received for a specific purpose.

2. Specific Donation- Specific donation is such amount of donation which is received for a specific purpose e.g. donation for construction of a building of sports council.

3. Entrance Fee - Non trading concerns charge entrance fee from members at the time of their initial entry in the concern.

4. Endowment fund - Fund usually of non profit institutions, arising from request or gift, the income of which is devoted to a specified purpose.

12.14 Self Assessment Questions

Q.1 What is Receipt and Payment account?

Q.2 State four features of Receipt and Payment account.

Q.3 Give two differences between Income & Expenditure Account and Receipt & Payment Account.

Q.4 Give two differences between Receipt & Payment Account & Cash Book.

Q.5 Give two differences between Income & Expenditure & Profit & Loss Account.

12.15 Reference Books

1. Fundamentals of Business Accounting - Oswal, Modi, Jain, Saini & Jain, CBH Publications, Jaipur.

2. Book-Keeping and Accountancy - Jain, Khandelwal, Pareek, Ajmera Book Company, Jaipur.

3. Fundamentals of Accounting - Agarwal, Shah,Goyal, Sharma - Malik & Co., Jaipur.

4. Advance Accounts - Shukla & Grawal, Sultan Chand & Sons, New Delhi.

Unit - 13 Consignment Accounts

Structure of Unit:

13.0 Objectives

After completing this unit, you will be able to:

- Understand special terminology related with consignment transactions;
- Appreciate difference between sale and consignment;
- Understand accounting procedure related with consignments.

13.1 Introduction

In the modern era due to the expanding size of the market, manufacturers and wholesalers use many methods to make available their products to the consumers living in every corner of the world, Consignment is one of them. A shipment of goods by a manufacturer or wholesaler to an agent to be sold by him on commission basis is termed as consignment. The risk for consignment of goods is to be borne by consignor.

13.2 Terminology

Consignment: Consignment means dispatch of goods by a businessman to his agent for selling on commission basis on his behalf and risk.

Consignor: The person who sends the goods to the agent to be sold by him on commission basis is called the consignor.

Consignee: The person to whom the goods are sent for sale is called the consignee.

Proforma Invoice: Goods sent to consignee are not sales but are to be sold by him on the risk of the consignor, so instead of an invoice a proforma invoice is prepared which contains full details of goods on consignment.

Activity A:

List any two agencies, with their details, which you have come across in your near by.

13.3 Account Sales

Account sales: It is a statement prepared by the consignee and sent to the consignor after a certain period or after the sale of goods. In this statement particular of goods sold, gross sale proceeds, expenses incurred by the consignee, commission, net sale proceeds and amount of advance are shown. Finally it shows the balance with consignee which is sent to the consignor by cheque or draft. The proforma of account sales is as follows:

Account sale

	Rs.	Rs.
Gross sale proceeds		xx
Less: Expenses incurred:	xx	
Insurance	xx	
Freight & Carriage	xx	
Storage	xx	
Landing charges	xx	
Commission	xx	
Del Credre commission	xx	
Overriding commission	xx	xx
		xx
Less: Advance remitted		xx
Balance due/ Draft enclosed		xx
E. & O.E.		

13.4 Advance on Consignment

Advance by consignee: Consignee is not liable to make any payment to consignor for goods sent on consignment unless the goods are sold, so he often asks for some advance payment. Advance payment may be in cash, cheque or bills of exchange. Advance provides some amount for principals business and also creates agent confidence. This advance is credited in consignee account. This advance is adjusted against the sale proceeds later on.

13.5 Commission

Commission: Commission is the remuneration of the consignee received as a consideration of sale of goods of consignor. It is given as a predetermined percentage of sales and thus more the sales, more is the commission earned by the consignee. There are three types of commission:

1. General commission: It is paid on total sales as a percentage. Sometimes it is given on invoice price.

2. Del credere commission: It is given on credit sales. In order to increase the normal commission the consignee may get extra commission for collecting the debts. If Del credere commission is given to agent, than the loss of bad debt will be borne by agent and if it is not given than the loss of bad debt will have to be borne by consignor.

3..Over riding commission: If the goods can be sold above a certain rate. This is calculated on the excess of sale proceeds over the expected sales as per agreement.

Activity B:

What is your opinion, that a agent should be given which type of commission, (as shown in para 13.5) all the three or any two or one.

13.6 Difference between Sales and Consignment

S. No.	Sale	Consignment
1	Once goods are sold, it is not returned back unless defective.	Unsold goods are always returned by agent to consignor.
2	Purchaser gets ownership of goods after sale	Agent does not get ownership of goods. He is a possessor of it.
3	On credit sales the relationship is of Debtor and creditor	In consignment relationship is of agent and principal.

13.7 Accounting for Consignment

In the books of consignor:

1. On goods being sent on consignment:
   Consignment Account Dr.
   To Goods sent on consignment A/c
   (Being goods sent on consignment)
2. Receipt of advance in cash/ cheque:
   Cash/ Bank/ B/R Dr.
   To Consignee's A/c
   (Cash /Cheque/ B/R received in advance)
3. Discounting of B/R:
   Bank Account Dr.
   Discount Account Dr.
   To B/R A/c
   (Being B/R discounted with bank)
4. Consignee expenses:
   Consignment account Dr.
   To Cash /Bank A/c
   (Being expenses incurred by consignor)
5. On receipt of account sales by sales amount:
   Consignee's Account Dr.
   To Consignment account
   (Being the amount of sale proceeds as per account sales)
6. Agents expenses on consignment:
   Consignment Account Dr.
   To Consignee's Account
   (Expenses incurred by consignee)
7. Agents commission due:
   Consignment account Dr.
   To Consignee's Account
   (Being commission to consignee)
8. Receipt of balance amount on consignment:
   Cash account Dr.
   B/R account Dr.
   To Consignee's A/c
   (Being receipts of balance from consignee)

9. If Del credere commission is not given than entry for bad debt written off or allowable discount will be:

Consignment account Dr.

To Consignee's Account

(Discount/Bad debts written off)

10. Accounting for stock with agent:

Stock with agent account Dr.

To Consignment account

(Being value of unsold stock with the agent)

11. Profit on consignment:

Consignment account Dr.

To Profit and loss account

(Being profit on consignment transferred)

12. Loss on consignment:

Profit & Loss account Dr.

To Consignment A/c

(Being loss on consignment transferred)

13. Closing entry for the goods sent on consignment account:

Goods sent on consignment account Dr.

To Trading Account

14. Normal loss:

No entry

15. Abnormal loss:

Abnormal loss account Dr.

To Consignment account

(Being goods lost by or due to…..)

16. Claim accepted by or received from insurance company against abnormal loss:

Insurance Co. Account Dr.

Profit and loss account Dr.

To Abnormal loss account

(Being claim accepted by insurance company)

Consignment Account

Particulars	Amount	Particulars	Amount
To Goods sent on consignment To Cash (Expenses paid by consignor) To Agent (Expense paid by agent) To Agent (Commission) To Profit & Loss a/c (Profit)		By Agent (Sales by agent) By Abnormal loss By Unsold stock	

Agent Account

Particulars	Amount	Particulars	Amount
To Consignment (Sales)		By Cash/Bank/B/R (Advance) By Consignment (Exp) By Consignment (Commission) By Cash/Bank/B/R (B.F)	

Abnormal loss Account

Particulars	Amount	Particulars	Amount
To Consignment		By Insurance Company By Profit & Loss account	

Goods sent on consignment Account

Particulars	Amount	Particulars	Amount
To Trading Account/ Purchase a/c		By Consignment	

In the books of agent

1. On receipt of goods on consignment:

   No entry

2. Advance to principal:

   Consignor's account Dr.
   To Bank/B/P A/c
   (Being advance given to consignor)

3. Agents expenses on consignment:

   Consignor's account Dr.
   To Bank A/c
   (Being expenses incurred by consignee)

4. Sales of goods on consignment:
   Bank Account (Cash sales) Dr.
   Debtors Account (Credit sales) Dr.
   To Consignor's Account
   (Being sale of goods received on consignment)

5. Commission on sales:

   Consignor's account Dr.
   To Commission A/c
   (Being commission on sale proceeds)

6. Final payment on consignment:

   Consignor's account Dr.
   To bank A/c
   To B/P A/c
   (Being payment of the balance of amount to consignor)

7. Unsold stock:

   No entry

8. For bad debts on account of credit sales when del credere commission is not given:

Bank A/c /Cash A/c	Dr.
Consignor's Account	Dr.
To Debtors A/c	

(Being bad debt written off)

9. For bad debt on account of credit sales when del credere commission is given:

Cash /Bank A/c	Dr.
Commission A/c	Dr.
To Debtors A/c	

(Being amount of debtors charged to commission a/c)

Principal's Account (Consignor's account)

Particulars	Amount	Particulars	Amount
To Cash/Bank/B/P To Cash (Exp) To Commission To Bank (B/f)		By Cash (cash sales) By Debtor (Credit sales)	

Activity C:

What are the problems or can arise to make entries in the books of consignor

13.8 Valuation of Unsold Stock with Agent

It is often seen that total goods sent on consignment is not always sold by the consignee up to the end of the year while preparing final accounts. In order to bring such unsold stock in the balance sheet of the consignor, it is necessary to calculate the value of such unsold stock. This unsold stock is valued at cost price or market price whichever is less. While calculating the cost of stock, cost plus proportionate expenses of non recurring expenses incurred by consignor and consignee are considered. Non recurring expenses are the expenses which are incurred to bring the goods to the godown of the consignee. Examples of such expenses are freight, carriage on purchase, packing and forwarding charges, export and import duties or customs duties, dock charges, insurance of goods in transit, octroi duty, loading and unloading charges, etc. But expenses incurred after the goods reach the godown of the consignee are not taken into consideration for the valuation of stock on consignment. Examples of such expenses are – warehousing, establishment expenses, carriage on sales, godown rent, insurance of godown or warehouse, advertisement, salesman's expenses. Expenses incurred by the consignee for bringing the goods up to the godown are non recurring expenses. The calculation of cost of unsold goods can also be calculated as follows:

Total cost of goods sent on consignment	xx
Add: Expense incurred by Consignor	xx
Add: Direct expenses incurred by Consignee	xx
Total cost	xx

Cost of unsold stock $\dfrac{\text{Total cost x Unsold Units}}{\text{Total No. of Units}}$

For solving practical problems student can use the following table for unsold stock :

$\dfrac{\text{Goods sent on consignment}}{\text{Total Units sent - Normal loss}}$ x Unsold Unit xx

Add: $\dfrac{\text{All expenses of Consignor x Unsold Unit}}{\text{Total Units sent - Normal loss}}$ xx

Add: $\dfrac{\text{Direct expenses of agent x Unsold Unit}}{\text{Total Units sent - Normal loss – Abnormal loss (Transit)}}$ xx

Value of unsold stock xx

13.9 Practical Questions Related to Consignment

Illustration 1

Mr. Pralay of Udaipur consigned 600 cases of Tea at Rs. 1000 per case to Mr. Mahesh of Jaipur paying freight Rs. 4000 and insurance Rs. 2,000. Mr. Mahesh sold 500 cases at Rs. 1,250 per case on credit and 50 case at Rs. 1,100 per case for cash. Mr. Mahesh spent for unloading and freight Rs. 3,000 and Godown rent Rs. 1,000. Mr. Mahesh remitted the amount due to Mr. Pralay after deducting his commission at 5%; 1 % (Overriding) and 2 % del credere. Mr. Mahesh found that one customer to whom credit of 30 days was allowed paid only Rs. 9,000 out of the total amount due from him Rs. 10,000 in full settlement of account. Other customers paid the amount on the due dates.

You are required to pass journal entries in the books of the consignor and consignee. Also make ledger accounts in the books of both the parties.

Answer:

Journal of Mr. Pralay

Date	Particulars	L.F.	Debit Amount	Credit Amount
	Consignment A/c Dr. To Goods sent on consignment A/c (600 cases of tea sent at Rs. 1,000 per case)		6,00,000	6,00,000
	Consignment A/c Dr. To Bank A/c (Being expenses incurred on consignment)		6,000	6,000
	Consignment A/c Dr. To Mahesh A/c (Expenses paid by Mahesh on consignment)		4,000	4,000
	Mahesh A/c Dr. To Consignment A/c (550 cases were sold by Mahesh)		6,80,000	6,80,000
	Consignment A/c Dr. To Mahesh A/c (Commission on sales charged by Mahesh)		54,400	54,400
	Stock on consignment A/c Dr. To Consignment A/c (Cost of unsold stock left with Mahesh)		50,750	50,750
	Consignment A/c Dr. To Profit and Loss A/c (Profit on consignment transferred)		66,350	66,350
	Bank A/c Dr. To Mahesh A/c (Amount received from Mahesh in settlement of account)		6,21,600	6,21,600

	Goods sent on consignment A/c Dr. To Trading A/c (Balance transferred)		6,00,000	6,00,000

Journal of Mr. Mahesh (Consignee)

Date	Particulars	L.F.	Debit Amount	Credit Amount
	Pralay A/c Dr. To Bank A/c (Expenses incurred on consignment)		4,000	4,000
	Consignor's Debtors A/c Dr. Bank A/c Dr. To Pralay A/c (Goods sold on consignment)		6,25,000 55,000	6,80,000
	Pralay Dr. To Commission A/c (Commission earned on consignment)		54,400	54,400
	Bank A/c Dr. Bad Debt A/c Dr. To Consignor's Debtors A/c (Amount collected from consignor's debtors and Rs. 1,000 uncollectable treated as bad debts)		6,24,000 1,000	6,25,000
	Commission A/c Dr. To Bad Debt A/c (Bad debts set off against del credere commission)		1,000	1,000
	Pralay Dr. To Bank A/c (Cash remitted to consignor)		6,21,600	6,21,600
	Commission A/c Dr. To Profit and Loss A/c (Balance of commission transferred)		53,400	53,400

Ledger of Mr. Pralay (Consignor)

Consignment Account

Particulars		Amount	Particulars	Amount
To Goods sent on consignment A/c		6,00,000	By Agent (Sales by agent)	6,80,000
To Cash A/c				
Freight	4,000			
Insurance	2,000	6,000		
To Mahesh				
Unloading & Freight	3,000			
Godown Rent	1,000	4,000	By Stock on Consignment	50,750
To Mahesh (Commission)		54,400		
To Profit & Loss a/c (Profit)		66,350		
		7,30,750		**7,30,750**

Mahesh Account

Particular	Amount	Particular		Amount
To consignment (Sales) A/c	6,80,000	By Consignment A/c :		
		Freight	3,000	
		Godown Rent	1,000	4,000
		By Consignment (Commission) A/c		54,400
		By Bank A/c (B.F)		6,21,600
	6,80,000			**6,80,000**

Goods sent on consignment Account

Particulars	Amount	Particulars	Amount
To Trading A/c	6,00,000	By Consignment A/c	6,00,000
	6,00,000		**6,00,000**

Ledger of Mr. Mahesh

Pralay Account

Particulars	Amount	Particulars		Amount
To Bank A/c(Expenses)	4,000	By Bank A/c (Cash Sales)	55,000	
To Commission A/c	54,400	By Consignor's Debtors A/c	6,25,000	
To Bank A/c (B.f.)	6,21,600			
	6,80,000			**6,80,000**

Consignor's Debtors Account

Particulars	Amount	Particulars	Amount
To Pralay	6,25,000	By Bank A/c	6,24,000
		By Bad Debt A/c	1,000
	6,25,000		**6,25,000**

Bad Debt Account

Particulars	Amount	Particulars	Amount
To Consignor's Debtors A/c	1,000	By Commission A/c	1,000
	1,000		**1,000**

Commission Account

Particulars	Amount	Particulars	Amount
To Bad Debt A/c	1,000	By Pralay	54,400
To Profit & Loss A/c	53,400		
	54,400		**54,400**

Working Notes:

1. **Valuation of stock**

Price paid for 600 cases @ Rs. 1000 per case	6,00,000
Add: All expenses of Consignor	6,000
Add : Unloading and Freight paid by Agent	3,000
Total cost of 600 cases	6,09,000

Cost of 50 cases = $\frac{\text{Rs. } 6,09,000 \times 50}{600}$ = 50,750

Illustration 2

From the details of consignment given below you are required to calculate : (a) Abnormal loss; (b) Amount of Abnormal loss to be charged to Profit & loss account; and (c) Stock at the end:

(i) 20,000 litres of Kerosene at Rs. 2 per litre

(ii) Freight Rs. 8,000 and Insurance Rs. 2,000 paid by Consignor.

(iii) Consignee has spent Rs. 2,500 on unloading and Rs.2,000 on selling. He is also entitled to 5% commission on sales.

(iv) 2,000 litres of Kerosene was lost in transit due to breakage of jars. The insurance company admitted the claim for Rs. 4,000.

(v) In addition to this the consignee is allowed a normal loss of 500 litres.

(vi) Sales – 16,000 litres at Rs. 4 per litre.

Answer :

Cost of 20,000 litres at Rs. 2 per litre	40,000
Add: Expenses incurred by the consignor	10,000
Cost of 20,000 litres	50,000

(a) Abnormal loss $= \dfrac{50{,}000 \times 2{,}000}{20{,}000} =$ 5,000

Less: Amount of claim admitted by Insurance co. 4,000

(b) Net loss to be charged to profit & loss account 1,000

(c) Value of stock at the end

$$\frac{\text{Goods sent on consignment x Unsold Unit}}{\text{Total Units sent - Normal loss}}$$

$$\frac{40{,}000 \times 1500}{20{,}000 - 500} \qquad 3{,}076$$

$$\frac{\text{All expenses of Consignor x Unsold Unit}}{\text{Total Units sent - Normal loss}}$$

$$\frac{10{,}000 \times 1500}{20{,}000 - 500} \qquad 769$$

$$\frac{\text{Direct expenses of agent x Unsold Unit}}{\text{Total Units sent - Normal loss – Abnormal loss(Transit)}}$$

$$\frac{2{,}500 \times 1500}{20{,}000 - 500 - 2{,}000} \qquad 214$$

Value of unsold stock 4,059

Illustration 3

2,000 Shirts were consigned by R & Co. of Udaipur to S & Co. of Agra at a cost of Rs. 150 each. R & Co. paid freight Rs. 20,000 and insurance Rs. 3,000.

During the transit 200 shirts were totally damaged by fire. S & Co. took the delivery of the remaining shirts and paid Rs. 28,800 as custom duty.

S & Co. had sent a draft to R & Co. for Rs. 1,00,000 as advance payment. 1,600 shirts were sold by him at Rs. 200 each. Expenses incurred by S & Co. on godown rent and advertisement, etc. amounted to Rs. 4,000. He is entitled to a commission of 5 %.

One of the customers to whom the goods were sold on credit could not pay the cost of 10 shirts.

Prepare the consignment account and the account of M/s S & Co. in the books of R & Co.. S & co. entitled his account immediately. Nothing was recovered from the insurers for the damaged goods.

Answer:

Consignment Account

Particulars		Amount	Particulars	Amount
To Goods sent on consignment A/c		3,00,000	By Agent (Sales by agent)	3,20,000
To Cash A/c			By Abnormal loss A/c	32,300
Freight	20,000			
Insurance	3,000	23,000		
To S & Co.			By Stock on Consignment	35,500
Customs duty	28,000			
Godown Rent	4,000			
Bad debt	2,000	34,000		
To S & Co.				
(Commission 5% of 3,20,000)		16,000		
To Profit & Loss a/c (Profit)		14,800		
		3,87,800		**3,87,800**

S & Co. Account

Particulars	Amount	Particulars	Amount
To Consignment(Sales)	3,20,000	By Consignment A/c	34,000
		By Consignment A/c	16,000
		By Bank Advance	1,00,000
		By Bank (B.F.)	1,70,000
	3,20,000		**3,20,000**

Working Note:

1. Calculation of loss in transit

200 shirts @ Rs. 150 each	30,000
Add : Freight and insurance Rs. $\frac{23,000 \times 200}{2,000}$	2,300
	32,300

As nothing has been recovered from Insurance co. this entire loss has been debited to profit and loss account.

2. Calculation of Unsold stock

Closing stock = 2,000 shirts – 200 – 1600
= 200 shirts

200 shirts @ Rs. 150 each	30,000
Add: Freight and Insurance $\frac{23,000 \times 200}{2,000}$	2,300
Add: Customs duty 28,800 x 200/1800	3,200
	35,500

3. No del credere commission has been given so the bad debt loss will be borne by the consignor.

Illustration: 4

V Traders of Delhi purchased 10000 pieces of sarees @ Rs. 100 per saree. Out of these sarees, 6000 were sent on consignment to Vastra Traders of Udaipur at a selling price of Rs. 120 per saree. The consignor paid Rs. 3,000 for packing and freight.

Vastra Traders sold 5000 sarees at Rs. 125 per saree and incurred Rs. 1,000 for selling expenses and remitted Rs. 50,000 to Delhi on account. They are entitled to a commission of 5% on total sales plus a further 20% commission on any surplus price realized over Rs. 120 per saree.

3000 sarees were sold at Delhi at Rs. 110 per saree.

Owing to fall in market price, the value of the stock of sarees in hand is to be reduced by 10%. Prepare the consignment account and trading account in the books of V traders and their account in the books of the agent M/s Vastra traders.

Answer:

In the books of V Traders

Consignment Account

Particulars	Amount	Particulars	Amount
To Goods sent on consignment	7,20,000	By Vastra Traders (Sales by	
To Cash (Freight)	3,000	agent) (5,000 x 125)	6,25,000
To Vastra Traders		By Goods sent on consignment	
Selling Exp. 1,000	1,000	(Loading – 6,000 x 20)	1,20,000
To Vastra Traders (Commission)	36,250	By Unsold stock	1,20,500
To Stock Reserve	30,000		
To Profit & Loss a/c (Profit)	14,800		
	8,65,500		**8,65,500**

Trading Account for the year ended

Particulars	Amount	Particulars	Amount
To Purchases	10,00,000	By Goods sent on consignment	6,00,000
To Gross profit	95,250	By Sales (3,000 x 110)	3,30,000
(1,00,000 – 10,000)		By Closing Stock	
		By Profit on consignment	75,250
	10,95,250		**10,95,250**

In the books of Vastra Trader

V Traders Account

Particulars	Amount	Particulars	Amount
To Bank A/c	1,000	By Bank A/c	6,25,000
To Commission A/c	36,250		
To Bank A/c	5,00,000		
To Balance C/d	87,750		
	6,25,000		**6,25,000**

Working notes:

Calculation of closing stock with the consignee (1,000 sarees)				
V Traders basic invoice price of consignment				7,20,000
Add: Expenses incurred by consignor				3,000
	Total		7,23,000	
Value of Closing Stock =	$\frac{7,23,000 \times 1,000}{6,000}$		=	1,20,500

Value of closing stock based on net realisable value

Basic cost of closing stock (1,000 x 100)		1,00,000
Less: Fall in market value 10%		10,000
		90,000
Add: Consignor's proportionate expenses	$\frac{3,000 \times 1,000}{6,000}$	500
		90,500
Loading in value of closing stock (i) – (ii)	1,20,500 – 90,500	= 30,000
Calculation of commission		
5% on total sales, viz. 6,25,000 x 5/100		31,250
20% on surplus over invoice price (Rs. 6,25,000 – 6,00,000)		5,000
	Total	36,250

13.10 Summary

Consignments facilitate the distribution of goods to various places through agents, who are paid commission in return. Consignment transactions thus are different from routine sale transactions and need different procedure of accounting. In this unit you have learnt various terms related with consignment transactions and accounting treatment thereof. Illustrations must have helped you in developing a grip over accounting in variety of situations.

13.11 Self Assessment Questions

Very short answer type questions:

1. Give two examples of normal loss.
2. Who prepares the account sale?
3. An agent is not given del credere commission. Pass journal entry in the books of consignor for bad debts of Rs. 3,000 relating to a debtors of the consignment.
4. Differentiate between consignment and sales in relation to risk of goods.
5. Why is del credere commission paid?
6. What remuneration is paid to consignee by principal for bearing the risk of bad debt?

Short answer type questions:

1. What is del credere commission?
2. What is overriding commission?
3. What is account sale? Give its proforma.
4. Explain the treatment of abnormal loss in consignment account.
5. Differentiate between the consignment and sales.

Essay type questions:

1. What do you understand by consignment of goods? Explain the difference between consignment and sale.

2. Write notes on the following:

   (a) Normal loss (b) Abnormal loss

Practical questions

Q 1 On 1st September, 2007 goods of the value of Rs 66,000 were consigned by Shri Karan Jaksha Samddar of Mumbai to his agent Shri Mahadev Chakraberty of Kolkata at proforma invoice price of 20% profit on cost. Shri Samddar paid insurance and other forwarding charges on consignment amounting to Rs 2,500. Shri Chakraberty was allowed Rs 1,500 per annum being the establishment cost; 5% commission on gross sales and 3% del creder commission. He was also allowed 10% of the net profit as extra commission after charging such commission. Shri Chakraberty made an expense of Rs 509 as landing charges.

Three-fourth of the goods were sold at 33 1/3 % profit on cost, half of which were credit sales. 1/3 of the balance of the goods was destroyed by fire and clam lodged for Rs 7,000 was settled at a discount of 10% .

Stock was valued at proforma invoice price. Show the consignment account and the stock lost on consignment as on 31st Dec.2007 in the books of Shri Karan Samddar.

Q 2 Ashok Goel of Delhi sends a consignment of goods to Ravi Goenka of Ranchi and charges performa invoice price so as to show a profit of 25% on cost. The agent receives commission @ 7% plus 3% del Credere on all sales made by him.

Stock of goods with the agent at the beginning of the year 20 cases at performa invoice invoice, price Rs 5,000. During the year ended 31st December,2007 Ashok Goel had the following transactions with Ravi Goenka:

(a) Performa invoice price of 100 cases of goods consigned to Ravi Goenka Rs 25,000.

(b) Freight and Insurance on the consignment paid by Ashok Goel Rs 1,000.

(c) Advance received from Ravi Goenka Rs 10,000.

(d) Sales made by Ravi Goenka:

   (i) 50 case on cash - Rs 12,500.
   (ii) 40 cases on credit - Rs 10,800.

(e) Selling expenses made by the agent Rs 1,200 and discount allowed to agent Rs 500.

(f) 15 cases of goods were damaged by the railway for which Ravi Goenka received Rs 1,400.

(g) Out of the goods sold on credit Rs 1,500 was irrecoverable and considered bad by the agent.

(h) Ravi Goenka remitted the balance due by him thought a bank draft.

Show consignment account in Ashok Goel's Ledger and necessary Ledger a/c in Ravi Goenka's books.

Q 3 The Radio Corporation of Kolkata sent on 1st April, 2007 100 sets on consignment basis to good music Ltd. Delhi the cost of each set was Rs 250. the consignors paid Rs 600 as freight and Rs 300 as Insurance. They drew upon the consignees for Rs 10,000 at 3 months. The consignees accepted the draft and on 4th April it was discounted at 6% The consignees paid Rs 50 per as cartage, Rs 250 as godown rent and Rs 1,000 as salary to salesmen, on 30th September, 2007 they sent an account sale to the Radio corporation including that 70 sets had been sold for Rs. 22,000. The account sale was accompanied by the necessary bank draft after deducting commission at 6% plus 1 ½ del credere commission. Assuming the Radio Corporation closes its books on 30th September, give the Ledger accounts to record the above transactions in its books.

Q 4 On July,1,2001, A had consigned to B, goods costing Rs.50,000 on which A paid freight and insurance amounting to Rs.2,500. On September 30,2001. B's first Account sales was received showing that he had affected sales for Rs. 32,000 of which Rs.30,000 had been received in cash. His expenses to date were Rs 2,000 and commission 5% on gross sales. On receipt of the account sales, the Consignment Account was balanced off, stock being valued at Rs. 28,000 . A Further Account sales was received on December 31,2001 showing that the balance of the goods had been sold for Rs. 36,000 and the cash collected . Debtors had paid their dues less discount of 3%. The expenses of B were Rs.2,500 . The rate of his commission was the same as before. Write up the Consignment Account and B's Account up to December 31, in the book of A assuming that B remitted the balance due with each account sales.

Q 5 The Elkay oil Mills, Mumbai consigned 10,000 Kgs. of castor oil to Dass of Calcutta on 1st April 2001. the cost of the oil was Rs.2 Per Kg. the elkay oil mills paid Rs.5,000 as freight and insurance. During transit, 250 Kgs. was accidentally destroyed for which the insurer paid directly to the consignor, Rs.450 in full settlement of the claim.

Dass took the delivery of the consignment on the 10th April and immediately accepted a bill drawn on him by the Elkay oil Mill for Rs.10,000 for 3 months. On 30th June, 2001 Dass reported that 7,500 Kgs. were sold @ Rs. 3 per Kg. the expenses being:

On godown rent Rs.200,

On advertisement Rs.1,000;and

On salesman salaries Rs.2,000.

Dass is entitled to a commission of 3% plus 1 ½% on del Credere.

Dass reported a loss of 100 kgs. of castor oil due to leakage. Assuming that Dass paid the amount by bank draft, show the account in the books of both the parties. The Elkay Oil Mill closes books on 30th June.

Q 6 Punjab Cycle Co. of Ludhiana consigned 150 bicycles to Kanpur Cycle Co. of Kanpur costing Rs.2,250 each, invoiced at Rs.3,000 each. The consignor paid freight Rs.15,000 and insurance in transit Rs.2,250. During transit, 15 bicycles were totally damaged.

Kanpur Cycle Co. took delivery of the remaining bicycles and paid Rs.2,295 for octroi duty. Kanpur Cycle Co. sent a bank draft to Punjab Cycle Co. for Rs.75,000 as advance and later on sent an account sales showing that 120 bicycles had been sold @ Rs.3,300 each. Expenses incurred by Kanpur Cycle Co. on godown rent were Rs.3,000. Kanpur Cycle Co. is entitled to a commission of 5% on invoice price and 25% on any surplus of sale price over invoice price. Insurance claim was settled at Rs.21,000.

Prepare the consignment account, consignee's account and accidental loss account in the books of the consignor.

Q 7 On 1st January, 2009, a flour mill consigned wheat flour to Sat Pal, invoiced at Rs.4,00,000. The mill cost of the wheat flour was Rs.3,70,000. The consignor paid Rs.5,000 as freight and Rs.10,000 as loading and unloading charges.

On 31st March, 2009, an account sale was received from the consignee showing that 90% of the goods had been sold for Rs.4,10,000 with selling expenses of Rs.2,000. The consignee enclosed a cheque for the proceeds less expenses and commission of 1% on gross sales. Show necessary ledger accounts in the books of the consignor.

Q 8 On 1st January, 2009, Mayank of Mumbai consigned to Dinesh of Delhi goods for sale. Dinesh is entitled to a commission of 4% on invoice price and 20% on any surplus price realised. Goods costing Rs.12,000 were consigned to Dinesh at invoice price of Rs.14,400. Expenses of consignment amounted to Rs.1,000. On 31st March, 2009, an account sales was received from Dinesh showing that he had effected sales for Rs.12,000 in respect of 3/4th of the goods supplied to him. His actual out of pocket expenses amounted to Rs.600. Dinesh accepted a bill drawn on him by Mayank for Rs.5,000 and remitted the balance due from him in cash.

Prepare consignment account and the account of Dinesh in the books of Mayank.

13.12 Reference Books

1. Financial Accounting Rao, Heda, Gupta
2. Financial Accounting Jain, Khandelwal, Pareek
3. Financial Accounting Grewal's, accouting

Unit - 14 Sectional and Self Balancing System

Structure of Unit:

14.0 Objectives

After completing this unit you will be able to:

- Understand the concept of self and sectional balancing system;
- Know the accounting process under self balancing system;
- Learn about inter account transactions;
- Distinguish between self and sectional balancing system;
- Enhance your practical knowledge about the topic.

14.1 Introduction of Sectional Balancing System

To keep one ledger is sufficient for small business units. But for big business units where number of accounts are huge, it is difficult to keep all the accounts in one ledger. Due to big size of ledger, it is very inconvenient to keep the ledger in a proper way and to find out the balance of particular account. In such a case more than one ledger are maintained. It is called multiple ledger system. Generally for accounts relating to debtors and creditors, separate ledger are maintained and for remaining accounts another ledger is kept. Thus three ledger are prepared. Debtors ledger (sales ledger), Creditors ledger (purchase ledger) and main ledger (general ledger). Some institute prepare a separate ledger called private ledger for private transaction where number of debtors and creditors is very large, more than one debtors and creditor ledger are kept according to alphabetically or geographically.

Sectional Balancing System

Trial balance will not agree if there is more than one ledger, General ledger will be imbalanced due to absence of account of debtors and creditors. In order to make the general ledger complete, total debtors account and total creditors account are opened (some opens these as Memorandum account), so that trial balance can be prepared. Multiple ledger system in which General ledger is made complete, is called sectional balancing system.

14.2 Performa

Generally three ledgers are kept in this system:-

1. **General ledger (main ledger)**: All the accounts are kept excluding individual accounts of debtors

and creditors. Total debtors account and total creditors account are opened with the total of the items of debtors and creditors.

2. Sales ledger (debtors ledger) :- Individual accounts of debtors relating to credit sales of goods.

3. Purchases Ledger (Creditors ledger):- Individual accounts of creditors relating to credit purchases of goods.

The Performa for preparing Total Debtors account and Total Creditors account in General ledger are as follows.

In General Ledger

Total Debtors A/c

Dr. **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance b/d To Credit Sales To B/R Dishonoured To Interest charged To Cash refund to customer To Creditor (B/R endorsed dishonoured) To Balance c/d			By Balance b/d By Cash received By Bank By Discount allowed By Sales return By Bad debts By B/R received By Transfer By Balance c/d	

In General Ledger

Total Creditors A/c

Dr. **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance b/d To Cash Paid To Bank To Discount Received To Purchase return To B/P To Transfer To Balance c/d			By Balance b/d By Credit purchase By B/P Dishonoured By Debtors (B/R endorsed dishonoured) By interest	

There is contra balance of some debtors and creditors –when debtors pay in advance or creditors are paid in excess.

Total debtors account and Total creditors account are prepared with the help of the total of subsidiary books. Total debtors account and total creditors account are prepared similar to the individual account as prepared in sales ledger and purchases ledger.

For example:- Goods sold to Abid for Rs. 1000. Total debtors account will be debited by total sales just like Abid's account in sales ledger is debited by sales.

Cash purchases, cash sales, bad debts recovered, provision for bad and doubtful debts, provision for discount and reserve are the items which do not affect individual account to be opened in sales and purchases ledger, so these items will not be included in total debtors account and total creditors account.

Activity A:
List any two institutions operating sectional system, with their details, which you have come across.

14.3 Practical Questions

Illustration 1

The ledger of Abid showed that the balance of debtors and creditors as on 1.4.2009 was as follows:

Total Debtors Rs. 27000 and total creditors Rs. 32000.

The following transaction took place during the year ended 31st march, 2010.

	Rs.		Rs.
Credit sales	55000	Cash paid to creditors	18000
Cash purchases	17000	Cash received from debtors	22000
Cash sales	22000	Bad debts	2500
Credit purchases	33000	Bad debts recovered	700
B/R received	30000	B/R old cancelled & renewed	17000
B/P accepted	27000	Interest on bills receivable renewed	1000
Discount allowed	2000	Provision for discount on creditors	1000
Discount Received	1500	Bills receivable received now honoured	3500
B/R Dishonoured	4500		

Prepare the total debtors account and total creditors account in the General ledger of Abid on 31st march 2010.

Solution:

In General Ledger

Total Debtors A/c

Dr. **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
1.4.09	To Balance b/d	27000	31.3.10	By Cash received	22000
31.3.10	To Credit Sales	55000		By Discount allowed	2000
	To B/R Dishonoured	4500		By B/R	1800
	To Interest charged	1000		(renewed with interest)	
	To B/R (cancelled)	17000		By Bad debts	2500
				By B/R received	30000
			31.3.10	By Balance c/d	30000
		104500			**104500**

In General Ledger

Total Creditors A/c

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
31.3.10	To Cash Paid	18000	1.4.09	By Balance b/d	32000
	To Discount Received	1500	31.3.10	By Credit purchase	33000
	To B/P	27000			
	To Balance c/d	16500			
		65000			**65000**

Note :- Cash purchases, cash sales, bad debts recovered, provision for bad and doubtful debts, provision for discount and reserve are the items which do not affect individual account to be opened in sales and purchases ledger, so these items will not be included in total debtors account and total creditors account.

14.4 Self Balancing System

Self Balancing System

General ledger is balanced by preparing 'Total Debtors A/c' and Total creditor A/c' under sectional balancing system. But sales ledger (debtors ledger) and purchase ledger (creditors ledger) remain imbalanced owing to the double entry system not being complete. In order to make these ledger self balanced, adjustment / control accounts are opened in these ledgers. The system in which sales ledger (debtor's ledger) and creditors ledger (purchases ledger) are made balanced together with general ledger is called self balancing system.

> **Activity B:**
> List any two organizations, operating self balancing system, with their details, which you have come across.

14.5 Accounting under Self Balancing System

Following control or adjustment accounts are opened in every ledger, in addition to the accounts generally opened, under self balancing system :-

1. In General ledger:-

(a) Sales ledger adjustment account or debtors ledger adjustment account, it is similar to Total debtors account,

(b) Purchase ledger adjustment account or creditors ledger adjustment account, it is similar to total creditors account.

2. **In Sales ledger or Debtors ledger**:- General ledger adjustment account or main ledger adjustment account, it is reverse to total debtors account.

3. **In Purchases ledger or Creditors ledger**:- General ledger adjustment account or main ledger adjustment account, it is reverse to total creditors account.

The following procedure is followed to implement this system:-

(a) All the transactions should be entered in concerned ledger just like it is done in a ledger system. For example – goods sold to Rock, Rock's account in sales ledger will be Dr. and sales account in general ledger will be Cr.

(b) To identify those transactions of which the entry of one part is made in general ledger and the entry of another part is made in other ledger, these transactions relate to debtors and creditors.

(c) Entries are made under self balancing system with the total of these transaction at the end of the year. These are as follows:-

(i) All the transaction, which are Dr. to Debtors a/c –

For example – Credit sales, dishonour of cheques and bill etc.

Sales ledger adjustment a/c (In general ledger) Dr.

To General ledger adjustment a/c (In sales ledger)

(ii) All the transaction, which are Cr. to Debtors a/c –

For example – Cash received from debtors, B/R, Discount allowed:-

General ledger adjustment a/c (In sales ledger) Dr.
To Sales ledger adjustment a/c (In general ledger)

(iii) All the transaction, which are Cr. to Creditors a/c –
For example – Credit purchase, B/P, dishonour of B/P etc.
General ledger adjustment a/c (In purchases ledger) Dr.
To purchases ledger adjustment a/c (In general ledger)

(iv) All the transaction, which are Dr. to Creditors a/c –
For example – Payment to creditors, B/P, Discount Received :-
Purchases ledger adjustment a/c (In general ledger) Dr.
To General ledger adjustment a/c (In purchase ledger)

Illustration 2

From example No.1 prepare sales ledger adjustment a/c and purchase ledger adjustment a/c in general ledger and general ledger adjustment a/c in sales ledger and in purchase ledger.

Solution:

In General Ledger

Sales Ledger Adjustment A/c

Dr. Cr.

Date	Particulars		Amount	Date	Particulars		Amount
1.4.09	To Balance b/d		27000		By General ledger		
31.3.10	To General ledger				adjustment a/c		
	adjustment a/c				Cash received	22000	
	Credit Sales	55000			Discount allowed	2000	
	B/R Dishonoured	4500			B/R (renewed		
	Interest charged	1000			with interest)	18000	
	B/R (cancelled)	17000	77500		Bad debts	2500	
					B/R received	30000	74500
					By Balance c/d		30000
			104500				104500

Purchase ledger adjustment A/c

Dr. Cr.

Date	Particulars		Amount	Date	Particulars		Amount
31.3.10	To General ledger adj. a/c			1.4.09	By Balance b/d		32000
	Cash Paid	18000		31.3.10	By General ledger adj. a/c		
	Discount	1500			purchase	33000	33000
	B/P	27000	46500				
	To Balance c/d		16500				
			65000				**65000**

In sales Ledger

General ledger adjustment account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
31.3.10	To Sales ledger adjustment a/c Cash rec. 22000 Discount 2000 B/R 18000 (renewed with interest) Bad debts 2500 B/R received 30000	74500	1.4.09 31.3.10	By Balance b/d By Sales ledger adjustment a/c Credit Sales 55000 B/R Dishonoured 4500 Interest charged 1000 B/R (cancelled) 17000	27000 77500
31.3.10	To Balance c/d	30000			
		104500			**104500**

In Purchase ledger

General ledger adjustment account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1.4.09	To Balance b/d	32000	31.3.10	By purchase ledger adj. a/c Cash Paid 18000 Discount 1500 B/P 27000	46500
31.3.10	To Purchases ledger adj. a/c purchase 33000	33000	31.3.10	By Balance c/d	16500
		65000			**65000**

Contra balance

Usually the balance of debtors account in sales ledger are Dr. balances and the balance of creditors in purchase ledger are credit balance, but in some cases the customers balance may be in credit and likewise bought ledger may have some Dr. balance then these are called contra balance. Debtors account may show credit balance because of advance payment or over payment or goods returned by them after full settlement. Alike wise due to excess payment to creditors or due to goods returned after settlement, some of the creditors account may show Dr. balance.

These contra balance are entered on the reverse side. In case of opening contra balance of debtors it is entered on Cr. side of total debtors a/c 'By balance b/d' and that of closing contra balance is entered in Dr. side 'To balance b/d opening contra balance of creditors is entered in Dr. side of total creditors account and that of such closing balance in cr. Side as by balance c/d.

Illustration 3

Prepare the sales ledger control account and purchase ledger control account from the following particulars:

	Sales ledger Rs.	Purchase ledger Rs.
Dr. balance as on 1.4.09	150000	1000
Cr. Balance as on 1.4.09	200	125000
Credit sales and purchase	400000	380000
Cheque received and paid	450000	350000

	Sales ledger Rs.	Purchase ledger Rs.
Advance paid to creditor	-	20000
B/R received and B/P accepted	50000	50000
Discount allowed and received	5000	3000
Return	10000	5000
Transfer from purchase to sales ledger	10000	10000
Bad debts	2000	-
Reserve for discount	10000	5000
B/R and B/P dishonoured	5000	5000
Dr. balance as on 31.3.10	?	1000
Cr. Balance as on 31.3.10	2200	?

Solution :

In General Ledger

Sales ledger control A/c

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1.4.09	To Balance b/d	150000	1.4.09	By Balance b/d	200
31.3.10	To General ledger control a/c		31.3.10	By General ledger control a/c	
	Credit Sales 400000			Bank 450000	
	B/R Dishonoured 5000	405000		Discount 5000	
31.3.10	To Balance c/d	2200		Return 10000	
				B/R 50000	
				Bad debts 2000	
				Transfer 10000	527000
			31.310	By Balance c/d	30000
		557200			**557200**

Purchase ledger control account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1.4.09	To Balance b/d	1000	1.4.09	By Balance b/d	1000
31.3.10	To General ledger control a/c		31.3.10	By General ledger control a/c	
	Bank 350000			Purchase 380000	
	Discount 3000			B/P dishonoured 5000	385000
	B/P 50000		31.3.10	By balance c/d	125000
	Advance 20000				
	Returns 5000				
	Transfer 10000	438000			
31.3.10	To Balance c/d	72000			
		511000			**511000**

Note:- Reserve for discount does not affect the total debtors a/c and total creditors a/c.

14.6 Inter Account Transfer

Some accounts may be in sales ledger as well as in purchases ledger too. For example- A purchased goods from B for Rs. 1000 on credit. A will be Dr. in Books of B's Sales ledger. After sometime, A sold goods to B for Rs. 600 on credit, then A will be Cr. in books of B's Purchases ledger. A will have to pay to B Rs. 400 net for final settlement. Hence A's account in sales ledger will show Dr. Balance and that of in purchases ledger it will show 'Cr.' Balance. B in his books will close the account of A by transferring A's Cr. balance in purchase ledger into sales ledger. Due to this transfer three accounts will be affected – sales ledger adjustment account, purchases ledger adjustment account and general ledger adjustment account.

Following three entries will be passed in this regard-

		Dr.	Cr.
1.	'A' (in the purchase ledger) Dr.	600	
	To 'A' (in the sales ledger)		600
	(the balance in A's account in purchase ledger)		
2.	Purchases ledger adjustment a/c Dr.	600	
	(in the general ledger)		
	To General ledger adjustment a/c		600
	(in the purchase ledger)		
	(adjustment account pertaining to the purchase ledger corrected pursuant to the transfer)		
3.	General ledger adjustment a/c Dr.	600	
	(in sales ledger)		
	To sales ledger adjustment a/c		600
	(in the general ledger)		
	(adjustment account pertaining to the sales ledger corrected pursuant to the transfer)		

If section balancing system is adopted then entries will be as follows:-

		Dr.	Cr.
1.	A (in purchase ledger) Dr.	600	
	To A (in sales ledger)		600
	(the balance in A's account in purchase ledger transferred to his account in the sales ledger)		
2	Total creditor a/c Dr.	600	
	To Total Debtors a/c		600
	(Entry consequent on transfer of A's balance in the purchase ledger to his account in the sales ledger)		

Illustration 4

Journalise the following aspect under:-

(a) Sectional balancing system and

(b) Self balancing system in the books of Green and Company.

(1) B is a debtor of business for Rs. 40000 and a creditor for Rs. 30000.

(2) C and D are debtors of the business for Rs. 20000 and Rs. 6000 respectively and Z is a creditor for Rs. 4000. Z owes D Rs. 2000 and it is mutually agreed to cancel their debts in the books of Green and Company.

Solution:

Journal

(a) Under sectional balancing system

1.	(i)	B Dr. (in purchases ledger)	30000	
		To B (in sales ledger)		30000
		(credit balance of B in purchase ledger transfer to his account in sales ledger)		
	(ii)	Total creditors a/c Dr. (in general ledger)	30000	
		To Total debtors a/c (in general ledger)		30000
		(account pertaining to the ledger corrected pursuant to the transfer)		
2.	(i)	Z's a/c Dr. (in purchases ledger)	2000	
		To D's a/c (in sales ledger)		2000
		(Z owes from D cancelled in the books)		
	(ii)	Total creditors a/c Dr. (in general ledger)	2000	
		To Total Debtors a/c (in general ledger)		2000
		(account pertaining to the ledger corrected pursuant to the transfer)		

(b) Under self balancing system

1.	(i)	B's a/c Dr. (in purchases ledger)	30000	
		To B's a/c (in sales ledger)		30000
		(credit balance of B in purchase ledger transfer to his account in sales ledger)		
	(ii)	Purchases ledger adjustment a/c Dr. (in G.L)	30000	
		To General ledger Adj. a/c (in P.L)		30000
		(adjustment account pertaining to the ledger corrected pursuant to the transfer)		
	(iii)	General ledger adj. a/c Dr. (in sales ledger)	30000	
		To Sales ledger adj. a/c (in general ledger)		30000
		(adjustment account pertaining to the ledger corrected pursuant to the transfer)		
2.	(i)	Z Dr. (in purchase ledger)	2000	
		To D (in sales ledger)		2000
		(Z owes from D cancelled in the books)		
	(ii)	Purchases ledger adjustment a/c Dr. (in G.L)	2000	
		To General ledger adj. a/c (in P.L)		2000
		(adjustment account pertaining to the ledger corrected pursuant to the transfer)		
	(iii)	General ledger adj. a/c Dr. (in sales ledger)	2000	
		To Sales ledger adj. a/c (in general ledger)		2000
		(adjustment account pertaining to the ledger corrected pursuant to the transfer)		

14.7 Rectification of Errors

In sectional balancing system: - If an error affects the accounts of parties (debtors and creditors) but not their total, in such a situation the accounts of concerned parties will be adjusted to rectify the error. If an error affects the total of debtors and creditors then additional entries are passed through total debtors and total creditors. it will happen when total of subsidiary books is wrong.

In self balancing system:- Posting in ledger is made through journal or subsidiary books. Total debtors account and total creditors account are affected by the total of those subsidiary books which are rectified by an entry made through adjustment account. if an error occurs due to posting made from journal or subsidiary books the entry for rectification will be made through general system, there will not be any effect on adjustment account of such error.

Procedure for rectification:-

1. If an error does not affect the total of the subsidiary books adjustment account will not be affected by error. No entry to rectify such error, rectification entry will be made as per general principle. No entry will be passed to rectify adjustment accounts.

2. If the total of subsidiary books are under cast this means the concerned side of concerned adjustment account has also been made with the short account. To rectify this error the same entry should be made as while preparing adjustment account by total of subsidiary books was carried over in adjustment account.

For Example:- Sales books is under cast by Rs. 500 it means that the entry in sales ledger adjustment account has also been made with short amount.

The journal entry for rectifying this error will be –

Sales ledger adjustment a/c Dr. (in general ledger)	500	
To General ledger adjustment a/c (in sales ledger)		500
(total of sales book under cast by Rs. 500 now rectified)		

3. If the total of subsidiary books is over cast, this means that concerned side of adjustment account has also been increased. Reverse entry by the amount of this error should be made for rectification.

For Example:- Total Sales books is over cast by Rs. 400. On account of this error the balance of debtors ledger adjustment account (Dr. side) is in excess by Rs. 400.

The journal entry for rectifying this error will be -

General ledger adjustment a/c (in sales ledger) Dr.	400	
To Sales ledger adjustment a/c (in general ledger)		400
(total of sales book over cast by Rs. 400 now rectified)		

Illustration 5:- Prepare journal entries in the books of Mohan Ltd. from the following information.

(a) Sales book was found under cast by Rs. 2000.

(b) Discount allowed to Mangal Rs. 100 correctly, entered in the cash book was not posted to his account.

(c) Credit balance of Rs. 600 in Ravi's account in purchase ledger was to be transferred to his account in sales ledger.

Give journal entries both under the self balancing system and the sectional balancing system.

Solution:

Journal

Under self balancing system :

(a)	Sales ledger adjustment a/c (in G.L.) Dr.	2000	
	To General ledger adjustment a/c (in sales ledger)		2000
	(total of sales book under cast by Rs. 2000 posted to adj. account, now rectified)		
(b)	No adjustment entry, credit Mangal with Rs. 100 in sales ledger.		
(c) (i)	Purchase ledger adjustment a/c (in general ledger) Dr.	600	
	To General ledger adjustment a/c (in purchase ledger)		600
	(for correction of the adjustment account)		

(ii) General ledger adjustment a/c (in sales ledger) Dr. 600
To sales ledger adjustment a/c (in general ledger) 600
(for correction of adjustment account)

Under sectional balancing system;

(a) Total debtors a/c Dr. 2000
To Sales a/c 2000
(for rectification of the consequence of the under casting the sales book)

(b) Credit Mangal with Rs. 100 (in sales ledger)

(c) (i) Ravi's a/c (in purchase ledger) Dr. 600
To Ravi's a/c (in sales ledger) 600

(for the transfer of ravi's credit balance Rs. 600 in the P.L. to his account in the S.L.)

(ii) Total creditors a/c Dr. 600
To Total Debtors a/c 600
(adjustment of total account because of the transfer from the creditors ledger to the debtors ledger)

Illustration 6. Rakesh & Co. maintain ledger on self balancing system on 30th sept. 2009 the general ledger discloses the following balances:-

Sales ledger adjustment account Rs.1,76,175
Purchases ledger adjustment account Rs.77,650

On scrutiny of ledger the following errors were detected:-

(i) An overcast of bills receivable book by Rs. 2500.
(ii) An under cast of sales book by Rs. 1000
(iii) Goods return by Som Rs. 500 have been entered in sales return book but not posted to Som's account in sales ledger.
(iv) Cash discount allowed to customer amounting to Rs. 375 has not been taken into consideration while preparing adjustment account.
(v) An overcast of purchase book by Rs. 4000.
(vi) Goods for Rs. 1900 purchased on credit, correctly entered in purchase book but wrongly posted as Rs. 1090 in the creditors personal account in purchase ledger.

Give necessary journal entries to rectify the adjustment account in different ledger. Also show the adjustment in two adjustment accounts in general ledger.

Solution:

Journal

(1) Sales ledger adjustment a/c (in general ledger) Dr. 2500
To General ledger adjustment a/c (in sales ledger) 2500
(total of B/R book overcast by Rs. 2500 posted to adjustment account, now rectified)

(2) Sales ledger adjustment a/c (in general ledger) Dr. 1000
To General ledger adjustment a/c (in sales ledger) 1000
(total of sales book under cast by Rs. 1000 posted to adjustment account, now rectified)

(3) General ledger adjustment a/c (in sales ledger) Dr. 375

To Sales ledger adjustment a/ c(in general ledger) 375

(cash discount allowed to customer not taken into consideration while preparing adjustment account now rectified)

(4) Purchase ledger adjustment a/c (in purchase) Dr.

To General ledger adjustment a/c (in purchase ledger)

(total of purchase book overcast by Rs. 4000 posted to adjustment account, now rectified)

In General Ledger

Sales ledger Adjustment A/c

Dr. Cr.

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
	To Balance b/d	176175		By General ledger Adj. a/c	375
	To General ledger Adj. a/c	2500		By Balance c/d	179300
	To General ledger Adj. a/c	1000			
		179675			**179675**

Purchase Ledger Adjustment account

Dr. Cr.

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
	To General ledger Adj. a/c	4000		By balance b/d	77650
	To Balance c/d	73650			
		77650			**77650**

Note:- errors of item (3) and (4) do not affect adjustment account, hence no journal entries have been passed for them.

14.8 Sectional Balancing System vs. Self Balancing System

Difference between sectional balancing system and self balancing system

	Sectional balancing system	Self balancing system
1. No. of accounts	Total debtors account and total creditors account in general ledger are opened in general ledger in addition to the account generally prepared.	In general ledger two adjustment account sales ledger adjustment account and purchase ledger adjustment account are prepared and one general ledger adjustment is prepared in each of sales ledger and purchase ledger.
2. To prepare trial balance	In this system trial balance can be prepared by opening of total debtors account and total creditors account in general ledger. Trial balance is not prepared in sales ledger and purchase ledger.	In this system all the necessary adjustment accounts are opened, so separate trial balance is prepared in all the ledger.
3. Rectification of error and adjustment entries	Entries for the error is made according to general principal.	In this system , entries for rectifying the effect on adjustment account are also made in addition to the general rectification.

Merits of sectional and self balancing system:

1. **Facility in posting**:- easy approach is possible to the account opened in ledger due to having more ledger.

2. **Easy to locate errors**:- due to having separate ledger ,errors are detected very easily so these errors can be rectified immediately.

3. **Facility in division of work**:- work of keeping records in separate ledger can be assigned to different book keepers . Due to this possibility of manipulation is also minimized.

4. **Convenience in preparing final account**:- in sectional balancing system total creditors account and total debtors account and in self balancing system, adjustment accounts are prepared . Hence final account are prepared very easily.

Illustration 7. From the following information, prepare the necessary adjustment accounts under self balancing system.

	Rs.
Debtors opening balance	
Debit	200000
Credit	10000
Cash and cheque receipt	800000
Credit sales	1000000
Discount allowed	30000
Return inward	20000
Bad debts	15000
Bills receivable received	100000
Bills receivable discounted	40000
Provision for bad debts	10000
Bad debts recovered	5000
Transfer from sales ledger to purchase ledger	5000
Transfer from purchase ledger to sales ledger.	6000
Closing credit balance of debtors	30000

Solution:-

In General Ledger

Sales ledger adjustment account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance b/d	200000		By Balance b/d	10000
	To General ledger			By General ledger Adj.	
	Adj. a/c			Bank 800000	
	Sales 1000000	1000000		Discount 30000	
	To Balance c/d	30000		Return 20000	
				B/R 100000	
				Bad debts 15000	
				Transfer 5000	
				Transfer 6000	976000
				By Balance c/d	244000
		1230000			**1230000**

In Sales Ledger

General ledger adjustment account

Dr. Cr.

Date	Particulars		Amount	Date	Particulars		Amount
	To Balance b/d		10000		By Balance b/d		200000
	To Sales ledger Adj. a/c				By General ledger Adj. a/c		
	Bank	800000			Sales	1000000	1000000
	Discount	30000			By Balance c/d		30000
	Return	20000					
	B/R	100000					
	Bad debts	15000					
	Transfer	5000					
	Transfer	6000	976000				
	To Balance c/d		244000				
			1230000				**1230000**

Note :- B/R discounted, provision for bad debts & bad debts recovered will not be entered in these accounts.

Illustration 8. from the following particulars, which have been extracted from the books of Neha and co. for the year ended 31.3.10, prepare general ledger adjustment account in the purchase ledger and sales ledger adjustment account in general ledger.

Debtors balance 1.4.09	Dr.	20000
	Cr.	300
Creditors balance 1.4.09	Dr.	200
	Cr.	15000
Purchases (including cash Rs. 4000)		12000
Sales (including cash Rs. 6000)		25000
Cash paid to suppliers in full settlement of claim of Rs. 9000		8500
Cash received from customers in full settlement of claim of RS. 15000		14100
B/P accepted (including renewals)		2000
B/P withdrawn upon renewal		500
Interest on bills payable renewed		20
Bills receivable received		3000
Bills receivable endorsed		800
Bills receivables endorsed dishonoured		300
Bills receivable discounted		1400
Bills receivable dishonoured		400
Interest charged on dishonoured bill		30
Transfer from one ledger to another ledger		700
Return to creditors		450
Debtors balance 31.3.10	Cr.	350
Creditors balance 31.3.10	Dr.	600

Solution:

In General Ledger

Sales ledger adjustment account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1.4.09	To Balance b/d	20000	1.4.09	By balance b/d	300
31.3.10	To General ledger adjustment a/c Credit Sales 19000 B/R Dishonoured 400 Interest on dishonoured bill 30 B/R endorsed dishonoured 300	19730	31.310	By General ledger adjustment a/c Cash received 14100 Discount allowed 900 Transfer from one ledger to another ledger 600 B/R received 3000	18600
			31.3.10	By Balance c/d	21280
31.3.10	To balance c/d	450			
		40180			**40180**

In purchase ledger

General ledger adjustment account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1.4.09	To balance b/d	15000	1.4.09	By Balance b/d	200
31.3.10	To purchase ledger adj. a/c Purchase 8000 Interest on bills payable 20 Bills received endorsed dishonoured 300 B/P 500	8820	31.3.10	By purchase ledger adj. a/c Cash 8500 Discount 500 Bills payable accepted 2000 B/R endorsed 800 Transfer from one ledger to another ledger 600 Return to creditors 700	13100
31.310	To Balance c/d	350	31.3.10	By balance c/d	10870
		24170			**24170**

Illustration 9. The following individual balance of customers accounts appeared in debtors ledger of a trade on 1st October 2009

(A) 27400 Rs. (B) 25800 Rs. (C) 13000 Rs. (D) 11000 (E) 10000 Rs.
Transaction for the half year ending 31st march 2009 were as follows:
Sales ; A 160000 Rs. B. 140000 Rs. C.300000 Rs. D. 400000 Rs. E. 200000 Rs.
Cash received : A. 50000 Rs. B. 60000 Rs. C. 310000 Rs. D. 220000 Rs E. 200000Rs.
Sales return :A. 4000 Rs. B. 10000 Rs. C. 9000Rs. E. 2000 Rs.
B/R received : A 30000 Rs. B. 39000 Rs. D. 39000 Rs.

B/R for Rs. 10000 received from D was dishonoured and Rs. 150 were paid as noting charge. Discount allowed to B Rs. 1000.

A balance of Rs. 2000 was transferred from D's account in purchase ledger to D's account in sales ledger.

You are required to write up the individual account and general ledger adjustment account as it would appear in debtors ledger for the half year ending 31st march 2010. Prepare a trial balance of the debtors ledger as on that date.

Solution:-

In debtors ledger

A's Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2009					
Oct. 1	To Balance b/d	27400	31.3.10	By Cash received	50000
31.3.10	To Credit Sales	160000	31.3.10	By B/R received	30000
			31.3.10	By Sales return	4000
			31.3.10	By Balance c/d B/F	1034000
		187400			**187400**

B's Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2009					
Oct. 1	To Balance b/d	25800	31.3.10	By Cash received	60000
31.3.10	To Credit Sales	140000	31.3.10	By B/R received	39000
			31.3.10	By Sales return	10000
			31.3.10	By Discount	1000
			31.3.10	By Balance c/d B/F	55800
		165800			**165800**

C's Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2009					
Oct. 1	To Balance b/d	13000	31.3.10	By Cash received	310000
31.3.10	To Credit Sales	300000	31.3.10	By Sales return	9000
	To Balance c/d	6000			
		319000			**319000**

D's Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2009					
Oct. 1	To Balance b/d	11000	31.3.10	By Cash received	220000
31.3.10	To Credit Sales	400000		By B/R received	39000
	To B/R (dishonoured)	10000		By Transfer from PL	2000
	To Cash (noting charge)	150		By Balance c/d B/F	160150
		421150			**421150**

E's Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2009					
Oct. 1	To Balance b/d	10000	31.3.10	By Cash received	200000
31.3.10	To Credit Sales	200000		By Discount	8000
				By Sales return	2000
		210000			**210000**

General ledger adjustment account for the year ending 31st march 2010

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2009					
Oct. 1	To Debtors ledger adj. in G.L.		31.3.10	By balance b/d	84200
31.3.10	Return 25000			By Debtors ledger	
	Cash 840000			adj. a/c in G,L.	
	B/R 108000			Sales 1200000	
	Discount 9000			B/R (dishonoured) 10000	
	Transfer 2000	984000		Noting charged 150	1210150
	To Balance c/d	319350		By Balance c/d	6000
		1303350			**1303350**

Trial Balance as at 31 st March 2010 (balance method)

Particulars	Dr. Rs.	Cr. Rs.
A's Account	103400	
B's Account	55800	
C's Account		6000
D's Account	160150	
General ledger adjustment account	6000	319350
	325350	**325350**

Activity D:

Work out by imaginary figures personal accounts and arrange them in general ledger and sales ledger accounts.

14.9 Summary

Ledger becomes bulky with the rising size of an organization and number of transactions. Therefore it is sub-divided generally in these parts: General Ledger, Debtors (Sales) Ledger and Creditors (Purchase) Ledger. This smoothen the process of posting into ledger and its maintenance. However since double entry is not complete in either of the Sub-divisions, two methods are resorted in order to balance the ledgers. In sectional balancing only general ledger is balanced (when two summary accounts namely Total Debtors Account and Total Creditors Account is opened in General Ledger). In order to achieve balancing of all ledgers, Self-balancing system is adopted whereby control accounts are opened in all these Sub-divided ledgers.

14.10 Self Assessment Questions

Very Short Answer Type Question:

1. Explain the meaning of Sectional Balancing System?

2. Explain the meaning of Self Balancing System?

3. Give the number of additional accounts to be opened in general ledger?

4. Give the name of adjustment accounts to be opened in self balancing system?

5. Total of purchase book under cast by Rs. 200. Give the journal entry For rectifying of this error under self balancing system?

6. Total of sales returns book overcast by Rs.100, give the journal Entry for rectifying it under self balancing system?

7. Give the adjustment entry for transfer from sales ledger to purchase Ledger?

8. Give two merits of self balancing system?

9. Give two points of distinction between section balancing system and self balancing system?

10. What do you mean by 'Contra Balance'?

11. Shukra keeps his accounting books on self balancing system. Total credit sales for the year 2004-05 was Rs. 500000/-. Give necessary journal entry to record this item in adjustment accounts?

12. Shani keeps his books on self balancing system. Bills were endorsed to creditors worth Rs. 2000 in this year 2004-05. Give the journal entry in adjustment accounts?

13. Ram keeps two sales ledger viz A-M and N-Z as per self balancing system. He records the amount received from Mohan Rs. 10000 in 2004-05 as received from Sohan. Give te journal entry for rectifying it in adjustment accounts?

Short Answer Type Question:

1. Explain the meaning of sectional and self balancing system?

2. What is the importance of self balancing system?

3. Explain the inter ledger transfer under self balancing system?

4. Distinguish between sectional balancing system and self balancing system?

5. Discuss the method of rectification of errors under self balancing system?

6. What do you mean by 'Contra Balance'? How are these shown in adjustment accounts under self balancing system?

7. Explain the necessity of sub-division of sales ledger?

8. The following is the summary of the sales ledger in Ravi's book for December 2004.

Balance as on 1.12.04	1,00,000	Cash received from debtors	70,000
Dishonoured bills and other charges	500		
Discount allowed	1000	Bills receivable from Debtors	3,900
Returns and allowances	400		
Sales during the month	60,000	Bad debts	200

Prepare sales ledger adjustment account.

(Answer: 85,000 Rs.)

9. From the following balances extracted from the books of account of Som and co., prepare the total creditors account:-

1 April,04	Balance of creditors-credit balance	1,59,260

	Balance of debtors- credit balance	13,820
31March,05	Sales	15,86,980
	Purchase	10,47,713
	Cash paid to creditors	9,87,280
	Discount allowed by creditors	7,980
	Purchase returns	6,300
	Balance of creditors-debit balance	185

(Answer: 2,05,598 Rs. Credit)

Essay Type Question:

1. Discuss the nature and uses of the ledger kept under sectional balancing system. Explain the general items appearing in a total debtors account and a total creditors account?
2. Explain the meaning of self balancing system of ledger. How does it differ from sectional balancing system of ledger? Describe its merits?

Numerical Questions:

1. From the following information, prepare total debtors account and total creditors account in the general ledger of Ravi Ltd.

Debtors on 1.4.04	8000	Cash paid to suppliers	6000
Creditors on 1.4.04	10,000	Discount received	150
Transaction for the year		Allowances from creditors	80
Credit purchases	4000	Acceptances received from Debtors	1800
Credit sales	4,400	Acceptances given to Creditors	2,600
Returns inward	160	Bills receivable dishonoured	400
Returns outward	240	Bills payable withdrawn	300
Cash received from Customers	5000	Bad debts written off	400
Discount allowed	180	Sundry charges debited to customer	140

(***Answer:*** Total Debtors account balance is 5,400 Rs. & total creditors account is 5,230 Rs.)

2. From the following information prepare (i) Total debtors account and (ii) total creditors account,

Balance of sundry debtors	64000	Balance of sundry creditors	74000
Credit purchase	18000	Bills receivable received	12000
Credit sales	39200	Returns inward	3500
Cash sales	3000	Returns outward	2400
Cash purchase	2000	Rebate allowed to debtors	1100
Paid to creditors	39500	Rebate allowed from creditors	600
Discount received	1300	Provision for doubtful debts	640
Cash received from debtors	31200	Bad debts	1800
Discount allowed	800	Bills receivable dishonoured	1500
Bills payable accepted	6000	Bad debts previously written off now recovered	1000

(***Answer***: Total debtors account balance 54,300 Rs.& total creditors account balance is 42,200 Rs.)

3. A firm keeps it's sold and bought ledger on self balancing system. From the following

particulars prepare the control accounts in the sold and bought ledgers:

Opening debtors	1,24,000	Return outward	50,000
Opening creditors	50,000	Acceptances from debtors Dishonoured	10,000
Credit purchase	2,06,000	Discount allowed to debtors	2000
Credit sales	2,68,000	Bad debts written off	4000
Cash received from Debtors	1,56,000	Bad debts written off in previous year now recovered	10,000
Return inward	6000	Closing debtors	2,34,000
Acceptances given	80,000	Closing creditors	21000

(***Answer*** : Payment of creditors 1,05,000 Rs.)

4. From the following extract from the books of Mr. Mangal, prepare the Necessary adjustment account in the general ledger,

   1.4.2004 sales ledger balance Rs. 27,400; Purchase ledger balance Rs.32,800. Transactions during the year:

Credit purchase	12,500	Cash sales	10,000
Credit sales	13,900	Sundry charges debited to customers	100
Cash received from customers	15400	Allowances from creditors	320
Cash paid to suppliers	18,400	Bills payable dishonoured	1800
Returns from customers	400	Discount allowed to debtors	260
Return outwards	400	Cash purchase	6180
Discount received	360	Bills receivable dishonoured	420
Bad debts written off	1440	Bad debts written off now recovered	180
Acceptances received from customers	5100	Transfer from bought ledger to sales ledger	300
Bills payable accepted	7200	bills receivable discounted	600

(***Answer***: Balance S.L. Adjustment a/c Rs. 18,920(Dr.) and balance of P.L. Adjustment a/c Rs. 20,120 (Cr.)

5. How would you rectify the following errors made during the year ending on 31st march 2005 by the staff of Kumar & Co. who keeps their sales ledger (A to M) and (N to Z) on the self balancing system.

   (a) Goods return Rs. 200 by Rajiv were not entered in the books.

   (b) A cheque for Rs. 1000 received from Uttam was wrongly posted to the account of Bihari.

   (c) The (N to Z) sales books was overcast by Rs. 300.

6. Shani Co. Ltd. Have three ledgers which are all kept under self balancing. from the following particulars prepare the relevent adjustment accounts that would appear in the general ledger.

Debtors balance on 1.4.04(Dr.)	15000	Bills receivable drawn	7500
Debtors balance on 1.4.04(Cr)	1000	Bills receivable dishonoured	2000
Creditors balance on 1.4.04(Dr)	600	Bills received discounted	1500
Creditors balance on 1.4.04(Cr)	12,800	Bills receivable endorsed to creditors	4300
Purchase (including cash Rs.1500)	36000	Bills receivable as endorsed to creditors dishonoured	1000
Sales (including cash Rs.3000)	75,000	Bad debts	800

Cash paid to creditors	21,000	Provision for bad debts	1100
Collection from debtors	62,000	Transfer from debtors ledger to creditors ledger	500
Discount allowed	260	Bills payable accepted	4000
Discount received	320	Debtors balance on 31.3.05(Cr.)	300
Return inward	2400	Creditors balance on 31.3.05(Dr.)	200

{***Answer*** : S.L. Adjustment a/c in Rs. 15,840 (Dr.), P.L. Adjustment a/c Rs. 16,180 (Cr.)}

7. The following transaction have been extracted from the books of Mr.Rohan. You are required to prepare the sales ledger adjustment account as on 31.3.09

	Rs.
Debtors balance as on 31.3.09	100000
Transaction during the period were	
Sales (including cash sales of Rs. 40000)	256000
Cash received from debtors	180000
Discount allowed	1000
Acceptance received from debtors	16000
Return from debtors	12000
B/R dishonoured	3000
Bad debts written off (after deducting bad debts recovered Rs. 2000)	8000
Transfer to bought ledger	600
Sundry charge debited to customer	1200

Answer : Balance of S.L adjustment a/c Rs. 100600 (Dr.)

8. Total account were prepared in general ledger in relation to sales ledger A-L and M-Z kept in the books of Jai. The following are the details for the month ending 31st march 2009.

	A-L (sales ledger) Rs.	M – Z (Sales ledger) Rs.
Opening balance (Dr.)	31750	19400
Opening balance (cr.)	300	600
Total sales	18200	16800
Sales return	600	200
Cash received from debtors	8900	13700
Discount allowed	150	250
Bad debts written off	100	200
Bills receivable received	2500	——
Closing credit balance	700	400

Rs. 1200 of sales were wrongly posted to a ledger account in A-L ledger instead of M- Z ledger. On 31st march 2009 it is transferred through the journal proper to the correct ledger account in M-Z ledger.

Prepare the total debtors account for the two sales ledger in the general ledger, also give the journal entry for the transfer of Rs. 1200 of the sales to the correct on 31st march 2009.

Answer: Total debtors account balance A-L 36900Rs., Dr., M-Z 22850 Rs. Dr.

9. Mohan & Co. maintain ledger on self balancing system on 30th June 2009, the general ledger discloses the following balance :-

Sales ledger adjustment account 35235 Rs. Dr.
Purchases ledger adjustment account 15530 Rs. Cr.
On scrutiny of ledger the following error were detected:-

(i) An overcast of bill receivable book by Rs. 500.

(ii) An under cast of sales book by Rs. 200.

(iii) Goods return by Hari Rs. 100 have been entered in sales return book but not posted to Hari's account in sales ledger.

(iv) Cash discount allowed to customer amounting to Rs. 75 has not been taken into consideration while preparing adjustment account.

(v) An overcast of purchase book by Rs. 800.

(vi) Goods for Rs. 380 purchased on credit, correctly entered in purchase book but wrongly posted as Rs. 218 in the creditors personal account in purchase ledger.

Give necessary journal entries to rectify the adjustment account in different ledger. Also show the adjustment in two adjustment account in general ledger.

Answer: Adjustment balance of S.L. adjustment a/c Rs. 35860 (Dr.) and adjustment balance of P.L. adjustment a/c Rs. 14730 Cr.

14.11 Reference Books

1. Financial Accounting — Rao, Heda, Gupta
2. Financial Accounting — Jain, Khandelwal, Pareek
3. Financial Accounting — Grewal's accouting

Unit - 15 Departmental Accounts

Structure of Unit:

15.0 Objectives

After completing this unit you will be able to :

- Maintain books in column form for department wise details.
- Ascertain department wise profit or loss.
- Learn how to do accounting for Interdepartmental transactions.

15.1 Introduction

In the present era of globalisation, business generally do not confine to one line of activity these days. In order to grow, enterprises operates many product lines whether in the same industry or in different industries. This creates a separate department for each line of activity. For example an automobile company may have departments for scooters, motor cycles, family car, luxury car etc. Thus an organisation may comprise various departments and its overall performance depends upon the performance of individual activity lines/departments.

Departmental accounts serve the following purposes:

(i) To compare current year results of department with the previous year.
(ii) To evaluate profit/loss of individual department.
(iii) To assist management in policy decisions to maximize profits.
(iv) To assist in rewarding departmental employees on basis of their performance.

15.2 Need

The overall profits may hide the inefficiency of weak departments, thus affecting the decision of management about which department to discontinue or shut down or expand etc. Hence to get the best results each department should be viewed as a "profit centre". Each department can be viewed as separate accounting entity and separate books can be maintained to assess individual performance.

> **Activity A:**
>
> Why departmental accounting is needed? List the purposes served by it.

15.3 Departmental Accounting System

Maintaining separate set of books for each department may becomes prohibitively expensive if number of departments are very large. Thus generally one set of books are maintained with various subsidiary books and corresponding ledger accounts in columnar form. i.e. separate columns are maintained for each department in subsiding books and ledgers. Thus it is known as column form of accounting. The format of subsidiary books may be as under:

Cash Book

Dr. **Cr.**

Date	Particular	L.F.	Total Rs.	Deptt. A Rs.	Deptt. B Rs.	Deptt. C Rs.	Date	Particular	L.F.	Total Rs.	Deptt. A Rs.	Deptt. B Rs.	Deptt. C Rs.

Purchase Book

Date	Particular		Invoice No.	L.F.	Total Amount	Deptt. A Rs.	Deptt. B Rs.	Deptt. C Rs.

Sales Book

Date	Particular		Invoice No.	L.F.	Total Amount	Deptt. A Rs.	Deptt. B Rs.	Deptt. C Rs.

Purchase Returns or Returns Outward Book

Date	Particular	Debit Note No.	L.F.	Total Amount	Deptt. A Rs.	Deptt. B Rs.	Deptt. C Rs.

Sales Returns or Returns Inward Book

Date	Particular	Credit Note No.	L.F.	Total Amount	Deptt. A Rs.	Deptt. B Rs.	Deptt. C Rs.

In the above way figures are available for business as a whole along with individual departments, to prepare Trading and P&L a/c at year end in column form.

Departmental Trading and P&L a/c for the year ended 31st march ....

Dr. Cr.

Particulars	Depttt. A	Deptt. B	Deptt. C	Particulars	Depttt. A	Deptt. B	Deptt. C
To opening stock				By Sales			
To purchases				By Closing stock			
To Direct expenses							
To G.P. c/d							
To Adm. Exps.				By G.P. b/d			
To Net Profit (General P&L a/c)				By Net Loss (General P&L a/c)			

General Profit and Loss a/c for the year ended 31st March ......

	Rs.		Rs.
To P& L a/c (if Loss) :		By P&L a/c (if Profit):	
Deptt. A	-	Deptt. A	-
Deptt B	-	Deptt. B	-
Deptt C	-	Deptt. C	-
To Interest on Debentures	-	By Dividends	-
To Salary of Manager	-	By Interest on Investments	-
To Office Expenses etc.	-	By Miscellaneous Income etc.	-
To Balance C/d (Capital A/c)	-	By Balance c/d (Capital A/c)	-

Activity B:

Which system of accounting do you think is most appropriate for departmental accounting? Give format of departmental trading account with imaginary figures.

15.4 Allocation and Apportionment of Expenses

To ascertain overall profitability of various departments, irrespective of the fact whether the departments are related or unrelated, the department wise figures of purchases, expenses, sales incurred exclusively for a departments are readily determined and allocated to those departments. However, common expenses (Indirect expenses) incurred for the benefits of various departments need to be taken into account. The common expenses need to be apportioned to various departments on some suitable basis. If common expenses cannot be suitability apportioned then preferably be shown in general P&L a/c e.g. interest on debentures & loans, salary of general manager, directors remuneration etc. Once all the incomes and expenses are identified either through allocation or apportionment the profit/loss of each department can be determined. For this individual departmental Trading and P&L a/c or a single Trading and P&L a/c in columnar form may be prepared. To arrive consolidated profits a general P&L a/c is prepared.

For apportioning common incomes/ expenses some of the suitable basis used are summarised in the following table:

Item of expenses/ incomes	Commonly used basis for apportionment
Canteen expenses, common room expenses, medical expenses and other labour welfare expenses	Number of employees in each department

Item of expenses/ incomes	Commonly used basis for apportionment
Depreciation of assets, fire insurance, repair and maintenance expenses of assets etc.	Asset value of each department
Rent, rates, taxes, repair and maintenance of building	Area occupied by each department
Discount received, carriage inward etc.	Purchases of each department
Discount allowed, bad debts, carriage outward, salesmen salary and commission, packing and delivery expenses etc.	Sales (or turnover) of each department
P.F. and E.S.I. contributions	Salaries of each department
Lighting	Number of light points in each department or by separate meter (if installed)
Advertising	Sales of each department or space devoted to each department if it is a print ad.

Activity C:

Narrate any ten Incomes and Expenses with suitable basis of apportionment.

Illustration 1 (Allocation or apportionment of expenses)

The Trading and Profit and Loss A/c for the six months ended 31st March 2010 of a Radio and Gramophone Equipment Company is given as under.

Trading and Profit and Loss A/c for ended 31st March 2010

		Rs.			Rs.
To Purchases :			By Sales :		
Radio (A)	1,40,700		Radio (A)	1,50,000	
Gramophone (B)	90, 600		Gramophone (B)	1, 00,000	
Spares and Service Deptt. (C)	64, 400	2, 95,700	Spares and Service Deptt. (C)	25, 000	2,75,000
To Salaries and Wages		48, 000	By Closing Stock :		
To Rent		10, 800	Radio (A)	60, 100	
To Sundry Expenses		11, 000	Gramophone (B)	20, 300	
To Net Profit		34, 500	Spares and Service Deptt. (C)	44, 600	1,25,000
		4,00,000			**4,00,000**

Prepare Departmental Trading and P & L A/c for each Deptt. A, B, and C taking into consideration the following further information:

(i) Radios and Gramophones are sold in show-room while service and repair is made in workshop.

(ii) Distribution of Salaries and wages were as under:

Show Room ¾, Workshop ¼ it was decided to allocate the salary and wages of Show Room among the Deptt. A and B in the ratio of 1 : 2

(iii) Rs. 500 per month is paid for Workshop rent and rent of Show Room is distributed equally among the deptt. A and B.

(iv) Sundry expenses are to be apportioned in the ratio of departmental sales.

Solution:

Departmental Trading and Profit and Loss Account
for the six months ended 31st March, 2010

Particulars	Total	Department			Particulars	Total	Department		
		A	B	C			A	B	C
To Purchases	2,95,700	1,40,700	90,600	64,400	By Sales	2,75,000	1,50,000	1,00,000	25,000
To G. .P. c/d	1,04,300	69,400	29,700	5,200	By C. Stock	1,25,000	60,100	20,300	44,600
	4,00,000	**2,10,100**	**1,20,300**	**69,600**		**4,00,000**	**2,10,100**	**1,20,300**	**69,600**
To Salaries & Wages	48,000	12,000	24,000	12,000	By G. .P. b/d	1,04,300	69,400	29,700	5,200
To Rent	10,800	3,900	3,900	3,000					
To S. Expenses	11,000	6,000	4,000	1,000					
To N. P.	47,500	47,500	–	–	By Net Loss	–	13,000	2,200	10,800
	1,17,300	**69,400**	**31,900**	**16,000**		**1,17,300**	**69,400**	**31,900**	**16,000**

Working Notes -

1. Calculation of Salaries and Wages of each Deptt.
   Showroom (A & B) Work Shop (C)
   3/4 of 48,000 = 36,000 1/4 of 48,000 = 12,000
   (A) (1/3 x 36,000) (B) (2/3 x 36,000)
   = 12,000 = 24,000
2. Calculation of Rent
   Total Rent Rs. 10,800 – Workshop Rent (C) 500 x 6 = 3,000
   Total Rent of Show Room i.e. of A & B = 7,800
   1/2 x 7,800 = 3,900 of A and 3,900 of B
3. Calculation of Sundry Expenses - (Total Rs. 11,000) :
   Sales Ratio of Deptt. A, B, and C = 150 : 100 : 25
   Or 6 : 4 :1
   6,000, 4,000 and 1,000

Illustration 2 (Calculation of Departmental Stock)

Bright Ltd. has three departments A, B and C. From the particulars given below compute: (a) the value of stock as on 31 March 2010 and (b) the departmental trading results :

(i)

	A Rs.	B Rs.	C Rs.
Stock as on 1st April 2009	24,000	36,000	12,000
Purchases	1,46,000	1,24,000	48,000
Actual sales	1,72,500	1,59,400	74,600
G.P. on normal selling prices	20%	25%	33.33%

(ii) During the year certain items were sold at discount and these discounts were reflected in the values of sales shown above. The items sold at discount were :

	Deptt. A Rs.	Deptt. B Rs.	Deptt. C Rs.
Sales at normal prices	10,000	3,000	1,000
Sales at acutal prices	7,500	2,400	600

Solution:

Departmental Trading A/c for the year ended 31st march, 2010

Dr. **Cr.**

Particulars	Deptt. A	Deptt. B	Deptt. C	Total	Particulars	Deptt. A	Deptt. B	Deptt. C	Total
To Opening Stock	24,000	36,000	12,000	72,000	By Sales (Actual)	1,72,500	1,59,400	74,600	4,06,500
To Purchases	1,46,000	1,24,000	48,000	3,18,000	By Closing Stock*	30,000	40,000	10,000	80,000
To G.P. (B.F.)	32,500	39,400	24,600	96,500					
	2,02,500	1,99,400	84,600	4,86,500		2,02,500	1,99,400	84,600	4,86,500

Working Note -

***Calculation of Closing Stock**

	Departments		
	A	B	C
Actual Sales (Given) i.e. After Discount	1,72,500	1,59,400	74,600
Add : Discount allowed (i.e. Difference between Normal Price and Actual Price of such sales)	2,500	600	400
Sales at Normal Price	1,75,000	1,60,000	75,000
Less : Gross Profit at the rates given i.e. 20%, 25%, and 33.33% respectively	35,000	40,000	25,000
Cost of Sales	1,40,000	1,20,000	50,000

As Opening Stock + Purchases – Closing Stock = Cost of Sales

Closing Stock = (Opening Stock + Purchases – Cost of sales)

Deptt. A: 24,000 + 1,46,000 – 1,40,000 = 30,000

Deptt. B: 36,000 + 1,24,000 – 1,20,000 = 40,000

Deptt. C: 12,000 + 48,000 – 50,000 = 10,000

Illustration 3 (Calculation of Departmental purchases)

You are given the following particulars of a business having three departments:

Department	Purchases	Opening Stock	Closing Stock
A	1,500 units	200 units	100 units
B	1,000 units	300 units	160 units
C	2,000 units	150 units	200 units

Additional Information:

(i) Purchases were made at a total cost of Rs. 92,000.

(ii) The percentage of gross profit on turnover is the same in each case.

(iii) Purchases and Sales prices are constant for the last 2 years.

(iv) Selling price per unit:

Department	Rs.
A	20
B	25
C	30

You are required to prepare Departmental Trading Account.

Solution:

Dr. **Departmental Trading Account** **Cr.**

Particulars	A	B	C	Particulars	A	B	C
To Opening Stock: A: 200 @ Rs. 16	3,200	6,000	3,600	By Sales: A: 1,600 @ Rs. 20	32,000	28,500	58,500
B: 300 @ Rs. 20				B: 1,400 @ Rs. 25			
C: 150 @ Rs. 24				C: 1,950 @ Rs. 30			
To Purchases :	24,000	20,000	48,000	By Closing Stock:	1,600	3,200	4,800
A: 1,500 @ Rs. 16				A: 100 @ Rs. 16			
B: 1,000 @ Rs. 20				B: 160 @ Rs. 20			
C: 2,000 @ Rs. 24				C: 200 @ Rs. 24			
To Gross Profit (20% on turnover)	6,400	5,700	11,700				
	33,600	**31,700**	**63,300**		**33,600**	**31,700**	**63,300**

Working Notes:

1. Calculation of gross profit rates:

Sales price of goods purchased:

A: 1,500 @ Rs. 20	30,000
B: 1,000 @ Rs. 25	25,000
C: 2,000 @ Rs. 30	60,000
	1,15,000
Less: Cost of goods purchased	92,000
Gross Profit	23,000

Gross profit ratio = 23,000/1,15,000 × 100 = 20%

2. The No. of units sold:

Department	Opening Stock	+	Purchases	–	Closing stock	=	Sold
A	200		1,500		100		1,600
B	300		1,000		160		1,140
C	150		2,000		200		1,950

3. Respective departmental cost per unit : (i.e. sales price Less 20%):

		Rs.
A :	Rs. 20 – Rs. 4	16
B :	Rs. 25 – Rs. 5	20
C :	Rs. 30 – Rs. 4	26

Activity D:

Calculate purchase price per unit and gross profit ratio for each department with following details purchases (Total cost Rs. 51,000).

Deptt. X 200 units, Deptt. Y 1400 units and Deptt. 2400 units.

Sales: Deptt.X 180 units @ Rs. 15, Deptt.Y 1500 units @ Rs. 18 and Deptt.Z 450 units @ Rs. 6.

Opening Stock : Deptt.X 100 Units, Deptt.Y 400 units and Deptt.Z 60 units.

15.5 Inter Departmental Transfers – Transfer Pricing and Unrealised Profit on Stock

Sometimes end product of one department becomes the raw material for other department and involves transfer from one department to other internally.

Each department in viewed as independent profit centres, thus inter department transfer assume the character of sales for transferor department and purchase for transferee department.

If goods are transferred at cost of the transferor it leads to nil profit for that department. Such transfer is normally resented by management of transferor department. Thus generally goods are transferred at transfer price which is more than cost i.e. cost, plus margin/mark-up. It results profit in its individual Trading and P&L a/c. No accounting problem arise if transfer takes place at cost, but when transfers are at cost plus mark-up (Transfer price) closing stock of transferee department includes certain goods received from transferor department at loaded price. It is appropriate from the point of view of individual department but from the point of view of business as a whole, a stock reserve be created to eliminate the unrealised profit. For creation of reserve for unrealised profit at end of year following Journal entry is made –

General P&L a/c Dr.
To Stock Reserve a/c

In next accounting year the above entry is reversed i.e. credited to general P&L a/c as stock reserve on opening stock. Unrealised profit in stock be calculated as under:

Unrealised = Transfer price of unsold stock × G.P. on sales of transfer or profit with transferee department.

Thus by creating stock reserve for unrealised profit stock is brought at cost for determining true profits of the business as a whole.

Illustration 4 (Inter Departmental Transfer - when transfer is at sale price i.e. at Profit)

Complex Limited has three departments A, B and C. The following information is provided:

	A	B	C
	Rs.	Rs.	Rs.
Opening stock	3,000	4,000	6,000
Direct materials	8,000	12,000	–
Wages	5,000	10,000	–
Closing stock	4,000	14,000	8,000
Sales	–	–	34,000

Stocks of each department are valued at cost to the department concerned. Stocks of A department are transferred to B at a margin of 50% above departmental cost. Stocks of B department are transferred to C department at a margin of 10% above departmental cost.

Other expenses were:

	Rs.
Salaries	2,000
Printing and stationery	1,000
Rent	6,000
Interest paid	4,000
Depreciation	3,000

Allocate expenses in the ratio of departmental gross profit. Opening figures of reserves for unrealised profit of departmental stocks were as follows:

	Rs.
Department B	1,000
Department C	2,000

Prepare departmental Trading and P&L a/c.

Solution:

Complex Limited

Departmental Trading and Profit & Loss Account for the year ending ...

Dr. **Cr.**

Particulars	Deptt.A Rs.	Deptt. B Rs.	Deptt. C Rs.	Total Rs.	Particulars	Deptt. A Rs.	Deptt. B Rs.	Deptt. C Rs.	Total Rs.
To Opening stock	3,000	4,000	6,000	13,000	By Internal transfer	18,000	33,000	–	51,000
To Direct. Materials	8,000	12,000	–	20,000	By Sales	–	–	34,000	34,000
To Wages	5,000	10,000	–	15,000	By Closing Stock	4,000	14,000	8,000	26,000
To Internal transfer	–	18,000	33,000	51,000					
To Gross Profit c/d	6,000	3,000	3,000	12,000					
	22,000	**47,000**	**42,000**	**1,11,000**		**22,000**	**47,000**	**42,000**	**1,11,000**
To Salaries	1,000	500	500	2,000	By Gross profit b/d	6,000	3,000	3,000	12,000
To Printing and Stationary	500	250	250	1,000	By Net Loss Transferred to General P&L a/c	2,000	1,000	1,000	4,000
To Rent	3,000	1,500	1,500	6,000					
To Interest paid	2,000	1,000	1,000	4,000					
To Depreciation	1,500	750	750	3,000					
	8,000	**4,000**	**4,000**	**16,000**		**8,000**	**4,000**	**4,000**	**16,000**

General Profit and Loss A/c

	Rs.		Rs.
To Net Loss b/d :		By Opening Reserve for unrealised profit on stock	
Deptt. A 2,000			
Deptt. B 1,000		Deptt. B 1,000	
Deptt. C 1,000	4,000	Deptt. C 2,000	3,000
To Reserve for Unrealised profit on stock	3,918	By Net Loss transferred to Capital A/c	4,918
	7,918		**7,918**

Working Note:

Unrealised profit in stock of 'B' Deptt.

$$\frac{18,000}{40,000} \times 14,000 = \text{Rs. } 6,300 \text{ (Stock from 'A' Deptt.)}$$

$$\frac{50}{150} \times 6,300 = \text{Rs.} 2,100 \text{ (profit charged by 'A' Deptt.)}$$

$$\text{Profit of Deptt. B}: \left(8,000 \times \frac{10}{100}\right) = 727 \text{ (Profit charged by 'B' Deptt.)}$$

$$\text{Profit of Deptt. A}: (8,000 - 727) = 7,273 \times \frac{18,000}{40,000} \times \frac{50}{150} = 1091$$

\ Total unrealised profit 2,100 + 727 + 1,091 = 3,918

Illustration 5

A Firm had two Departments, Cloth and Readymade Clothes. The clothes were generally made by the firm itself out of cloth supplied by the Cloth Department at its usual selling price. From the following figures, prepare Departmental Trading and Profit and Loss Account for the year ending 31st March 2010.

	Cloth Department Rs.	Readymade Cloths Deptt. Rs.
Stock on 1.4.09	3,00,000	50,000
Purchases	20,00,000	15,000
Sales	22,00,000	4,50,000
Transfer to Readymade clothes Department	3,00,000	–
Expenses - Manufacturing	–	60,000
Selling	20,000	6,000
Stock on 31.3.10	2,00,000	60,000

The stock in the Readymade Clothes Department may be considered as consisting of 75% cloth and 25% other expenses. The Cloth Department earned gross profit at the rate of 15% in 2008-09. General Expenses of the business as a whole were Rs. 1,10,000.

Solution:

Departmental Trading and P&L A/c for the year ending 31st March 2010

Particulars	Cloth Deptt.	Readymade Cloths Deptt.	Particulars	Cloth Deptt.	Readymade Cloths Deptt.
To Opening Stock	3,00,000	50,000	By Sales	22,00,000	4,50,000
To Purchases	20,00,000	15,000	By Transfer to ready made Cloth Deptt.	3,00,000	–
To Transfer from Cloth Deptt.	–	3,00,000			
To Manufacturing Exps.		60,000	By Closing Stock	2,00,000	60,000
To G.P. c/d	4,00,000	85,000			
	27,00,000	**5,10,000**		**27,00,000**	**5,10,000**
To Selling Exps.	20,000	6,000	By G.P. b/d	4,00,000	85,000
To Net Profit	3,80,000	79,000			
	4,00,000	**85,000**		**4,00,000**	**85,000**

General Profit and Loss a/c for the year ending 31st March 2010

	Rs.		Rs.
To General Expenses	1,10,000	By Net Profit :	
To Stock Reserves		Cloth Deptt.	3,80,000
(Additional required) (b)	1,575		
To Balance c/d	3,47,425	Readymade Cloth Deptt.	79,000
	4,59,000		**4,59,000**

Working Notes:

(a) Calculation of G.P. rate of cloth Deptt. for the year 2009-10

Sales including transfer (22,00,000 + 3,00,000) 25,00,000

Gross Profit = 4,00,000

\ G.P. Rate = $\frac{4,00,000}{25,00,000} \times 100 = 16\%$

(b) Calculation of stock reserve (Additional required) :

(i) Closing Stock of Readymade Cloth Deptt. = 60,000

\ Cloth element = $60,000 \times \frac{75}{100} =$ 45,000

\Profit in Stock = $45,000 \times \frac{16}{100} =$ 7,200

(ii) Opening Stock of Readymade Cloth Deptt. = 50,000

\Cloth element = $50,000 \times \frac{75}{100} =$ 37,500

\Profit in Stock = $37,500 \times \frac{15}{100} =$ 5,625

So, Required Additional Reserve = 7,200 – 5625 = 1,575

15.6 Summary

Departmental store is one of the important form of trade organisation. In this form a business entity runs several departments under one roof with different activities or services or product lines.

Departmental stores keeps their accounts on double entry system. They maintain subsidiary and main books like an ordinary business activity but the special feature in that departmental accounting is done generally in column form to know financial performance of individual departments. Overall performance of business may be ascertained by preparing consolidated Trading and P&L a/c and B/S at year end.

Another special feature of departmental accounting is that indirect expenses (i.e. common expenses) are apportioned on suitable basis for charging to individual departments. Inter department transfers are also dealt with according to accounting principles specially valuation of inventories at cost or market price whichever is lower.

15.7 Key Words

(i) **Profit centre:** A profit centre is a location or activity line or department to which profit or cost may be ascertained and used for the purpose of cost control.

(ii) **Direct expenses:** These expenses refer to expenses that are specifically incurred and charged for specific or particular job/service or cost centre or department. Such expenses are also known as chargeable expenses e.g. hire charges of special tools for a particular job, royalties payable on use of patents, cost of drawing designs/layouts.

(iii) **Indirect expenses:** It is not possible to allocate such expenses to jobs or cost centre. Such expenses are apportioned on suitable basis, e.g. factory rent, common lighting, advertisements, etc.

(iv) **Allocation:** Amount that can be clearly charged to the respective cost centre or department.

(v) **Apportionment:** Common expenses or overheads to be charged to various cost centres or departments on suitable basis.

(vi) **Transfer price:** It refers to loaded price i.e. cost plus mark-up/margin. Inter- department transactions are generally recorded at this price.

(vii) **Unrealised profit:** Amount of loading or mark up included in unsold stock with transferee department received from transferor department at transfer price.

15.8 Self Assessment Questions

(A) Theoretical questions

(1) Discuss the different basis of apportionment of indirect expenses while preparing departmental accounts.

(2) Explain the departmental accounting system in detail.

(3) Why departmental accounting is necessary? What purposes it serves?

(4) How inter departmental transfers are dealt with in departmental accounting?

(B) Numerical problems

Q.1 A firm has two departments – Sawmill and Furniture. Furniture is made with wood supplied by the Sawmill department at its usual selling price. From the following figures prepare Departmental Trading and Profit and Loss Account for the year ended 2010.

	Sawmill *Rs.*	*Furniture* *Rs.*
Opening Stock	1,50,000	25,000
Sales	11,00,000	2,25,000
Purchases	10,00,000	75,000
Supply to Furniture Department	1,50,000	-
Selling Expenses	10,000	3,000
Wages	-	30,000
Stock on 31-03-2010	1,00,000	30,000

The value of stocks in the Furniture Department consists of 75% wood and 25% of other expenses. The Sawmill Department earned gross profit at 15% in 2009. General expenses of the business as a whole came to Rs. 55,000.

(**Ans.:** Profit Mill Rs. 1,90,000 and Furniture 39,500 Stock Reserve Rs. 787).

Q.2 From the under mentioned information and instructions, prepare Department trading and profit and loss A/c in column form of the three departments of out fitting supply stores Ltd:

	Tailoring Rs.	Ladies Wear Rs.	Outfitting Rs.
Stock 1 April, 2009	41,000	34,000	94,000
Stock 31 March, 2010	33,000	44,000	83,000
Purchases for the year	2,10,000	75,000	1,39,000
Purchases Returns	14,000	5,000	2,000
Sales for the year	4,00,000	1,54,000	3,62,000
Sales Returns	Nil	4,000	12,000
Wages	73,000	30,000	25,000

Goods were transferred from one department to another at cost price as below:

Tailoring to Ladies wear Rs. 1,000 and to Outfitting Rs. 6,000; Ladies Wear to Tailoring Rs. 5,000 and to Outfitting Rs. 1,000; Outfitting to Tailoring Rs. 5,000 and to Ladies Wear Rs. 5,000. Apportion equally, stationery Rs. 900, Postage Rs. 600, General Charges Rs. 39,000, Insurance Rs. 1,800, and Depreciation Rs. 5,400.

Allocate the following further expenditure on suitable basis and appended not stating the basis selected for each item:- Establishment Rs. 72,000, Bad Debts Rs. 18,000, Advertising Rs. 5,400 and Income tax Rs. 17,190.

Rent and Taxes Rs. 45,000 is to be split up in proportion to space occupied, i.e. Tailoring 4, Ladies Wear 2, Outfitting 3, Other space 1.

Ans.:

Gross Profit Rs.	1,20,000	60,000	1,80,000
Net Profit Rs.	37,980	15,930	1,00,800

Q.3 From the following information and instructions make out a Trading and Profit and Loss A/C showing the estimated net profits of the three departments for the interim period of six months ending 30th Sept., 2009. A Stock reserve of 10% on the estimated value of stock as on 30 Sept., 2009 is to be made before arriving at the estimated net profits on the departments concerned -

	X Rs.	Y Rs.	Z Rs.
Direct Expenses	4,000	2,500	1,300
Sale for the period	25,000	20,000	10,000
Purchase for the period	12,000	10,000	8,000

It was not possible for the management to take stock but the normal rates of gross profit for the departments concerned were 40% and 30% and 20% respectively on sales. The indirect expenses amounted to Rs. 2,700 which is to be distributed in the ratio of amounts of Gross Profit earned and depreciation on plant and machinery of Rs. 16,500 @ 10% per annum to be apportioned on the basis of turnover. Value of opening stock was as follows:

X Deptt.	Y Deptt.	Z Deptt.
Rs. 10,000	Rs. 12,000	Rs. 5,000

Ans.:

		X	Y	Z
(i)	Closing Stock on 30.9.09	7,000	8,000	5,000
(ii)	Gross Profit Rs.	10,000	6,000	2,000
(iii)	Net Profit Rs.	3,050	1,200	(-)400

Q.4. The following purchases were made by a business house having three departments.

Deptt. A 1000 units

Deptt. B 2000 units

Deptt. C 2400 units, at a total cost of Rs. 1,00,000

Opening Stock were :

Deptt. A 120 units : Deptt. B 80 units and Deptt. C 152 units.

The sales were:

Deptt. A 1020 units @ Rs. 20 each

Deptt. B 1920 units @ Rs. 22.50 each

Deptt. C 2496 units @ Rs. 25 each

The rate of gross profit is the same in the each case. Prepare departmental trading accounts.

Ans.:

	A	B	C
(i) Closing Stock units	100	160	56
(ii) Per unit Cost Rs.	16	18	20
(iii) Gross Profit Rs.	4,080	8,640	12,480

Q.5. Manohar Ltd. has two departments A and B. The latter department gets all its requirement from the A department at the usual selling price. On 31st March, 2010, the following was the trial balance -

	Dr. Rs.	Cr. Rs.
Share capital		1,00,000
Stock (A Department) On 1-4-2009	40,000	
Stock (B Department) On 1-4-2009	2,500	
Purchases – A	5,50,000	
B	5,000	
Sales - A		6,25,000
B		75,000
Transfer goods to B Department	25,000	25,000
Directors' fees remuneration	15,000	
Wages and salaries - A	10,000	
B	20,000	
Rent and rates (3/4 to A)	4,000	
Lighting (3/4 to B)	1,000	
Depreciation - A	500	
Depreciation - B	2,500	
Office salaries	8,000	
Furniture and fittings	10,000	
Office expenses	1,500	
Equipments	25,000	
Carriage inwards	33,000	
Investments	50,000	
Income from investments		5,000
Cash at bank	27,000	
	8,30,000	**8,30,000**

Closing stock of A on hand was Rs. 48,000 and that of B amounted to Rs. 3,750. It is desired to ascertain profit or loss on strict accountancy principles. Trading conditions and accounting methods in 2009-10 were the same as in 2008-09.

Ans. Gross profit : A Rs. 65,000; B Rs. 26,250; Net profit; A Rs. 61,250; B Rs. 22,000; Total Net Profit from General P&L A/c Rs. 63,375; Balance sheet total Rs. 1,63,375.

15.9 Reference Books

1. Advanced Accountancy, Vol. I : R.L. Gupta and M. Radhaswamy
2. Advanced Accountancy, Vol. I : S.N. Maheshwari
3. Advanced Accounting, Vol. I : Sehgal and Sehgal
4. Financial Accounting : Jain Khandelwal and Pareek

Unit - 16 Branch Accounts

Structure of Unit:

16.0 Objectives

After completing this unit, you will be able to:

- Distinguish between Dependent and Independent Branches.
- To calculate branch profit in head office books on cost basis by using debtor method stock and debtor method and final accounts method.
- To ascertain branch in profit in head office books on wholesale price basis.
- Do accounting in the books of branch having independent system of accounting.
- Incorporate branch results in head office books to present consolidated picture to users of accounting information.

16.1 Introduction

A business can grow by tapping more customers. If customers are scattered all over and cannot be tapped from one place, the objective can be achieved by opening branches at far-flung places. Retail trade expansion is possible through branches at distant places.

16.2 Types of Branches

On the basis of location branches are divided in two parts:-

(a) Inland Branches i.e. branches situated within country.

(b) Foreign Branches i.e. branches situated outside country.

As branches, whether inland or foreign, are essentially a part of Head Office (HO), total results of HO cannot be ascertained without clubbing it with branch results. The branch results consist of two parts, namely, profit/loss made by the branch and their assets and liabilities at the end of the year. The main problem is of ascertaining the branch results and presentation of consolidated accounts to the end users. On the basis of accounting procedures, for determination of branch results and preparation of consolidated results, the branches are divided in two categories:

(a) Dependent branches: These are branches, which depend upon the HO for ascertainment of their results of operation because they do not maintain their own set of books. In other words, the HO maintains the accounts of branches and branches do not maintain accounts. Branches keep record of transactions relevant for their activities such as debtors, stock position, cash etc. The HO may follow any of the following methods to know the results of branch:

(i) Debtor method
(ii) Stock and Debtor method
(iii) Final Account method
(iv) Wholesale Price method

The most important thing to note is that accounts of branch are maintained in the books of HO, under all the above stated method.

(b) Independent branches: These are branches which maintain their own set of accounting books and hence are in a position to extract trial balance and to ascertain their results. However, autonomy is only with regard to the maintenance of accounting books. As far as their operations are concerned, both dependent and independent branch are completely dependent on the HO. All major policy decisions are taken by the HO. Goods are supplied by HO and cash collected by branch is remitted to the HO. Thus, division of branches into dependent and independent depends solely on the accounting procedures followed for determination of branch results. The accounting problem in such cases is of incorporating the trial balance of branch in the books of HO at the end of the accounting year to prepare consolidated accounts.

Activity A:
Do you agree that division of branches depends solely on the accounting procedure followed? Explain.

16.3 Accounting for Dependent Branches

These branches do not maintain complete accounting records. All accounting is done by Head Office (HO). Branches maintain few memorandum books i.e. for register and petty expenses records. Dependent branches have following characteristics:

(i) Such branches sell goods received from HO.

(ii) Such branches do not purchase goods from market.

(iii) Goods are generally sent to branch at cost and sometimes at invoice price.

(iv) Such branches sell goods for cash only and on credit if permitted by HO.

(v) Routine expenses e.g. staff salary, rent, advertisement expenses etc. are paid by HO. Branch pays only for petty expenses.

(vi) Branch does not determine its profit/loss.

However it is important to note that HO records any those transactions which have taken place between HO and branch. HO do not record for independent transactions of branch e.g. sale of goods of branch, bad-debts and commission to debtors, goods returned from customers, cash from customers etc.

Activity B:
Narrate three main characteristics of dependent branch.

In case of dependent branches H.O. uses following methods for accounting:

(A) Debtors Method (B) Stock and Debtors Method

(C) Final Account Method (D) Whole Sale Price Method

Accounting treatment under above methods are as under:

(A) Debtors Method: In this method H.O. maintains each branch account in its books. It is prepared like a consignment account / nominal account. The scheme of journal entries are as under in books of H.O.

1. On sending goods -

    Branch a/c Dr.

        To Goods sent to Branch a/c

2. On payment of branch expenses / for sending petty cash -

    Branch a/c Dr.

        To Bank a/c

3. Petty expenses incurred by branch -

    No entry

4. On sale of goods by branch (for cash/credit)

    No entry

5. On receiving cash from branch -

    Bank a/c Dr.

        To Branch a/c

6. On return of goods by branch -

    Goods sent to Branch a/c Dr.

        To Branch a/c

7. For discount to customer or Bad-debts -

    No entry

8. For goods returned by customers

    No entry

9. For stock, assets with branch at year end -

    Branch stock a/c Dr.

    Branch debtors a/c Dr.

    Branch petty cash a/c Dr.

    Branch asset (Furniture) a/c Dr.

        To Branch a/c

10. For Liability of branch at year end -

    Branch a/c Dr.

        To Branch liabilities a/c

11. For profit -

    Branch a/c Dr.

        To General P&L a/c

12. For Loss -

    General P&L a/c Dr.

        To Branch a/c

13. For closing goods sent to branch are -

    Goods sent to branch a/c Dr.

        To purchases a/c (In trading concern)

        or

        To Trading a/c (In manufacturing concern)

Note: In beginning of next year Branch assets/liabilities will be recorded as opening balances in branch a/c.

A specimen of Branch a/c is given below:

In the Books of H.O.

Dr. **Branch a/c** Cr.

To Balance B/d:		By Goods sent to branch	–
Branch stock	–	By Bank (Receipts)	–
Branch debtors	–	By Balance C/d:	
Branch petty cash	–	Branch stock	–
Branch asset	–	Branch debtors	–
To Goods sent to branch	–	Branch petty cash	–
To Bank (expenses)	–	Branch asset	–
To General P&L a/c (profit)	–	By General P&L a/c (Loss)	–

> **Activity C:**
> List any three transactions for which no entry is made in books of H.O.

Illustration 1 (Branch selling only for cash)

An oil mill at Jaipur had a branch at Udaipur. Following are the transactions between the Head Office and the Branch for the year ending 31st March, 2010:-

		Rs.
Stock on 1-4-2009		50,000
Goods Supplied to Branch		2,00,000
Cash sent to Branch:		
Rent	2,000	
Salaries	8,000	10,000
Goods Returned by Branch		24,000
Cash Sales		2,50,000
Stock on 31-3-2010		40,000

Other Information:

(i) The goods are sent to the branch at cost price.

(ii) It is arranged that the branch will deposit daily all cash received into the H.O. A/c in a local bank and necessary advice will be sent to the H.O.

Pass necessary Journal entries and prepare Udaipur Branch Account in the books of Head Office showing the profit/Loss of the branch.

Solution: **Journal (Head Office)**

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
2009	Udaipur Branch A/c	Dr.		50,000	
April 1	To Branch Stock A/c				50,000
	(Being opening Stock brought forward)				
2010	Udaipur Branch A/c	Dr.		2,00,000	
March 31	To Goods sent to Branch A/c				2,00,000
	(Being Goods sent to Branch)				
March 31	Udaipur Branch A/c	Dr.		10,000	
	To Bank A/c				10,000
	(Being Branch expenses paid)				

March 31	Bank A/c	Dr.	2,50,000	
	To Udaipur Branch A/c			2,50,000
	(Being amount deposited by branch in to H.O.'s Bank A/c)			
March 31	Goods sent to Branch A/c	Dr.	24,000	
	To Udaipur Branch A/c			24,000
	(Being goods returned by branch)			
March 31	Branch Stock A/c	Dr.	40,000	
	Udaipur Branch A/c			40,000
	(Being closing stock with the branch)			
March 31	Udaipur Branch A/c	Dr.	54,000	
	To General P&L A/c			54,000
	(Being net profit of branch)			
March 31	Goods sent to Branch A/c	Dr.	1,76,000	
	To Trading A/c			1,76,000
	(Being goods sent to Branch A/c closed)			

Udaipur Branch A/c

2009	Particulars	Rs.	2010	Particulars	Rs.
April 1	To Branch Stock A/c	50,000	Mar.31	By Bank A/c	2,50,000
2010					
Mar. 31	To Goods sent to Branch A/c	2,00,000	Mar. 31	By Goods sent to Branch A/c	24,000
Mar. 31	To Bank A/c (Expenses paid)	10,000	Mar. 31	By Branch Stock A/c	40,000
Mar. 31	To General P&L A/c	54,000			
		3,14,000			**3,14,000**

Working Note : Goods sent to Branch A/c

Particulars	Rs.	Particulars	Rs.
To Udaipur Branch A/c (Goods Returned)	24,000	By Udaipur Branch A/c (Good sent)	2,00,000
To Trading A/c	1,76,000		
	2,00,000		**2,00,000**

When branch sells both for cash and credit and goods are sent to branch at cost:

In this case if balance of branch debtors at beginning / at end is not given than branch debtor a/c is to be prepared as under to find out missing figure.

Branch Debtors a/c

To Balance b/d (B.F. if any)	–	By Cash	–
To Sales (Credit)	–	By Sales return	–
To B/R dishonoured	–	By Discount / Bad-debts	–
		By B/R	–
		By Balance c/d (B.F. if any)	–

Illustration 2 (Branch selling for cash and credit)

Shyam General Stores of Delhi has a branch at Agra which is supplied with all goods from the head office at cost. The Branch Manager keeps his own sales ledger and deposits daily in local bank all his receipts from cash and credit sales in the head office account. The branch expenses are remitted regularly by cheques from the H.O. on the imprest system.

From the particulars given below, prepare Agra Branch account in the books of Head office.

	Rs.
Branch Stock on 1-4-2009	14, 400
Branch Furniture on 1-4-2009	20,000
Branch Debtors on 1-4-2009	24,600
Petty Cash with the Branch on 1-4-2009	400
Transactions during the year:	
Goods Supplied to Branch	44,000
Cash Sales	24,000
Credit Sales	48,000
Cash received from debtors	45,000
Returns Inward	1,000
Bad debts of the Branch	1,200
Rent, Rates and Taxes	7, 000
Wages and Salaries	7, 600
Petty Expenses	600
Branch Stock on 31-3-2010	22,400
Petty Cash with the Branch on 31-3-2010	400

Depreciation on Branch Furniture is to be charged @ 10% p.a.

Solution:

Books of Head Office - Agra Branch Account for the year ending 31st March, 2010

2009				2010			
April 1	To Balance b/d						
	Branch Stock	14,400		Mar. 31	By Bank a/c :		
	Branch Furniture	20,000			Cash Sales	24,000	
	Branch Debtors	24,600			Cash from Debtors	45,000	69,000
	Branch Petty cash	400	59,400				
2010				Mar. 31	By Balance c/d :		
Mar. 31	To Goods Sent to				Branch Stock	22,400	
	Branch a/c		44,000		Branch Furniture	18,000	
"	To Bank a/c :				Branch Debtors	25,400	
	Rent, Rates and taxes	7,000			Branch petty cash	400	66,200
	Wages and Salaries	7,600					
	Petty Exps.	600	15, 200				
"	To P&L a/c (Profit)		16,600				
			1,35,200				**1,35,200**

Working Note:

1. Furniture is shown after 10% depreciation (20,000 - 2,000) = 18,000.
2. No record by H.O. for credit sales, sales returns and bad-debts.
3. Balance of Branch debtors is determined as under:

Branch Debtors A/c

Particulars	Rs.	Particulars	Rs.
To Balance b/d	24,600	By Cash received	45,000
To Sales	48,000	By Returns	1,000
		By Bad debts	1,200
		By Balance c/d (B/F)	25,400
	72,600		**72,600**

Activity D:
Prepare a Branch Debtors a/c with imaginary figures.

When goods are sent to Branch at invoice price (i.e. at cost + loading)

Generally in this case all transactions will be recorded at invoice price in branch a/c. To ascertain true profit/loss branch a/c is to be brought at cost to H.O. The adjustment entries for this will be as under:

(i) For loading in opening stock -

Branch stock adjustment a/c Dr.

To Branch a/c

(ii) For loading in goods sent to branch (net of return from branch) -

Goods sent to Branch a/c Dr.

To Branch a/c

(iii) For loading in closing stock -

Branch a/c Dr.

To Branch stock adjustment a/c

Illustration 3 (Goods sent to branch at invoice price)

Gupta Bros. of Jaipur have their branch at Jodhpur and they charge all goods sent to branch at cost plus 25%. It is arranged that all cash received by the Branch is to be deposited in their Bank Account at Central Bank, Jodhpur. All branch expenses are to be paid by the Head office.

From the following information, prepare Branch Account in the Head office books for the year ending 31st March 2010.

	Rs.
Stock at branch on 1st April 2009	45,000
Goods sent to Branch	3,00,000
Cash Sales	2,25,000
Credit Sales	1,62,500
Cash received from debtors	75,000
Goods returned by branch	75,000
Sales return	7,500
Discount and Allowances to customers	3,500
Bad debts	1,500
Branch Rent, Taxes and Rates	12,000
Other Expenses	18,000
Branch debtors on 1st April 2009	37,500
Branch debtors on 31st March 2010	1,12,500
Stock at Branch on 31st March 2010	55,500

Solution:

In the Books of H.O. Jodhpur Branch A/c
for the year ended 31st March, 2010

Particulars		Rs.	Particulars		Rs.
To Balance b/d			By Bank A/c		
Stock	45,000		Cash Sales	2,25,000	
Debtors	37,500	82,500	Received from Drs.	75,000	3,00,000
To Goods sent to Branch a/c		3,00,000	By Goods sent to Branch A/c		
To Bank a/c :			(Goods returned)		75,000
Rent, Rates and Taxes	12,000		By Stock Reserve (Adjustment)		9,000
Other Expenses	18,000	30,000	By Goods sent to Branch A/c		60,000
To Goods sent to Branch		15,000	(Adjustment)		
(Adjustment)			By Balance c/d		
To Stock Reserve		11,100	Stock	55,500	
To Profit Transferred to			Debtors (1)	1,12,500	1,68,000
General P&L A/c		1,73,400			
		6,12,000			**6,12,000**

Working Note:

1. Debtors balance is determined as under:

Branch Debtors A/c

	Rs.		Rs.
To Balance b/d	37,500	By Cash	75,000
To Sales (Credit)	1,62,500	By Sales Returns	7,500
		By Discount and Allowances	3,500
		By Bad Debts	1,500
		By Balance c/d (B/F)	1,12,500
	2,00,000		**2,00,000**

(B) Stock and Debtors Method

When goods is sent to branch at invoice price and branch is selling for cash and credit both then to record all transactions relating to Branch in books of H.O. an alternative method may be used known as stock and debtors method. In this method H.O. maintains following accounts relating to branch in its books:

(i) Branch stock a/c
(ii) Goods sent to branch a/c
(iii) Branch debtors a/c
(iv) Branch expenses a/c
(v) Branch stock reserve a/c
(vi) Branch adjustment a/c (P&L a/c)

Scheme of Journal entries (H.O. Books)

To record transactions in books of H.O. the entries in this method will be as under:

1. For sending goods to branch –
   Branch stock a/c Dr.
   To Goods sent to branch a/c (at Invoice price)
2. For return of goods from branch -
   Goods sent to branch a/c Dr. (at Invoice price)
   To Branch stock a/c
3. For cash sales by branch -
   Bank a/c Dr.
   To Branch stock a/c
4. For credit sales by branch -
   Branch debtors a/c Dr.
   To Branch stock a/c
5. For return by customers -
   Branch stock a/c Dr.
   To Branch debtors a/c
6. For receipts from debtors -
   Cash / Bank a/c Dr.
   To Branch debtors a/c
7. For discount allowed or bad-debts -
   Branch expenses a/c Dr.
   To Branch debtors a/c
8. For payment of branch expenses -
   Branch expenses a/c Dr.
   To Cash/Bank a/c

9. For loading in goods sent to branch -
Goods sent to branch a/c Dr.
To Branch adjustment a/c
10. For loading in stock at end -
Branch adjustment a/c Dr.
To Branch stock reserve a/c
11. For transfer of branch expenses at end -
Branch adjustment a/c Dr.
To Branch expenses a/c
12. For Closing Goods sent to branch a/c -
Goods sent to Branch a/c Dr.
To Purchases / Trading a/c
13. For profit at Branch -
Branch adjustment a/c Dr.
To P&L a/c

Note: At year end balances of branch stock a/c, branch debtors a/c and branch stock reserve a/c are to be carried forward.

Illustration 4 (Stock and Debtors Method)

The Royal Motors of Jaipur has retail branch at Rewari. The goods are invoiced to the branch at selling price which is obtained by adding 25% on cost. All Expenses are paid by the Head Office. The particulars are as follows.

	Rs.		Rs.
Balance On 1.4.2009		Branch Expenses paid by the H.O.	
Stock	50,000	Rent	9,600
Debtors	18,000	Salaries	50,500
Goods sent to Branch	7,50,000	Misc. Expenses	3,000
Cash Sales	30,000	Discount allowed to debtors	5,000
Stock Reserve Account	10,000	Bad Debts	1,000
Goods returned by Branch	10,000	Balance on 31.3.2010	
Credit Sales	6,80,000	Stock	83,000
Cash received from Debtors	6,50,000	Debtors	37,000
Goods returned by Debtors	5,000		

You are required to journalise the above transactions and show necessary accounts.

Solution:

In the books of H.O. Journal Entries

			Rs.	Rs.
2009	Branch Stock Reserve A/c	Dr.	10,000	
April 1	To Branch Adjustment A/c			10,000
	(Being adjustment in the value of Opening Stock made)			
2010	Branch Stock A/c	Dr.	7,50,000	
	To Goods sent to Branch A/c			7,50,000
	(Being goods sent to Branch)			
Mar. 31.	Goods sent to Branch A/c	Dr.	10,000	
	To Branch Stock A/c			10,000
	(Being Goods returned from the Branch)			

Mar. 31.	Bank A/c	Dr.	30,000	
	To Branch Stock A/c			30,000
	(Being cash sales)			
Mar. 31	Branch Debtors A/c	Dr.	6,80,000	
	To Branch Stock A/c			6,80,000
	(Being Credit Sales 6,80,000)			
Mar. 31.	Branch Stock A/c	Dr.	5,000	
	To Branch Debtors A/c			5,000
	(Being Goods returned by Customers)			
Mar. 31.	Bank A/c	Dr.	6,50,000	
	To Branch Debtors A/c			6,50,000
	(Being Cash collected from Debtors)			
Mar. 31.	Branch Expenses A/c	Dr.	6,000	
	To Branch Debtors A/c			6,000
	(Being Discount allowed Rs. 5,000 and Bad debts w. off Rs. 1,000)			
Mar. 31.	Branch Expenses A/c	Dr.	63,100	
	To Bank A/c			63,100
	(Being Branch Expenses paid)			
Mar. 31.	Branch Adjustment A/c	Dr.	69,100	
	To Branch Expenses A/c			69,100
	(Being balance of Branch Expenses A/c transferred)			
Mar. 31.	Branch Adjustment A/c	Dr.	2,000	
	To Branch Stock A/c			2,000
	(Being Loss of Stock trans. to Branch Adj. A/c)			
Mar. 31	Goods sent to Branch A/c	Dr.	1,48,000	
	To Branch Adjustment A/c			1,48,000
	(Being Loading in the value of goods sent to Branch)			
Mar. 31.	Goods sent to Branch A/c	Dr.	5,92,000	
	To Trading A/c			5,92,000
	(Being balance of goods sent to Branch A/c transferred)			
Mar. 31.	Branch Adjustment A/c	Dr.	16,600	
	To Branch Stock Reserve A/c			16,600
	(Being adjustment in closing stock)			
Mar. 31.	Branch Adjustment A/c	Dr.	70,300	
	To General P&L A/c			70,300
	(Being balance of Branch Adj. A/c transferred)			

Ledger Accounts
In the Books of H.O. (Jaipur)
Branch Stock Account

2009		Rs.	2010		Rs.
April 1	To Balance B/d	50,000	Mar. 31.	By Goods sent to Branch a/c	10,000
2010			Mar. 31.	By Cash a/c	30,000
Mar. 31.	To Goods sent to Branch a/c	7,50,000	Mar. 31.	By Branch Debtors a/c	6,80,000
Mar. 31.	To Branch Debtors a/c	5,000	Mar. 31.	By Branch Adj. a/c	2,000
			Mar. 31.	By Balance c/d	83,000
		8,05,000			**8,05,000**

Branch Debtors Account

		Rs.			Rs.
2009		Rs.	2010		Rs.
April 1	To Balance b/d	18,000	Mar. 31.	By Branch Stock a/c	5,000
2010			Mar. 31.	By Cash a/c	6,50,000
Mar. 31	To Branch stock a/c	6,80,000	Mar. 31.	By Branch Exp. a/c	5,000
			Mar. 31.	By Branch Exp. a/c	1,000
			Mar. 31.	By Balance c/d	37,000
		6,98,000			**6,98,000**

Goods sent to Branch Account

2010		Rs.	2010		Rs.
Mar. 31	To Branch Stock a/c	10,000	Mar. 31	By Branch Stock a/c	7,50,000
Mar. 31.	To Branch Adj. a/c	1,48,000			
Mar. 31.	To Trading a/c	5,92,000			
		7,50,000			**7,50,000**

Branch Expenses Account

2010		Rs.	2010		Rs.
Mar. 31.	To Branch Debtors a/c	5,000	Mar. 31.	By Branch Adj. a/c	69,100
Mar. 31.	To Branch Debtors a/c	1,000			
Mar. 31.	To Cash a/c				
	(9,600 + 50,500 + 3,000)	63,100			
		69,100			**69,100**

Branch Adjustment Account

2010		Rs.	2009		Rs.
Mar. 31.	To Branch Exps. a/c	69,100	April 1.	By Stock Reserve a/c (Opening)	10,000
Mar. 31.	To Branch Stock a/c	2,000	2010		
Mar. 31.	To Stock Reserve a/c (Closing)	16,600	Mar. 31.	By Goods sent to Branch a/c	1,48,000
Mar. 31.	To P & L a/c	70,300			
		1,58,000			**1,58,000**

Stock Reserve Account

2010		Rs.	2010		Rs.
Mar. 31.	To Branch Adj. a/c	10,000	April 1.	By Balance b/d	10,000
Mar. 31.	To Balance c/d	16,600	2005		
			Mar. 31.	By Branch Adj. a/c	16,600
		26,600			**26,600**

(C) Final Accounts Method

In this method in place of Branch a/c, Branch Trading and P&L a/c is prepared to ascertain profit/ Loss. Branch a/c will appear as under showing amount receivable from branch (i.e. as personal a/c):

To Opening balance:		By Opening balance:	
Stock	–	Creditors	–
Debtors	–	Outstanding expenses	–
Petty cash	–	By Goods sent to branch (Return)	–
Furniture	–	By Cash / Bank	–
Prepared expense	–	By Branch Loss (from P&L a/c)	–
To Goods sent to branch	–	By Balance c/d (Due from branch)	–
To Cash sent to branch	–		
To Branch profit (from P&L a/c)	–		

Note: Balance in branch a/c will be equal to :

(i) Assets minus liabilities with branch.

(ii) Branch Trading and P&L a/c is prepared as memorandum a/c to find out profit/loss of branch. i.e. not based on double entry basis.

Illustration 5

Indore head office sends goods to its Kota Branch at selling price which is ascertained by adding 25% in cost. Branch keeps sales ledger only. All transactions are recorded in the books of Head Office. From the following information in relation to Kota Branch prepare Branch trading and Profit and Loss a/c and Kota Branch a/c in the books of the H.O. for the year ended 31st March, 2010.

	Rs.		Rs.
Opening stock	20,000	Goods returned to H.O.	4,000
Closing stock	32,000	Cash received from debtors	89,600
Goods sent to Branch	1,00,000	Branch Expenses paid by H.O.	10,000
Cash sales	9,600	Debtors at the end	8,000
Credit sales	84,000	Write off furniture at the rate of 10%	
Furniture purchased by H.O. for branch	4,000		

All cash collected by the Branch from cash sales and debtors is deposited in the H.O. Account in a local bank.

Solution:

Books of H.O. (Indore)

Branch Trading and Profit and Loss a/c for the year ending 31st March 2010

	Rs.			Rs.
To Opening stock $\left(20,000 \times \frac{100}{125}\right)$	16,000	By Sales :		
To Goods sent to Branch less returns to H.O.		Cash	9,600	
		Credit	84,000	93,600
		By Closing Stock		25,600
$\left\{(1,00,000 - 4,000) \times \frac{100}{125}\right\}$	76,800	$\left(32,000 \times \frac{100}{125}\right)$		
To Gross Profit c/d	26,400			
	1,19,200			**1,19,200**
To Branch Expenses	10,000	By Gross Profit b/d		26,400
To Depreciation on furniture	400			
To Net profit		16,000		
	26,400			**26,400**

Kota Branch Account for the year ended 31st March 2010

		Rs.			Rs.
To Balance b/d			By Goods sent to branch a/c		3,200
Stock	16,000		$\left(4,000 \times \frac{100}{125}\right)$		
Debtors	13,600	29,600	By Bank a/c		
To Goods sent to branch a/c		80,000	Cash sales	9,600	
$\left(1,00,000 \times \frac{100}{125}\right)$			Receipts from debtors	89,600	99,200
To Bank a/c			By Balance c/d		37,200
Furniture	4,000				
Expenses	10,000	14,000			
To P & L a/c (Profit)		16,000			
		1,39,600			**1,39,600**

Working Note -

1. Branch debtors opening balance is ascertained as under:

Branch Debtors A/c

To Balance b/d (B.F.)	13,600	By Cash	89,600
To Sales (Credit)	84,000	By Balance (Given) c/d	8,000
	97,600		**97,600**

(D) Wholesale Price Method

Under this method the concept of branch profit is modified. Under three methods studied earlier profit was recognised as selling price minus cost to H.O. of goods supplied. But under this method profit is divided in two parts –

(i) Profit of H.O. = whole sale price – cost to H.O.

(ii) Profit of Branch = selling price – wholesale price.

The goods are supplied to branch at wholesale price. The cost to branch is treated as wholesale price. The rational for doing this is that branch. Credit for only profit equal to retail price minus wholesale price, lies in effective economic contribution made by the branch to H.O., as H.O. always has the option to sale on wholesale price.

The point to be noted is that memorandum Trading and P&L a/c is prepared on wholesale price basis. Branch a/c is opened in books of H.O. like a personal a/c. As excess of wholesale price over cost to H.O. i.e. loading is taken as profit of H.O. The loading on opening and closing stock are removed in the H.O. Trading and P&L a/c with the help of following entries as it represents unrealised profit/portion of the loading on goods supplied:

H.O. Trading and P&L a/c Dr. (For loading on closing stock)
To Stock Reserve a/c

Stock Reserve a/c Dr. ((For loading on opening stock)
To H.O. Trading and P&L a/c

Note: The final balance in Branch a/c must be same as final net assets to check the accuracy of the accounts prepared.

Illustration 6 (Goods supplied at wholesale price):

A Head Office sends goods to its branch at cost plus 80%. Goods are sold to customers at cost plus 100%. However sales at H.O. are made at wholesale price. From the following particulars find out profit made by H.O. and branch on wholesale price basis:

	H.O.	**Branch**
Opening stock	20,000	-
Purchases	2,00,000	-
Goods sent to branch (at invoice price)	90,000	-
Sales	2,70,000	90,000
Expenses	10,000	4,000

Solution:

Let cost be 100 then invoice (wholesale) price to 180 and list (selling) price is 200.

H.O. Trading and P&L a/c

To Opening Stock	20,000	By Goods sent to Branch	90,000
To Purchases	2,00,000	By Sales	2,70,000
To G.P. c/d	1,60,000	By Closing Stock	20,000
	3,80,000		**3,80,000**
To Stock reserve $\left(90,000 \times \frac{80}{180}\right)$	4,000	By G.P. b/d	1,60,000
To Expenses	10,000		
To N.P. c/d	1,46,000		
	1,60,000		**1,60,000**

Working Note: Calculation of Closing Stock at H.O.:

Cost of goods for sale = 20,000 + 2,00,000 = 2,20,000

Less: Cost of goods sent to branch $\left(90,000 \times \frac{100}{180}\right)$ = 50,000

= 1,70,000

Less: Cost of goods sent by H.O. $\left(2,70,000 \times \frac{100}{180}\right)$ = 1,50,000

= **20,000**

Memorandum Branch Trading and P&L a/c

To Goods from H.O.	90,000	By Sales	90,000
To G.P. c/d	9,000	By Closing Stock	9,000
	99,000		**99,000**
To Expenses	4,000	By G.P. b/d	9,000
To Net Profit c/d	5,000		
	9,000		**9,000**

Working:

Calculation of closing stock at branch:

Cost of goods for sale = 90,000

Less: Cost of goods sold $\left(90,000 \times \frac{180}{200}\right)$ = 81,000

Stock = 9,000

16.4 Accounting for Independent Branches

Such branches generally trade on large scale. These branches are authorised to purchase directly from market. Such branches keep complete record of all transactions on double entry system. H.O. a/c appears in place of capital a/c in books of branch. H.O. maintains branch a/c in its books and transaction between H.O. and Branch balance shows amount receivable or payable to H.O. Branch prepares its trial balance and final accounts as usual.

Incorporation of items of branch trial balance in the books of H.O.

To ascertain profit/Loss of branch, trial balance of branch is to be incorporated in H.O. books. After incorporation H.O. prepare branch Trading and P&L a/c to find out branch profit/Loss.

(A) Incorporation of all items:

For incorporation the Journal entries are as follows:

1. For incorporating debit balances -

   Branch Items a/c Dr.

   To Branch a/c

2. For incorporating credit balances -

   Branch a/c Dr.

   To Branch Items a/c

   Note: After above entries Branch a/c in H.O. books will balance.

3. For revenue items of Dr. balances -

   Branch Trading and P&L a/c Dr.

   To Branch Items a/c

4. For revenue items of Cr. balances -

   Branch Items a/c Dr.

   To Branch Trading and P&L a/c

Note: Real and personal a/c balances i.e. assets and liabilities will appear in consolidated B/S of H.O.

Illustration 7 (Incorporation of all items)

The Madras Branch of Hindustan Metal Co. Ltd. Kolkata sent the following Trial Balance to its Head office on 31st March 2010.

Trial Balance of Madras Branch as on 31st March 2010

Particulars	Dr. Amount Rs.	Cr. Amount Rs.
Opening Stock	22,500	–
Purchases	6,69,500	–
Goods from H.O.	3,40,000	–
Goods returned to H.O.	–	22,500
Sales	–	11,27,500
Wages and Salaries	55,000	–
Bad debts	7,500	–
General expenses	40,000	–
Rent and Rates	5,000	–
Cash in hand	62,500	–
Sundry Debtors	1,20,000	–
Furniture and Fixtures	19,000	–
Sundry Creditors	–	86,000
Head Office Account	–	1,05,000
Total	**13,41,000**	**13,41,000**

The Closing Stock with the Branch was worth Rs. 52,000. The H.O. incorporates and opens ledger accounts for each item of Branch Trial balance. Pass incorporation entries in the books of H.O. Also give closing entries and prepare Branch Trading and Profit and Loss a/c for the year ended 31st March, 2010. How would Madras Branch a/c appear on 1st April 2010?

Solution: **Journal of Head Office**

Date	Particulars		Dr. Amount	Cr. Amount
2010			Rs.	Rs.
Mar. 31	Branch Opening Stock a/c	Dr.	22,500	
	Branch Purchases a/c	Dr.	6,69,500	
	Goods from H.O. a/c	Dr.	3,40,000	
	Branch Wages and Salaries a/c	Dr.	55,000	
	Branch Bad Debts a/c	Dr.	7,500	
	Branch General Expenses a/c	Dr.	40,000	
	Branch Rent and Rates a/c	Dr.	5,000	
	Branch Cash a/c	Dr.	62,500	
	Branch Sundry Debtors a/c	Dr.	1,20,000	
	Branch Furniture and Fixtures a/c	Dr.	19,000	
	To Madras Branch a/c			13,41,000
	(Being debit balance of Madras Branch Incorporated)			
Mar. 31.	Madras Branch a/c	Dr.	12,36,000	
	To Goods Returned to H.O. a/c			22,500
	To Branch Sales a/c			11,27,500
	To Branch Sundry Creditors a/c			86,000
	(Being credit balances of Madras Branch incorporated)			
Mar 31.	Branch Trading a/c	Dr.	10,87,000	
	To Branch Opening Stock a/c			22,500
	To Branch Purchases a/c			6,69,500
	To Goods from H.O. a/c			3,40,000
	To Branch Wages and Salaries a/c			55,000
	(Being balances transferred to close the accounts)			
Mar. 31	Goods returned to H.O. a/c	Dr.	22,500	
	Branch Sales a/c	Dr.	11,27,500	
	To Branch Trading a/c			11,50,000
	(Being balances transferred to close the accounts)			
Mar. 31.	Branch Closing Stock a/c	Dr.	52,000	
	To Branch Trading a/c			52,000
	(Being branch closing stock taken into books)			
Mar. 31.	Branch Trading a/c	Dr.	1,15,000	
	To Branch P & L a/c			1,15,000
	(Being branch Gross Profit transferred)			
Mar. 31.	Branch P & L a/c	Dr.	52,500	
	To Branch Bad Debts a/c			7,500
	To Branch General Expenses a/c			40,000
	To Branch Rent and Rates a/c			5,000
	(Balance transferred to close the accounts)			
Mar. 31.	Branch P & L a/c	Dr.	62,500	
	To H.O. P & L a/c			62,500
	(Being Branch Net Profit transferred)			

Branch Trading and Profit and Loss Account
for the year ended 31st March, 2010

	Rs.		Rs.
To Opening Stock	22,500	By Goods returned to H.O.	22,500
To Purchases	6,69,500	By Sales	11,27,500
To Goods from H.O.	3,40,000	By Closing Stock	52,000
To Wages and Salaries	55,000		
To Gross Profit c/d	1,15,000		
	12,02,000		**12,02,000**
To Bad Debts	7,500	By Gross Profit b/d	1,15,000
To General Expenses	40,000		
To Rent and Rates	5,000		
To P & L a/c (H.O.)	62,500		
	1,15,000		**1,15,000**

On 1st April 2010 Branch are will appear as under in H.O. Banks :-

Madras Branch Account

2010		Rs.	2010		Rs.
April 1	To Branch Cash a/c	62,500	April 1	By Branch Sundry Creditors a/c	86,000
April 1	To Branch Sundry Debtors a/c	1,20,000			
April 1	To Branch Furniture and Fixture a/c	19,000			
April 1	To Branch Stock a/c	52,000			

(B) Incorporation of Profit etc.:

Under this method any profit of branch and assets and liabilities are incorporated. The entries are as under:

1. For branch profit -
   Branch a/c Dr.
   To General P&L a/c
2. For branch Loss -
   General P&L a/c Dr.
   To Branch a/c
3. For branch assets -
   Branch assets a/c Dr.
   To Branch a/c
4. For branch liabilities -
   Branch a/c Dr.
   To Branch liabilities a/c

Note: H.O. a/c balance is not to be incorporated as it already appears as branch a/c in H.O. books. Opening entry will be reversed at beginning of year.

Sometimes after incorporation of assets and liabilities branch a/c do not balance. It means there is cash or goods is in transit i.e. cash remitted by branch but not yet received by H.O. or Goods despatched by H.O. but not yet received by branch. To record such items the following entry is to be passed in H.O. books –

Cash in Transit a/c Dr.
Goods in Transit a/c Dr.
To Branch a/c

Similarly if branch is using any fixed asset and fixed asset a/c is maintained by H.O. then depreciation is to be recorded by making following entries –

Branch depreciation a/c Dr.
    To Branch fixed asset a/c
Branch P&L a/c Dr.
    To Branch depreciation a/c

Illustration 8

The Chennai Branch of Hindustan Metal Co. Ltd. Kolkata sent the following Trial Balance to its head office prepared on 31st March 2010.

Trial Balance of Chennai Branch as on 31st March 2010

Particulars	Dr. Amount Rs.	Cr. Amount Rs.
Cash in hand	62,500	
Sundry Debtors	1,20,000	
Furniture and Fixtures	19,000	
Sundry Creditors		86,000
Head Office Account		1,05,000
Stock (Closing)	52,000,	
Profit and Loss Account (Profit for the year)		62,500
Total	**2,53,500**	**2,53,500**

Pass necessary journal entries for incorporation and prepare Chennai Branch a/c in the books of the H.O.

Solution: **Journal of Head Office**

			Dr. Amount	Cr. Amount
2010			Rs.	Rs.
Mar 31	Chennai Branch a/c	Dr.	62,500	
	To P & L (H. O.) a/c			62,500
	(Being Net Profit as shown by Branch P & L a/c transferred to H.O. P & L a/c)			
Mar. 31	Branch Cash a/c	Dr.	62,500	
	Branch Sundry Debtors a/c	Dr.	1,20,000	
	Branch Furniture and Fixtures a/c	Dr.	19,000	
	Branch Stock a/c	Dr.	52,000	
	To Chennai Branch a/c			2,53,500
	(Being branch assets incorporated in the books of H.O.)			
Mar. 31	Chennai Branch a/c	Dr.	86,000	
	To Branch Sundry Creditors a/c			86,000
	(Being Branch Sundry Creditors incorporated in the books of H.O.)			

Ledger of Head Office
Chennai Branch Account

2010		Rs.	2010		Rs.
Mar. 31	To Balance b/d	1,05,000	Mar. 31	By Branch Cash a/c	62,500
Mar. 31	To (H.O.) P and L a/c	62,500	Mar. 31	By Branch Sundry Debtors a/c	1,20,000
Mar. 31	To Branch Sundry Creditors a/c	86,000	Mar. 31	By Branch Furniture and Fixtures a/c	19,000
			Mar. 31	By Branch Stock a/c	52,000
		2,53,500			**2,53,500**

> **Activity E:**
> Pass Opening entry in H.O. books to incorporate assets and liabilities of branch.

To prepare combined P&L a/c and B/S

To know overall performance of H.O. and branches a combined P&L a/c and B/S are prepared and presentation may be in column form as under.

Illustration 9

The following is the Trial Balance of Mewar Cables Ltd. and its Rajkot Branch for the year ended 31st March 2010.

Trial Balance as on 31st March 2010

Particulars	Head Office		Rajkot Branch	
	Dr. (Rs.)	Cr. (Rs.)	Dr. (Rs.)	Cr. (Rs.)
Opening Stock	75,000	–	24,000	–
Purchases and Sales	3,60,000	5,10,000	–	1,27,500
Goods to Branch (from H.O.)	–	81,000	81,000	–
Goods returned from Branch (to H.O.)	3,000	–	–	3,000
Sales returns	21,000	–	9,000	–
Salaries	60,000	–	7,500	–
Rent	9,000	–	5,400	–
Expenses and Commission	36,000	–	2,700	–
Bad debts	4,500	–	900	–
Discount	6,000	–	600	–
Capital	–	1,80,000	–	–
Fixed Assets	45,000	–	–	–
Creditors	–	75,000	–	–
Debtors	1,80,000	–	33,000	–
Bank and Cash Balance	10,800	–	2,100	–
Rajkot Branch Account	35,700	–	–	–
Head Office Account	–	–	–	35,700
	8,46,000	8,46,000	1,66,200	1,66,200
Closing Stock	**90,000**		**30,000**	

Pass necessary incorporation entries in the books of the Head Office after preparing the Trading and Profit and Loss of the Head Office and Branch in column form. Also give a Combined Balance Sheet as on 31st March 2010.

Solution:

Books of Head Office
Combined Trading and Profit and Loss Account
for the year ended 31st March, 2010

Particulars	H.O. Rs.	Branch Rs.	Total Rs.	Particulars	H.O. Rs.	Branch Rs.	Total Rs.
To Opening Stock	75,000	24,000	99,000	By Sales (Less Returns)	4,89,000	1,18,500	6,07,500
To Purchases	3,60,000	–	3,60,000	By Goods to Branch (Net)	78,000	–	78,000
To Goods from H.O. (Net)	–	78,000	78,000	By Closing Stock	90,000	30,000	1,20,000
To G.P. c/d	2,22,000	46,500	2,68,500				
	6,57,000	**1,48,500**	**8,05,500**		**6,57,000**	**1,48,500**	**8,05,500**
To Salaries	60,000	7,500	67,500	By Gross Profit b/d	2,22,000	46,500	2,68,500
To Rent	9,000	5,400	14,400				
To Exps. and Commission	36,000	2,700	38,700				
To Bad Debts	4,500	900	5,400				
To Discount	6,000	600	6,600				
To Net Profit	1,06,500	29,400	1,35,900				
	2,22,000	**46,500**	**2,68,500**		**2,22,000**	**46,500**	**2,68,500**

Incorporation entries:

Journal of Head Office

Date	Particulars		L.F.	Rs.	Rs.
2010 Mar. 31	Rajkot Branch a/c	Dr.		29,400	
	To P & L a/c				29,400
	(Branch net profit transferred to H.O. P & L a/c)				
Mar. 31	Branch Debtors a/c	Dr.		33,000	
	Branch Cash and Bank a/c	Dr.		2,100	
	Branch Stock a/c	Dr.		30,000	
	To Rajkot Branch a/c				65,100
	(Branch assets incorporated in the books of H.O.)				

Balance Sheet of H.O. as on 31st March 2010

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital		1,80,000	Fixed Assets (Head Office)		45,000
Profit and Loss a/c :			Stock :		
Head Office	1,06,500		Head Office	90,000	
Rajkot Branch	29,400	1,35,900	Rajkot Branch	30,000	1,20,000
Sundry Creditors (H.O.)		75,000	Sundry Debtors :		
			Head Office	1,80,000	
			Rajkot Branch	33,000	2,13,000
			Cash and Bank Balance :		
			Head Office	10,800	
			Rajkot Branch	2,100	12,900
		3,90,900			**3,90,900**

16.5 Summary

Setting branches at various places is a way of expanding business activities at large scale within country or outside the country. Various types of transactions take place between branches and H.O. From the point of view of accounting procedure branches are broadly divided in two parts. One keeping no complete record (i.e. Dependent branch) and other keeping complete record of all transactions (i.e. Independent branch).

In case of dependent branch all accounting is done by H.O. by Debtor method / Stock and Debtor method / Final account method / Wholesale price method, to ascertain profit & loss of branch.

In case of Independent branch complete books are maintained by branch. Branch prepares its final a/c's and at year end branch trial balance is incorporated in books of H.O. to ascertain true profit / loss of branch.

Finally combined final a/c's are prepared at year end.

16.6 Key Words

Wholesale price	:	refers to cost plus margin added by H.O. Generally H.O. supply goods at this price to whole sellers and also at branch.
List price	:	refers to sale price of goods. It is wholesale price + margin added by branch. Branch sells goods to customers at this price.
Memorandum trading a/c	:	Trading a/c which is prepared by H.O. to find out profit / Loss of branch. It is not based on double entry system.
Cash in transit	:	refers to cash remitted by branch but not yet received by H.O. It is to be brought in books at year end.
Goods in transit	:	refers to goods despatch/ sent by H.O. but not yet received by branch. It is to be included in stock at year end.

16.7 Self Assessment Questions

(A) Theoretical questions

(1) Explain stock and debtors method of accounting in case of dependent branch.

(2) How are the accounts of independent branch situated in the country incorporated in H.O. books. Give necessary entries.

(3) How accounting is done in books of H.O. when goods are sent to branch at wholesale price?

(B) Numerical questions

Q.1 Bhilwara Oil Mill has a selling branch at Pune and charges all goods sent to the branch at cost plus 33.33%. It is arranged that all cash received by the branch is to be paid daily to the head office account in a local bank and necessary advice sent to the head office. All branch expenses are to be paid by the head office by cheque.

From the following particulars, prepare an account in the head office ledger showing the profit or loss of the branch for the year ended 31st March, 2010:

	Rs.
Stock at Branch on 1st April 2009	6,000
Goods sent to Branch less returns	40,000

Debtors of Branch on 1st April 2009	750
Cash sent to Head Office Account in Bank	62,000
Branch Rent, Rates and Taxes	1,600
Other expenses of Branch	2,400
Stock at Branch on 31st March 2010	7,400
Debtors of Branch on 31st March, 2010	800

Ans : Branch Net Profit Rs. 29,100

Q.2 On 31st March 2010, the Trial Balance of the Kanpur Branch stood as follows:

	Rs.	Rs.
Stock on 1st April 2009	12,000	
Furniture	4,800	
Debtors	11,200	
Goods received from Delhi Office	32,000	
Salaries,, Rent and Expenses	4,400	
Cash in hand	3,600	
Delhi Office Account		22,000
Sales		45,600
Sundry Creditors		400
Total	**68,000**	**68,000**

Stock on 31st March 2010 was Rs. 9,200.

Find the Kanpur Branch profit and draft Journal Entries to incorporate branch assets and liabilities in the Delhi Office books. Prepare also the Kanpur Branch a/c in the Delhi Office Ledger.

Ans : Branch Net Profit Rs. 6,400

Q.3 From the following information, show:

(a) The journal entries to incorporate the trial balance of the branch in the head office books, and

(b) The branch current account after incorporation of the branch data.

Pune branch Trial Balance as at 31st March, 2010

	Rs.		Rs.
Purchases	17,350	Sales	38,200
Goods from H.O.	8,100	H.O. current account	7,560
Selling expenses	4,260	Creditor	2,340
Administrative expenses	2,040		
Sundry expenses	1,380		
Petty cash	50		
Cash at bank	1,250		
Debtors	6,400		
Stock on 1st October, 2009	7,270		
	48,100		**48,100**

Stock in hand at the branch on March 31, 2010 Rs. 8,200. Pune branch current account in the head office books showed a balance of Rs. 8,440, while the goods sent to Pune branch account showed a balance of Rs. 8,980 by the closing date.

A Provision for doubtful debts is to be raised, calculated at 1½% of debtors accounts.

Ans. : Goods in transit Rs. 880. Branch Gross Profit Rs. 13,680, Branch Net Profit Rs. 5,904.

Q.4 A Mumbai Merchant opens a new branch in Delhi which trades independently of the Head Office. The transactions of the branch of the year ended 31.3.2010 are as under.

		Rs.	Rs.
Goods supplied by head office			20,000
Purchases from outsiders:			
	Credit	15,500	
	Cash	3,000	18,500
Sales :	Credit	25,000	
	Cash	4,600	29,600
Cash received from customers			30,400
Cash paid to creditors			14,200
Expenses paid by branch			8,950
Furniture purchased by branch on credit			3,500
Cash received from head office initially			4,000
Remittance to Head Office			11,000

Prepare the Branch trading and profit and loss account and the branch account in the head office books after incorporation of the branch trial balance, taking the following into consideration:

(a) The accounts of the branch fixed assets are maintained in head office books.

(b) Write off depreciation on furniture at 5% p.a.

(c) A remittance of Rs. 2,000 from the branch to the head office is in transit.

(d) The branch closing stock is valued at Rs. 12,000.

Ans. : Branch Net loss Rs. 6,025 Branch Gross Profit Rs. 3,100

Q.5 X Company Ltd. with its Head Office at Banaras has a Branch Office in Ranchi which obtains supplies partly from Head Office at cost and partly from outside suppliers. The Branch keeps a separate set of books. On 31st March 2010 the following Trial Balance was extracted:

Trial Balance

Particulars	Head Office Dr.	Head Office Cr.	Ranchi Branch Dr.	Ranchi Branch Cr.
	Rs.	Rs.	Rs.	Rs.
Share Capital	----	3,00,000	----	----
Fixed Assets	1,60,000	----	80,000	----
Profit and Loss a/c on 1.4.09	----	40,000	----	----
Opening Stock at cost	1,40,000	----	19,000	----
Debtors and Creditors	1,70,000	1,00,000	15,000	20,500
Cash	30,000	----	10,000	----
Purchases and Sales	12,00,000	14,00,000	67,500	2,05,000
Sundry Expenses	1,50,000	----	22,500	----
Goods from Head Office to branch	----	1,20,000	1,15,000	----
Current Account on 31.3.2010	1,10,000	----	----	1,03,500
	19,60,000	**19,60,000**	**3,29,000**	**3,29,000**

The difference between the balance on the Head Office and Branch Current Account is due to goods and cash being in transit at the close of the year. Fixed assets are to be depreciated at 10%. Stock on 31st March, 2010 were: Head Office Rs. 1,00,000 and Branch Office Rs. 21,000.

Prepare the Company's Profit and Loss Account for the year ended 31st March 2010 and its Balance Sheet as on that date.

	Ans.: H.O.	Branch
Gross Profit	2,80,000	24,500
Net Profit	1,14,000	(-) 6,000

Net closing balance of General P & L A/c Rs. 1,48,000

Balance Sheet Total Rs. 5,68,500

Cash in Transit Rs. 1,500 Goods in transit Rs. 5,000

16.8 Reference Books

Financial Accounting, Vol. I : Sehgal and Sehgal

Advanced Accountancy, Vol. I : S.N. Maheshwari

Advanced Accountancy, Vol. I : R.L. Gupta and M. Radhaswamy

Financial Accounting : Jain, Khandelwal and Pareek

Unit - 17 Company Accounts - Issue of Shares

Structure of Unit:

17.0 Objectives

After studying this unit you would be able to learn:

- Meaning and features of a company;
- Meaning, nature and classes of shares;
- Meaning, nature and types of share capital and presentation in Balance Sheet;
- Special terms related to shares;
- Accounting treatment on issue of shares in cash;
- Accounting treatment on issue of shares other than cash;
- Accounting treatment of calls-in-arrears and calls-in-advance;
- Accounting treatment when over-subscription.

17.1 Introduction: Meaning and Features of a Company

According to section 3 (i) (ii) of the Companies Act "A company formed and registered under this Act or an existing Company".

Juney Marshal: "A Corporation is an artificial being, invisible, intangible, existing on in contemplation of the law."

So, we can say that "a company is an artificial person existing in the eyes of law and having distinct entity from its members."

Features:

1. Incorporation: A company is an artificial person created through a process of law i.e. the companies Act, 1956.

2. Separate Legal Entity: A company is legal person and its entity is quite distinct its members. It can have its own property, conduct business, enter into contract etc.

3. Limited Liability: Shareholders of a company will have limited liability i.e. to the unpaid value of his share.

4. Common Seal: Every company has its own common seal, which is a fixed on all the important documents of the company.

5. Transferability of Shares: Shares of a company are transferable, except in case of private company.

6. Perpetual Existence: The existence of a company is not affected by death, insolvency, lunacy of its members.

7. Voluntary Association: Its existence is through voluntary association of people.

8. Management and Ownership Separate: Though share holders are true owners of a company. It is not run by all the members but it is run by their elected representatives called "Directors."

> **Activity A:**
> A shareholder wants to run the business of a company. He seeks your advice, how can he be run the company's business:

17.2 Meaning, Nature and Classes of Shares

Total capital of the company is divided into units of small denominations. Each unit is called as "Share." For example if the total capital of a company is of 10 crores, which is divided in 10 lakhs units of Rs. 100 each. Unit of Rs. 100 is called as a share.

Nature: The shares of a company are movable property, transferable in the manner provided by the Articles of Association of the company. They are treated as goods under the Sales of Goods Act, 1930.

Classes: According to the Companies Act, 1956, a company can issue only two types of shares namely:

(i) Preference shares [Section 85(1)] : Those shares which have two preferential rights.

- **(a)** They have a right to receive dividend at a fixed rate before any dividend is paid on equity shares.
- **(b)** When the company goes into liquidation, they have a preferential right to be repaid the amount of capital before any amount is paid to equity shares.

Classes of Preference shares: (a) **Cumulative Preference Shares:** The holders of this class are entitled to get all arrears of preference dividend before any dividend is paid on equity shares. **(b) Non-cumulative Preference Shares:** If dividend is not declared for any year, they have no right to get unpaid dividend.**(c) Participating Preference Shares:** The Articles of Association may have a provision to the effect that after dividend has been paid at fixed rate these holders will have a right to participate in the remaining profits. **(d) Non-Participating Preference Shares:** When the holders of these shares are not entitled to participate in surplus profit only fixed dividend is given to them. **(e) Convertible Preference Shares:** which carries a right to convert them into equity shares according to the rules of issue and at their option. **(f) Non-Convertible Preference Shares:** When these holders have no right of converting their shares. **(g) Redeemable Preference Shares:** Holders have a right to receive payment with stipulated period with the terms of issue and the fulfilment of certain conditions under section 80. **(h) Irredeemable Preference Shares:** The capital which cannot be refunded before winding up, but as per the Companies Act, no company, limited by Shares, shall issue irredeemable preference shares or is redeemable after the expiry of 20 years from the date of issue.

(ii) Equity shares (section 85(2)): The shares which have no preferential rights. These holders cannot get dividend at a fixed rate and payment is made at the time of liquidation after payment to preference holders, each such holder have voting rights and control the affairs of the company.

> **Activity B**
> A company wants to issue preference shares which are redeemable after 25 years. Directors want your advice whether they can issue such shares:

Distinction between Preference shares and Equity Shares

1. There is a fixed rate of dividend for preference shareholders while, it varies year to year in case of equity holders.

2. Preference shareholders have a right to get dividend before equity shares, but equity holders have no such right. They can get dividend on the mercy of directors.

3. Arrears of dividend may accumulate if they are cumulative preference shares, but in no case arrears are payable to equity holders.

4. Preference shareholders have a right to refund their capital at the time of liquidation before the equity shareholders, but equity shareholders can get payment after paying to preference shareholders.

5. Preference shareholders have no voting rights normally, but equity shareholders enjoys voting rights.

6. Preference shareholders have a right of conversion in the term of issue but equity shareholders have no such right.

7. Preference shareholders have no right to take part in management of the company, but equity shareholders have full such right.

17.3 Meaning, Nature and Types of Share Capital

Meaning: The capital of the company is divided into shares. Share capital means the sum of amount raised by a company through the issue of shares.

Nature: In case of public company, capital is generally subscribed by individuals, institutions and others. One consolidated share capital account is opened for all. But in case of private companies, there are maximum 50 subscribers.

Types: (a) Authorised share capital: The capital which is mentioned in the "Memorandum of Association." It is a maximum capital and also called as "Registered or Nominal capital." **(b) Issued Capital:** The part of the authorised capital which is offered to the public. **(c) Subscribed capital:** It is the part of issued capital which is actually subscribed by the public. **(d) Called-up capital:** The amount of nominal value of share that has been called by the company for the payment by the subscribers. **(e) Paid-up Capital:** It is that part of called-up capital which is actually paid by shareholders. It means called up capital minus calls in arrears. **(f) Reserve capital:** It is a capital which is not called by the company during its life time i.e. can be called at time of liquidation by passing a special resolution.

Illustration 1: Suppose a company has a registered capital of Rs. 1 crore divided into 1 lakh equity shares of Rs. 100 each. Out-of which company issued 60,000 shares to public. Public subscribe 59000 shares only. The company called Rs. 80 per share and a holder of 100 shares did not pay a call money of Rs. 30 per share. The company has passed a resolution not to call uncalled part during lifetime.

Classify the above into various types of capital.

Solution :

(i) **Authorised Capital:** 1,00,000 Equity shares of Rs. 100 each = Rs. 1,00,00,000.

(ii) **Issued Capital:** 60000 Equity Shares of Rs. 100 each = Rs. 60,00,000.

(iii) **Subscribed Capital:** 59,000 Equity Shares of Rs. 100 each = Rs. 59,00,000.

(iv) **Called-up Capital:** 59,000 Equity Shares of Rs. 100 each called up Rs. 80 per shares = Rs. 47,20,000.

(v) **Paid up Capital:** Rs. 47,20,000 - 3,000 (100X300) = Rs. 47,17,000.

(vi) **Reserve Capital:** uncalled part i.e. 59000 X 20 = Rs. 11,80,000.

> **Activity C**
>
> A company issued 6,000 shares of Rs. 100 each Rs. 80 called up. The Directors do not want to call uncalled amount. Whether they can do so, if yes, what are the formalities for it?

Disclosure of Share Capital in the Company's Balance Sheet : As per schedule VI, the disclosure is made in following manners:

AN EXTRACT OF BALANCE SHEET OF ...... LTD. (Only Liabilities Side)

Liabilities		**Amount Rs.**
Share Capital:		
Authorised Capital:		
.... Equity Shares of Rs. ..... each.		-
.... Preference Shares of Rs. ..... each.		-
Issued Capital:		
.... Equity shares of Rs. .... each.	-	
.... Preference Shares of Rs. ..... each.	-	
Subscribed, Called-up and Paid-up Capital :		
.... Equity shares of Rs. .... each, Rs. ...... called up	-	
.... Preference Shares of Rs. .... each, Rs. .... called up	-	
(of the above shares. ... shares are allotted as fully paid up for		
consideration other than cash)	-	
Less: Calls-in-arrears.		
By Directors Rs.		
By others Rs.	-	-

Illustration 2

From the figures of preceding illustration, how would you show the relevant items in the Balance Sheet of the company.

Solution

.... LTD.
BALANCE SHEET AS ON ....

LIABILITIES	AMOUNT Rs.	ASSETS	AMOUNT Rs.
Authorised Capital :			
1,00,000 Equity Shares of Rs. 100 each	1,00,00,000		
Issued Capital :			
6,000 Equity Shares of Rs. 100 Each	60,00,000		
Subscribed, Called-up and Paid-up Capital :			
59,000 Equity Shares of Rs. 100 each			
Rs. 80 called up = Rs. 47,20,000			
Less: Calls in arrears 3,000	47,17,000		

Note: Reserve Capital cannot be shown in the balance Sheet.

Activity D

A company has a registered capital of 2 lakh equity shares of Rs. 100 each. The directors decide to offer 2,10,000 equity shares fully paid-up to the public to meet out monetary requirement of the company. Advice whether the company can issued:

17.4 Special Terms Related to Shares

(i) Private Placement: A company can raise its capital by issuing shares privately to promoters, relatives and friends. These shares are not allowed to sale for a minimum period of three years, that is called as lock-in period.

(ii) Sweat Equity Shares: Equity shares are issued to the employees or directors at a discount and for other than cash consideration, for service provided by them. These shares are not saleable within one year. Provisions of section 79 should be followed. Entries are same for issue of these shares as per issue of equity shares.

(iii) Right issue: Existing shareholders must be provided with an opportunity in subscribing in further issue, unless the company has resolved otherwise.

(iv) Issue of shares to promoters: In lieu of their remuneration, the company can issue shares without receiving cash payment to promoters, the entry to be passed is as under:

Good will A/c / Incorporation Cost A/c Dr.
    To Share Capital A/c

(v) Buy-Back of Shares (Sec. 77) : When company purchases its own shares, it is termed as "Buy-Back of Shares " Conditions for issuing such shares: **(1)** It should be authorised by its Article of Association **(2)** special resolution is passed in the general meeting. **(3)** Buy back shares should be fully paid up. **(4)** The debt-equity ratio after buy back should not be less than 2:1. **(5)** The buy back can be from open market, odd lot purchases, purchases from employees or by other mode. **(6)** Buy back can be made out of free reserves, or, the securities premium account or proceeds of any shares or other specified securities. **(7)** The buy back must not exceed 25% of its total paid up capital and free reserves **(8)** The process of buy back should be completed within 12 months from the date of passing the special resolution **(9)** The company cannot issue further share within the period of six months except bonus shares or in discharge of existing obligation. **(10)** Buy back should be as per SEBI guidelines.

(vi) Escrow Account: In order to perform obligations under the scheme of buy back of securities, a company is required to open an escrow account which shall consist of : **(a)** Cash deposited with a commercial bank or **(b)** Bank guarantee in favour of a merchant banker, or **(c)** Deposit of acceptable securities with appropriate margin, or (d) combination of (a), (b) and (c) with merchant banker.

(vii) Preferential Allotment: An allotment is made at a predetermined price to the pre identified people who are interested in taking a strategic stake in the company, such as promoters, venture capitalists, financial institutions etc.,

Employees Stock Option Scheme (ESOS): A scheme under which the company grants option to an employee to apply for shares of the company at a predetermined price. It is a right not obligation. The SEBI has issued guidelines for ESOS of listed companies.

Employees Stock Purchases scheme [ESPS] A scheme in which a company offers shares to its employees as part of a public issue or otherwise. The journal entry will be passed as follows:

Bank A/c	Dr.	(Issue price X No. of Shares)
Employee compensation Expenses A/c	Dr.	(Difference in market price and Issue price X No. of Shares)
To Share Capital A/c		(No. of shares X Nominal value)
To Securities Premium A/c		(No. of Shares X (M.P. - Face value))

Illustration 3 : On July 1, 2010, Reliance Industries Ltd., issued 1,000 shares under ESPS at Rs. 50 when the market price was Rs. 110. Record Journal entry assuming face value of a Share is Rs. 10.

Solution:

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Date	Particulars	L.F.	Amount Rs.	Amount Rs.
2010	Bank A/c Dr. (1000 X 50)		50000	
July, 1	Employee Compensation Expenses A/c Dr. (1000 X 110-50)		60000	
	To Share Capital A/c (1000 X 10)			50000
	To Securities Premium A/c			60000
	(Issue of 1000 shares under ESPS at a price of Rs. 50 each when market price Rs. 110)			

17.5 Accounting Entries for Issue of Shares in Cash

When shares are issued to public for subscription, the following important point should be kept in mind : **(1)** Application money should not be less than 25% of the issue price of each share **(2)** Calls are made as provided in the Articles of Association, in the absence of Articles of Association, the provision of Table A of the Companies Act will apply : **(a)** A period of one month must elapse between two calls **(b)** the amount of one call should not be more than 25% of the face value of the share **(c)** A notice of 14 days period should be given to pay the amount. **(3)** Minimum subscription:

The minimum amount of capital that should be subscribed by the public before a company proceed with allotment of shares. It should be 90% of the issued amount. The amount is fixed by the directors which normally includes : (a) the price of property to be purchased (b) preliminary expenses payable (c) working capital (d) repayment of borrowed money, which is taken for above (a) and (b), **(e)** other expenses required for the usual conduct of the business operation. **(4)** share amount can be demanded full with application or in instalments.

Terms of Issue of shares

(A) At Par: When shares are issued for an amount equal to face value of shares. They are said to be issued at par. The following entries should be passed, it is explained through an example:

Illustration: X Ltd. invited applications for 5000 equity shares of the value of Rs. 10 each. The amount is payable Rs. 4 on application, Rs. 3 on allotment and balance equally in two calls. The whole of the above issue was subscribed and amount duly received. Give Journal Entries for the above transactions:

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Date	Particulars	L.F.	Amount	Amount
Date of receipt	Bank A/c Dr. To Equity Share Application A/c (Being application money received)		20,000	 20,000
Date of Allotment	Equity share Application A/c Dr. To Equity Share Capital A/c (Being the transfer of application money)		20,000	 20,000
Date of Allotment	Equity share Allotment A/c Dr. To Equity Share Capital A/c (Being the amount due on allotment)		15,000	 15,000
Date of receipt	Bank A/c Dr. To Equity Share Allotment A/c (Being the receipt of allotment money formall)		15,000	 15,000
Date of call	Equity Share First call A/c Dr. To Equity Share Capital A/c (Being first call due)		7,500	 7,500
Date of Receipt	Bank A/c Dr. To Equity Share First Call A/c		7,500	 7,500
Date of II calls	Equity shares Second and Final Call A/c Dr. To Equity Share Capital A/c (Being final call due)		7,500	 7,500
Date of Receipt	Bank A/c Dr. To Equity Share Second & Final Call A/c (Being final call received)		7,500	

Note: If there is under subscription, entries should be made as above, but the amount will be changed accordingly.

(B) Issue of shares at a Premium (Section 78) : When shares are issued at the amount more than the face value e.g. if share of Rs. 10 face value issued at Rs. 12, Rs. 2 is called as premium. Premium is credited to "Securities Premium Account" and it should be shown in liabilities side of balance sheet under the heading "Reserves and Surplus." The securities premium account can be used in following purpose only as per provision of section 78: **(a)** for issuing fully paid up bonus shares **(b)** for writing off preliminary expenses **(c)** for writing off the commission or discount on issue of securities or debentures **(d)** for buy-back of shares **(e)** providing for the premium payable on redemption of preference shares or debentures.

Accounting treatment: The amount of premium can be demanded in lump-sum or in instalments. If question is silent it is assumed that premium becomes due along with the allotment money.

(a) When premium is payable with allotment money: the third entry for due on allotment will be made as follows:

Share Allotment A/c Dr.
To Share Capital A/c (Capital amount)
To Securities Premium A/c (Premium Amount)
(Being allotment money due including Rs. .... for securities premium)

(b) When premium is payable with application and allotment both: The second entry for transfer of application money will be made as follows:

Share Application A/c Dr.
To Share Capital A/c (Capital amount)
To Securities Premium A/c (Premium amount)

(Being application money transferred to capital A/c and for premium transferred to securities premium A/c)

The third entry for amount due on allotment will be made as follows :

Share Allotment A/c Dr.
To Share Capital A/c (Capital amount)
To Securities Premium A/c (Premium amount)
(Being the allotment due and securities premium transferred to premium account)

Note: once premium is received, it cannot be refunded as per provision of section 77 A and 78.

Activity E

A company issued 1 lakh shares of at Rs. 100 each Rs. 120, which is subscribed, called up and fully paid up. The company wants to issue 10,000 bonus shares of Rs. 100 each, paid up Rs. 50, by utilising the securities premium account, It has sought your advice, can it utilise Securities Premium Account.

(C) Issue of Shares at a Discount (Section 79)

When shares are issued at price less than its nominal value. it is said that shares are issued at a discount. Suppose a share of face value Rs. 10 issued at Rs. 9, it is called as issue at a 10% discount. The provision of section 79 prescribes the following conditions, before issuing shares at a discount. (a) The shares of that class already issued (b) The Articles of Association of the company must provide for the issue at discount. (c) At least one year must be elapsed since the company was entitled to commence the business. (d) It should be authorised by an ordinary resolution passed by the company at its general meeting and sanctioned by the Company Law Board of the central government. (e) the rate of discount must not exceed 10 percent of the nominal value of the share (f) The shares are issued within two months from the date of receiving sanction from central government or within extended time.

Note: Discount on issue of shares is a capital loss. Therefore, it is shown on the assets side of the balance sheet under the head "Miscellaneous Expenditure."

Accounting treatment: Discount is effective on the allotment and thus if the question is silent, it should be recorded at the time of allotment. The third entry for due on allotment will be made as follows to consider the discount amount:

Share Allotment A/c Dr. (with due amount of face value)
Discount on Issue of Shares A/c Dr. (with discount amount)
To Share Capital A/c
(Being allotment due and discount is debited in a separate account)

It should be noted that to write off of discount is desirable but not compulsory. It can be charged against Capital Reserve or Securities Premium or in the absence of information by gradually charged to Profit and Loss Account over a period of years: The journal entry will be:

Capital Reserve / Securities Premium / P & L A/c Dr.
To Discount on issue of Shares A/c
(Being amount of discount written off.)

Activity F

A company was incorporated on 20th January 2010 and commences its business after getting sanction on 1st June 2010. The company has decided to issue its 1 lakh shares of face value of 100 each at Rs. 95 per share on same date. The company has passed a resolution and applied for sanction from central government. Do you think the company will get sanction? Give your reasons?

Activity G

A company commenced its business on 1st January 2010 and issued equity shares at that time. Now company wants to issue its preference shares first time in the year 2011, at 5% discount a special resolution has been passed and case is pending for sanction from central government. Do you think sanction will be given?. Give your reasons.

17.6 Accounting Entries for Issue of Shares Other Than Cash

Sometimes companies issue its shares for purchase consideration. The following journal entries will be passed:

Note: No. of shares to be issued = $\frac{\text{Purchases Price}}{\text{Issue Price}} = \frac{30,00,000}{12}$ =2,50,000 Shares

1. (a) On purchases of assets:

Sundry Assets A/c Dr. (Name of Individual Assets)
To Vendor (with the amount of purchases consideration)

(b) On purchases of business:

Sundry Assets A/c Dr. (Agreed value of assets)
Goodwill A/c Dr.
To Liabilities (Agreed value of liabilities)
To Capital Reserve A/c

If purchases consideration is more than net assets, difference amount is debited to Goodwill A/c

If purchase consideration is less than net assets, then the difference is credited to Capital Reserve A/c.

2. On Issue of shares:

Vendor Dr.
To Share Capital A/c

Note: 1. If shares are issued at premium, 'the securities premium account' should be credited from such amount and if these are issued at a discount "Discount on issue of shares account" should be debited.

2. Number of shares to be issued to vendor is calculated as follows:

$$\frac{\text{Purchases Price}}{\text{Issue Price of a share}}$$

Illustration 4: A Ltd. purchased the business of Ram Bros. for Rs. 30 lakh payable in fully paid equity shares of Rs. 10 each. What entries will be made if such issue is at a premium of 20%.

Solution:

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Date	Particulars	L.F.	Amount Rs.	Amount Rs.
2010 July, 1	Sundry Assets A/c Dr. To Ram Bros. (Being Purchases of business as per agreement)		30,00,000	30,00,000
	Ram Bros. Dr. To Equity Share Capital A/c To Securities Premium A/c (Being issue of 2,50,000 shares of Rs. 10 each at a premium of 20%)		3,00,000	2,50,000 5,00,000

17.7 Calls in Arrears, Calls in Advance and Interest Their on

Calls-in-Arrears and Interest their on: When some shareholders make a default in depositing the calls amount due on allotment, the unpaid amount is called as calls-in-arrears.

Accounting Treatment: (A) Without opening Calls-in-Arrears Account: The call is demanded in full, but the Journal entry for receiving cash on call will be reduced by the unpaid amount. Suppose a company issued 10,000 shares of Rs. 10 each and first call demanded Rs. 2 but holder of 100 shares did not pay the call in time. The journal entries for call are as follows:

Share First Call A/c Dr. 20,000
To Share Capital A/c 20,000
(Being first call due)

Bank A/c Dr. 19,800
To Share First Call A/c 19,800
(Being call money received except on 100 shares)

(B) By Opening Calls-in-Arrears Account: In the above example first two entries will be the same and third entry will be:

Calls-in-Arrears A/c Dr. 200
    To Share First Call A/c 200
(Being first call unpaid on 100 shares)

The second entry may be combined of II and III entries :

Bank A/c Dr. 19,800
Calls-in-Arrears A/c Dr. 200
    To Share First Call A/c 20,000
(Being first call money received and calls-in-Arrears of 100 shares transferred to a separate A/c)

Interest on calls-in-Arrears: The Company is authorised to charge interest on such arrears at a specified rate given in its Articles. If Table A applies the rate will be 5% p.a.. In the above example if the arrears is received after six months and table A is applied for charging the interest. The following entry is made:

Bank A/c Dr. 205
    To Calls-in-Arrears/Share first call A/c 200
    To Interest on Calls-in-Arrears A/c 5
(Being unpaid call and interest their on received)

Note: The interest will be credited to Profit and Loss A/c at the end of accounting period.

Presentation in the Balance Sheet: The calls-in-arrears will be shown as deduction from the amount of the called up capital on the liabilities side of the Balance Sheet.

Calls-in-Advance and Interest their on:

When shareholder pays future calls, in advance that is called as Calls-in-Advance. A company can accept such advance if it is authorised by its Articles of Association. (Section 12)

Accounting Treatment: It will be learn through following example: A company issued 10,000 shares of Rs. 10 each payable Rs. 4 application, Rs. 4 on Allotment, remaining on final call. A holder of 200 shares paid final call with allotment money. The entries related to advance are as follows:

Bank A/c Dr. 40,400
    To Share Allotment A/c 40,000
    To Calls-in-Advance A/c 400
(Being allotment money received and calls received on 200 shares in advance)

Share Final Call A/c Dr. 20,000
    To Share Capital A/c 20,000
(Being final call due)

Bank A/c Dr. 19,600
Calls-in-Advance A/c Dr. 400
    To Share final call a/c 20,000
(Being final call received and advance is adjusted)

Interest on calls-in-Advance: Interest is payable as provided by Articles of Association. In the absence Table A is applied and there 6 percent per annum, interest is given. In the above example if company demanded final call after six months from allotment the entry regarding to interest is as follows:

Interest on Calls-in-Advance A/c Dr. 12
    To Bank/Outstanding Interest A/c 12
(Interest on Advance paid/outstanding)

Activity H

Application money is received by a company on shares offered on 1st January 2010. A holder of 100 shares paid full with application i.e. Rs. 4 for allotment and Rs. 2 for call. Call due on 1st July 2010. Company seeks the advice about the interest on advance payable from which date?

Note: 1. If interest is outstanding at the end of accounting period it will be shown in the heading of "current liabilities" on the liabilities side of the balance sheet **2.** Interest account should be transferred by debiting it to Profit and Loss Account at the end of accounting year. **3.** No dividend is payable on advance amount. **4.** If advance is received with application though interest is payable from date of allotment.

Activity I

Z Ltd. has a balance of Rs. 40,000 in Calls-in-Arrears Account and also Rs. 40,000 credit balance in Calls-in-Advance Account. The Accountant has prepared a Balance Sheet and not shown both balances, assuming that it have been set off against each other. Do you think it is correct? Give with reasons and show it correctly.

17.8 Over Subscription of Shares

Sometimes it may happen that applications for more shares are received than the number of shares offered to the public, such situation is called as **"over subscription".** There are three alternative to deal such situation: **(A) Full Allotment:** A company may allot the shares to some of the applicants in full and return to remaining applicant. **(B) Prorata Allotment:** Prorata allotment is made to all applicants. **(C) Partial Allotment:** It is a combination of above two, some applications may be accepted in full, some may be out-rightly rejected and proportional allotment may be made to the remaining:

Accounting Entries in Case of Over-Subscription:

For Application Money Received

Bank A/c Dr.
  To Share Application A/c

Application Money for Allotted Shares

Share Application A/c Dr.
  To Share Capital A/c

Excess Application Money

Refund

Share Application A/c Dr.
  To Bank A/c

Adjustment

Share Application A/c Dr.
  To Share Allotment
  To Calls-in-Advance A/c

Combined Entry

Share Application A/c Dr.
  To Share Capital A/c
  To Bank A/c
  To Share Allotment A/c
  To Calls-in-Advance A/c

Illustration 5: A company has invited application for 50,000 shares of Rs. 100 each, amount called: Rs. 30 on application Rs. 30 on allotment and remaining in two equal calls. Application were received for 1,10,000 shares. It was decided (i) to refuse allotment to the applicants for 10,000 shares, (ii) to allot 50% to Mr. A who has applied for 20,000 shares (iii) to allot in full to Mr. B who has applied for 10,000 shares, (iv) to allot balance of the available shares pro-rata among the other application. (v) to utilise excess application money in part payment of allotment and calls. Give Journal entries, assuming all payments are received in time. Ignore narrations.

Solution:

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Date	Particulars		L.F.	Amount Rs.	Amount Rs.
	Bank A/c	Dr.		33,00,000	
	To Share Application A/c				33,00,000
	Share Application A/c	Dr.		15,00,000	
	To Share Capital A/c				15,00,000
	Share Allotment A/c	Dr.		15,00,000	
	To Share Capital A/c				15,00,000
	Share Application A/c	Dr.		3,00,000	
	To Bank A/c				3,00,000
	Share Application A/c	Dr.		15,00,000	
	To Share Allotment A/c				12,00,000
	To Calls-in-Advance A/c				3,00,000
	Bank A/c	Dr.		3,00,000	
	To Share Allotment A/c				3,00,000
	Share First Call A/c	Dr.		10,00,000	
	To Share Capital A/c				10,00,000
	Bank A/c	Dr.			
	Calls-in-Advance A/c	Dr.		10,00,000	
	To Share First Call A/c				10,00,000
	Share Final call A/c	Dr.		10,00,000	
	To Share Capital A/c				10,00,000
	Bank A/c	Dr.		10,00,000	
	To Share Final Call A/c				10,00,000

Working Note

Statement Showing Details of Adjustments

Cate gories	Shares Applied	Shares Alloted	Application money received	Disposition of Application money has			
				Application	Allotment	Calls in Adv.	Refund
			Rs.	Rs.	Rs.	Rs.	Rs.
I	10,000	-	3,00,000			-	3,00,000
II	20,000	10,000	6,00,000	3,00,000	3,00,000	-	-
III	10,000	10,000	3,00,000	3,00,000	-	-	-
IV	70,000	30,000	21,00,000	9,00,000	9,00,000	3,00,000	-
Total	1,10,000	50,000	33,00,000	15,00,000	12,00,000	3,00,000	3,00,000

17.9 Preparation of Cash Book

When shares are issued, it would be proper to record the cash transaction in the cash book and non-cash transactions in a Journal. It can be learnt through the following example.

Illustration 6: A Company offered 2 lakh shares of Rs. 10 each to the public on following terms:

Name of demand	Money Called	Date of Demand	Date of Receipt
Application	Rs. 4 per share	1 January 2010	31st January 2010
Allotment	Rs. 3 per share	1 March 2010	15th March, 2010
First Call	Rs. 2 per share	1 May 2010	15th May, 2010
Second Call	Rs. 1 per share	1 July 2010	15th July, 2010

The public applied for 1,90,000 shares, which are allotted on 1st March 2010. A shareholder holding 2000 shares failed to pay calls, remaining amount received in time. Prepare Cash Book and enter the transactions in the books of company. Ignore narrations.

IN THE BOOKS OF A COMPANY CASH BOOK (Bank Column Only)

Date	Particulars	LF	AMOUNT	Date	Particulars	LF	AMOUNT
2010			Rs.	2010			Rs.
Jan, 31	To share Application A/c		8,00,000		By Balance c/d		19,94,000
March,15	To Share Allotment A/c		6,00,000				
May, 15	To Share first call A/c		3,96,000				
July, 15	To Share Second Call A/c		1,98,000				
			19,94,000				19,94,000

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Date	Particulars		L.F.	Amount (Dr.) Rs.	Amount (Cr.) Rs.
	Share Application A/c	Dr.		8,00,000	
	To Share Capital A/c				8,00,000
	Share Allotment A/c	Dr.		6,00,000	
	To Share Capital A/c				6,00,000
	Share First Call A/c	Dr.		4,00,000	
	To Share Capital A/c				4,00,000
	Share Final Call A/c	Dr.		2,00,000	
	To Share Capital A/c				2,00,000

17.10 Summary

A company is an enterprise established through a process of law, for the purpose of carrying on some business. Total capital of a company is divided into units of small denominations, each such unit is called as "Share". A company can issue equity shares or preference shares. Company can issue shares either in cash or for consideration other than cash, shares can be issued to employees as sweat equity shares or under ESOS (Employees stock option scheme). Shares can be issued either at par, at premium or at discount. Share money can be demanded in instalments. Company can charge interest on calls-in-arrears as per provision of Articles of Association. Company can pay interest on calls in advance to share holders as per provisions of Articles of Association. When application for purchases of shares received more than the offered shares, this situation is called as 'oversubscription'. Company cannot issue excess shares over offered shares, hence excess money received can be adjusted for further calls.

17.11 Key Words

Over subscription: When Share are applied for more than the shares offered for subscription.

Pro-Rata Allotment: When shares are over-subscribed, the allotment of shares is made in a fixed proportion.

Call: It is a demand by a company to the holders of partly paid up shares to pay further instalments towards full face value.

Calls-in-Arrear: It is an amount not yet received by the company against the call or calls demanded.

Calls-in-Advance: It is a amount received by the company from its allotees against calls not yet payable.

17.12 Self Assessment Questions

1 State whether the following statements are true or false

- **(i)** Share Application Account is a Real Account.
- **(ii)** A Company cannot issue its shares at a discount at the time of first issue.
- **(iii)** Share is one unit, in which the share capital of a company is divided.
- **(iv)** Equity holders have a right to get dividend at a fixed rate.
- **(v)** Securities premium account can be used to write off issue expenses.

2 What is "Share capital"? Explain the meaning of different types of share capital. How is it shown in the Balance Sheet?

3. What are the rules for utilising the balance of Securities Premium Account?

4. Can a company issue shares at discount? What conditions must a company comply with before the issue of such shares?

5. Distinguish between:

- **(i)** Calls-in-Arrears and Calls-in-Advance
- **(ii)** Under Subscription and Over-Subscription
- **(iii)** Equity share and Preference share

6. B Ltd. issued 8,000 equity shares of Rs. 100 each, Rs. 5 per share was called, payable Rs. 2 on application, Re. 1 on allotment, Re. 1 on first call and Re. 1 one second call. All money was duly received with the following exceptions:

X, who holds 250 shares paid nothing after application
Y, who holds 500 shares paid nothing after allotment
Z, who holds 1250 shares paid nothing after first call

Prepare Journal and show the relevant items in Balance Sheet.

7. C Ltd. issued 20,000 shares of Rs. 10 each at a premium of Rs. 2 per share, payable Rs. 3 on application, Rs. 5 on allotment (including premium) and the balance by two equal calls. The due dates of the instalments are: Application on 1st July, 2010, Allotment on 1st August, 2010, First call in 1st October, 2010, Final Call in 1st December, 2010.

Interest should be received @ 10% p.a. on calls-in-arrears and interest should be paid @ 5% p.a. on calls-in-advance as per Articles of Association.

A holder of 1000 shares paid the entire amount with allotment. Another holder of 2000 shares paid amount due on allotment and first call with second call.

Show the journal entries in the books of the Company.

17.13 Reference Books

R.L. Gupta	-	Advanced Accounting
P.C. Tulsian	-	Financial Accounting
Shukla & Grewal	-	Advanced Accounting

Unit - 18 Company Accounts - Forfeiture and Re-issue of Shares, Redemption of Preference Shares

Structure of Unit:

18.0 Objectives

After studying this unit, you would be able to learn:

- Accounting treatment of share forfeiture;
- Accounting treatment for re-issue of forfeited shares;
- What are the rules related to redemption of preference shares?
- Accounting process for redemption of preference shares out-of-Profit;
- Accounting procedure for redemption of preference shares out of fresh issue of shares;
- Accounting method for redemption of preference shares partly out of profits partly out of fresh issue of shares;
- How redemption of preference shares made by conversion?
- How the items related to redemption of preference shares should be disclosed in balance sheet?

18.1 Accounting Treatment for Forfeiture of Shares

As we have read in previous unit, what will be the accounting entries when a company issues its shares to public. Now we deal with, when amount is unpaid on these shares how we will treat them. When shareholders fails to pay any allotment or calls within the specified period, the company is authorised to forfeit the shares. That means cancelling the shares on default. The holder of those shares will lose the amount already paid by him and shareholder will be cease to be a member of the company. It is to be noted that shares can be forfeited only if the Articles of Association permits it. The defaulting shareholders must be given a minimum of 14 days notice saying to pay unpaid amount together with the accrued interest there on at the prescribed rates. The notice must state that shares will be forfeited if amount is not paid. If the shareholder still does not pay, the company may forfeit them by passing an appropriate resolution.

Accounting Treatment on forfeiture of Shares, which were issued at par :

Following entry will be passed:

Share Capital A/c Dr. (With called up amount)
To Forfeited Shares A/c (With amount already received)
To Share Allotment A/c (With amount due on Allotment)
To Unpaid calls A/c/Calls-in-arrear a/c (With amount due but not paid)

Note: If forfeited shares are not issued till the date of preparation of balance sheet, the balance on shares forfeited account will be added to the paid up capital in the liabilities side of the balance sheet.

Illustration 1 : Hari Ltd, issued 1 lakh shares of Rs. 10 each, payable Rs. 3 on application Rs. 4 on allotment, Rs. 2 on first call and the balance on final call. Gita the holder of 2,000 shares failed to pay the allotment & first call money and her shares were forfeited. After this forfeiture, the final call made and another holder Ram failed to pay final call on 1000 shares and his shares were forfeited. Pass Journal entries. Ignore narration.

Solution: **JOURNAL**

Accounting treatment for forfeiture of shares issued at a premium :

Date	Particulars	L.F.	Amount Rs.	Amount Rs.
	Bank A/c Dr.		3,00,000	
	To Equity Shares Application A/c			3,00,000
	Equity Shares Application A/c Dr.		3,00,000	
	To Equity Share Capital A/c			3,00,000
	Equity Share Allotment A/c Dr.		4,00,000	
	To Equity Share Capital A/c			4,00,000
	Bank A/c Dr.		3,92,000	
	To Equity Share Allotment A/c			3,92,000
	Equity Share First call A/c Dr.		2,00,000	
	To Equity Share Capital A/c			2,00,000
	Bank A/c Dr.		1,96,000	
	To Equity Share First Call A/c			1,96,000
	Equity Share Capital A/c (2000 X 9) Dr.		18,000	
	To Equity Share Allotment A/c (2000 X 4)			8,000
	To Equity Share First Call A/c (2000 X 2)			4,000
	To Share Forfeiture A/c (2000 X 3)			6,000
	Equity Share Final Call A/c Dr.		1,98,000	
	To Equity Share Capital A/c			1,98,000
	Bank A/c Dr.		1,97,000	
	To Equity Share Final Call A/c			1,97,000
	Equity Share Capital A/c (1000 X 10) Dr.		10,000	
	To Equity Share Second Call A/c (1000 X 1)			1,000
	To Share forfeiture A/c (1000 X 9)			9,000

(A) When premium is received on those shares: According to section 78 of Companies Act, Securities premium will not be transferred to share forfeiture account. The entry will be:

Share Capital A/c Dr. (amount called up so far)
To Share Allotment A/c (with amount not received on allotment)
To Share Calls A/c (with amount demanded but not received)
To Share Forfeiture A/c (with amount received so far excluding premium)

(B) When full or part premium is not received on those shares:

When shares are forfeited, but the premium is not received on those shares, then premium must be debited with unpaid amount of premium at the time of forfeiture. The entry will be:

Share capital A/c Dr. (Amount called up excluding premium)
Securities Premium A/c Dr. (Premium amount called up and not received)
To Share Allotment A/c (Allotment called and not received)
To Share Calls A/c (Calls demanded but not received)
To Share Forfeiture A/c (Amount received so far excluding premium)

Illustration: 2

A Ltd. issued 10,000 equity shares of Rs. 100 each at Rs. at 20 premium per share, payable Rs. 25 on Application (including Rs. 10 for premium), Rs. 45 (including Rs. 10 for premium), Rs. 25 on first call and Rs. 25 on Second Call. Application for 9,000 shares received and a holder of 1000 shares does not pay the allotment and first call. His shares are forfeited. A holder of 500 shares does not pay final call and his shares are forfeited. Make necessary entries with regard to forfeiture only.

Solution:

Equity Share Capital A/c (1000 X 75)	Dr.	75,000	
Securities Premium A/c (1000 X 10)	Dr.	10,000	
To Equity Shares Allotment A/c (1,000 X 45)			45,000
To Equity Shares First Call A/c (1000 X 25)			25,000
To Share Forfeiture A/c (1,000 X 15)			15,000
Equity Share Capital A/c (500 X 100)	Dr.	50,000	
To Equity Share First Call A/c (500 X 25)			12,500
To Equity Share Second Call A/c (500 X 25)			12,500
To Share Forfeiture A/c (500 X 50)			25,000

Activity A

A company forfeited 100 shares issued at a premium of Rs. 20 face value Rs. 100 per share, due to non receipt of allotment & final call money, which is Rs. 60 per share. Application money Rs. 60 per share including full premium. The accountant of the company transferred to share forfeiture account Rs. 6,000. Whether it is correct. If not give reasons.

Accounting treatment for forfeiture of shares issued at a discount : When the shares originally issued at a discount are forfeited, then discount allowed must be written back. Hence, Discount on Issue of Shares Account should be credited with discount originally allowed: The entry will be:
Share Capital A/c Dr. (With amount credited to capital account in respect of the forfeited shares)
To Discount on Issue of Shares A/c (With discount allowed)
To Share Allotment A/c (Amount called up not received on allotment)
To Share Call A/c (Amount called but not received)
To Share Forfeiture A/c (Amount actually received)

Illustration 3: India Ltd. issued 10,000 shares of Rs. 10 each at a discount of 10%. Amount was payable Rs. 3 on application Rs. 4 on allotment and remaining with final call. All the shares were subscribed and all the money was duly received except on 1,000 shares allotment and final call money and on 100 shares final call only. These shares were forfeited after final call. Make Journal entry for forfeiture only.

Solution:

Equity Share Capital A/c (1100 X 10) Dr.	11,000	
To Discount on issue of shares A/c (1100 X 1)		1,100
To Share Allotment A/c (1000 X 4)		4,000
To Share Final Call A/c (1100 X 2)		2,200
To Share Forfeiture A/c (1000 X 3), (100 X 7)		3,700

Note: In the absence of information discount is adjusted with allotment.

18.2 Re-Issue of Forfeited Shares

The directors of the company have the authority in accordance with the provisions contained in Articles of Association to re-issue the forfeited shares if find suitable. Provisions related to re-issue are as follows:

(1) Forfeited shares can be re-issued at par, at discount or at premium.

(2) The discount on re-issue should not exceed the amount earlier received on forfeiture. Such discount will be debited to share forfeiture account.

(3) When the shares were originally issued at par or premium, maximum permissible discount on re-issue is the amount credited on forfeiture account on these shares.

(4) When the shares were originally issued at a discount, maximum permissible discount on re-issue is the amount credited to forfeited account plus amount of original discount.

(5) Balance of share forfeiture account is a capital profit and it will be transferred to capital reserve account after re-issue of these shares.

(6) When only a portion of the forfeited shares are re-issued then profit made on re-issue will be calculated and such part from forfeiture account is transferred to capital reserve.

Accounting Treatment on Re-issue of Forfeited Shares:

(A) If the forfeited shares are re-issued at par.

Bank A/c Dr. (amount actually received for paid up amount)
To Share Capital A/c (paid up amount)
(Being forfeited shares re-issued at par)

(B) If the shares forfeited are re-issued at premium:

Bank A/c Dr. (amount actually received)
To Share Capital A/c (paid up amount)
To Securities Premium A/c (premium on re-issue)
Being forfeited shares are re-issued at premium)

(C) If the forfeited shares are re-issued at discount.

(A) When shares originally issued at par or at premium-

Bank A/c Dr. (amount actually received)
Share Forfeiture A/c Dr. (discount amount)
To Share Capital A/c (paid up amount)
(Being shares forfeited are re-issued at discount)

(B) When shares originally issued at discount:

Bank A/c Dr. (amount actually received)

Discount on Issue of Shares A/c Dr. (up to original discount per share)

Share Forfeiture A/c Dr. (excess discount over original discount on re-issue)

To Share Capital A/c (paid up amount)

(Being shares forfeited are re-issued at discount, original discount is transferred to discount account)

Transfer of Balance of Shares Forfeiture Account:

After re-issue of forfeited shares, the credit balance left in the forfeiture account is a capital profit, hence, it will be transferred to "Capital Reserve Account." If all the forfeited shares are not re-issued then only proportion of share forfeiture account that belongs to the re-issued shares should be transferred to "Capital Reserve Account". The Journal entry will be:

Share Forfeiture A/c Dr.

To Capital Reserve A/c

(Being share forfeiture account transferred to Capital Reserve Account)

Surrender of Shares: When a shareholder feels that he is not able to pay further calls, he may himself surrender of his shares before forfeiture to the company. These shares are then treated as cancelled. Entries are passed as forfeiture of shares.

Illustration 4: ABC Ltd. forfeited 300 shares of Rs. 100 each issued at par on which application money Rs. 40, allotment money Rs. 20, first calls Rs. 20 and final calls Rs. 20 is demanded. The holder is not paid allotment and first call, and shares are forfeited before calling final call. Give the necessary entries (ignoring narration) regarding forfeiture and re-issue of share in each of the following cases:

Case I : If 200 of these shares were re-issued as Rs. 80 paid up for Rs. 90.

Case II : If 200 of these shares were re-issued as Rs. 80 paid up for Rs. 70.

Case III : If all these shares were re-issued at Rs. 70 per share full paid up.

Solution **JOURNAL**

Date	Particulars	L.F.	Amount Rs.	Amount Rs.
	Equity Share Capital A/c (300 X 80) Dr.		24,000	
	To Equity Share Allotment A/c (300 X 20)			6,000
	To Equity Share First Call A/c (300 X 20)			6,000
	To Share Forfeiture A/c (300 X 40)			12,000
Case I	Bank A/c (200 X 90) Dr.		18,000	
	To Equity Share Capital A/c (200 X 80)			16,000
	To Securities Premium A/c (200 X 10)			2,000
	Share Forfeiture A/c Dr.		8,000	
	To Capital Reserve A/c (12000 X 200/300)			8,000
Case II	Bank A/c (200 X 70) Dr.		14,000	
	Share Forfeiture A/c Dr. (200 X 10) Dr.		2,000	
	To Equity Share Capital A/c (200 X 80)			16,000

	Share forfeiture A/c Dr.		6,000	
	To Capital Reserve A/c			6,000
	(12,000/300X200)=(8000-2000)			
	Bank A/c (300 X 70) Dr.		21,000	
	Share forfeiture A/c (300 X 30) Dr.		9,000	
	To Equity Share Capital a/c (300 X 100)			30,000
Case III	Share forfeiture A/c Dr.		3,000	
	To Capital Reserve A/c			3,000
	(12,000/300X300 = (12000-9000))			

Illustration 5: X Ltd. forfeited 100 Equity Shares of Rs. 10 each Rs. 6 called up, issued at a discount of Rs. 10% to Z on which he paid an application money Rs. 2 per Equity Share only. Give Journal entries to record forfeiture and re-issue of Equity Shares in each of the following cases:

Case I: If 90 of these share were re-issued at Rs. 8 called up for Rs. 6 per share. Case 2: If 1(100) all these shares were issued as fully paid up for Rs. 7 per share.

Solution **JOURNAL**

Date	**Particulars**	**L.F.**	**Amount Dr. (Rs.)**	**Amount Cr. (Rs.)**
	Entry for forfeiture of 100 shares:			
	Equity Share Capital A/c (100 X 6) Dr.		600	
	To Discount on Issue of Share A/c (100 X 1)			100
	To Forfeited shares A/c (100 X 2)			200
	To Share Allotment A/c(100 X 3)			300
Case I	Bank A/c (90 X 6) Dr.		540	
	Discount on Issue of Shares A/c (90 X1) Dr.		90	
	Forfeited Shares A/c (90 X1) Dr.		90	
	To Share Capital A/c (90 X8)			720
	Forfeited Shares A/c (90 X1) Dr.		90	
	To Capital Reserve A/c			90
Case II	Bank A/c (100 X7) Dr.		700	
	Discount on Issue of Shares A/c (100 X 1) Dr.		100	
	Forfeited Share A/c (100 X 2) Dr.		200	
	To Share Capital A/c (100 X 10)			1,000

Activity B

A company forfeited 200 shares of Rs. 10 each issued at 5% discount after calling first call. Application Rs. 2, Allotment Rs. 4, first call Rs. 2, remaining on second call per share. The company wants to re-issue these shares fully paid at Rs. 7 per share. The holder of these shares paid only application money. Suggest whether company can do so.

Illustration 6: A applied for 1000 equity shares of Rs. 10 each at premium of Rs. 2.50. But he was allotted only 500 shares. After having paid Rs. 3 on application, he would not pay allotment money of Rs. 4.50 per shares (including premium) and on his subsequent failure to pay the first calls of Rs. 2 per share, his shares were forfeited. These shares were re-issued at Rs. 8 per share as fully paid. Give journal entries to record the forfeiture & re-issue of shares assuming that the company follows the practice of adjusting the excess application money towards the other sums due on shares.

Solution : **JOURNAL**

Date	Particulars	L.F.	Amount (Dr.) Rs.	Amount (Cr.) Rs.
	Share Capital A/c (500 X7) Dr.		3500	
	Securities Premium A/c Dr.		750	
	To Forfeited Shares A/c			2500
	To Share Allotment A/c			750
	To Share First Call A/c			1000
	Bank A/c (500 X8) Dr.		4000	
	Forfeited Shares A/c (500 X 2) Dr.		1000	
	To Share Capital A/c			5000
	Forfeited Shares A/c Dr.		1500	
	To Capital Reserve A/c			1500

Working Note:

Excess application money received (500 X 3)	Rs. 1500
Total due on Allotment (500 X 4.50)	Rs. 2250
Amount due but not paid (2250-1500)	Rs. 750

Out of total due on allotment. Rs. 1000 on allotment and Rs. 1250 is for securities premium. Out of excess application money Rs. 1500, Rs. 1000 is adjusted for allotment and Rs. 500 is adjusted for securities premium as question assumes. Therefore securities premium a/c is debited for Rs. 1250-500 = Rs. 750 (the outstanding amount)

Activity C

A Company issues 2000 shares to Mr. B of Rs. 100 each at a premium of Rs. 10 per share. Mr. B applied for 3000 shares. Amount called: Rs. 50 on application. Rs. 30 on allotment including premium and Rs. 20 on first call and remaining on second call. Company seeks your advice how the excess application money will be adjusted at the time of allotment. Advise them.

Activity D

A Company issued 1000 equity shares of Rs. 100 each at par. Application money Rs. 50, allotment Rs. 30 and first call Rs. 20 per share demanded. A holder of 100 shares does not pay allotment first call and his shares were forfeited. The company wants to re-issue these shares on maximum discount allowable. Suggest the amount per share on which company can re-issue these shares.

18.3 Redemption of Preference Shares

The issue and redemption of preference shares is governed by section 80 and 80A of the Companies Act. Since from amendment made in 1988, the company cannot issue irredeemable preference share and certain restrictions imposed on redemption of irredeemable preference shares issued prior to amendment. The provisions for the redemption of preference shares as, the Companies (Amendment) Act, 1988 are as follows:

1. A Company cannot issue irredeemable preference shares.

2. A Company can issue redeemable preference share which are redeemable within 20 years of its issue.

3. Irredeemable shares issued prior to amendment should be redeemed within five years from the date of commencement of the amendment.

4. If redeemable preference shares issued prior to this amendment, which are redeemable after 20 years of its issue. These shares should be redeemed on the date of actual redemption or 20 years from the date of commencement of amendment, which is earlier.

5. A Company, which is not in position to redeem preference shares within the stipulated period, may issue fresh redeemable preference shares equal to amount due including arrear of dividend (if any) with the permission of Company Law Board.

Note: When a Company does not redeem preference shares in stipulated period or fails to comply these provision then: (a) the defaulter company cannot pay dividend on equity shares till preference shares are not redeemed. (B) A penalty of Rs. 1,000 per day or imprisonment of 3 year, to defaulter officers or both.

Activity E

A company issued irredeemable preference shares in 1968. After the new amendment, company seeks your advice, when these shares should be redeemed.

Activity F

A Company issued redeemable preference shares in 1985, which are redeemable in 2010. After the amendment, Company seeks your advice, when these shares should be redeemed.

18.4 Rules Regarding Redemption of Preference Shares

According to section 80 of the Companies Act, the following provisions are applied:

(i) Preference shares can be redeemed, if they are fully paid up. Hence, prior to redemption, company should made these shares fully paid up.

Activity G

A Company wants to redeem 10,000 preference shares of Rs. 100 each partly paid up Rs. 80. Company seeks your advice. Can these shares may be redeemed or not, how they will be redeemable.

(ii) Few shareholders, who could not make the final payment of calls money on these shares, though company can redeem only those shares which are fully paid up.

(iii) If preference shares are redeemable at a premium, then such premium (a capital loss) must be provided out of the profits of the company either capital or revenue. First of all, securities premium must be utilised then the revenue profits will be used to write off the premium payable on redemption. If the sufficient profit either capital or revenue are not available, then company can not redeem these shares at premium. The following entry will be passed to write-off such premium :

Securities Premium A/c Dr.
or/and General Reserve A/c Dr.
or/and Profit and Loss A/c Dr.
    To Premium on Redemption of Preference Shares A/c
(Provision for premium on redemption made at the time of redemption of preference shares.)

Activity H

A Company wants to redeem its 1000 preference shares of Rs. 100 each at a premium of Rs. 10 per shares, The balance of Securities Premium Account is available on that date Rs. 4,000 and balance of Profit and Loss account and other revenue profits Rs. 5000 only. Company seeks your advice, whether these shares can be redeemed at above said premium out of profits.

(iv) The redemption can be made either out of profits or out of proceeds of a fresh issue. A provision equivalent to nominal value of the redeemable preference shares should be made out of profits if redemption is made out of profits. Here profit means : Which is available for distribution of dividend: i.e. credit balance of P&L, A/c, General reserve, Reserve Fund, Insurance Fund, Dividend Equalisation Fund, Workman's Compensation Fund, Debenture Redemption Fund, Debenture Sinking Fund. The reserve and funds created under the provisions of Income Tax Act is like: Housing project reserve account, Hotel Project Reserve Account, Foreign Project Reserve Account, Export Profit Reserve Account etc. are available for distribution as dividend after 5 years. The Investment Allowance Reserve, Development Rebate Reserve Account and Development Allowance Reserve Account are now available for distribution of dividend. When company decided to redeem these shares out of profits a Capital Redemption Reserve Account is created out of the above funds, equal to nominal value of redeemable shares and following entry will be passed :

General Reserve A/c/P&L A/c/Other Funds or Reserve A/c Dr.
    To Capital Redemption Reserve A/c
(Amount transferred equal to nominal value of redeemable preference shares to CRR A/c)

Capital profits like Securities Premium, Capital Reserve, and Profit Prior to Incorporation cannot be used to transfer C.R.R. Account.

Activity I

A Company wants to redeem 1,00,000 preference shares of Rs. 100 each at par out of profits. The available balances are: Securities Premium Account Rs. 10,00,000, Capital Reserve Rs. 2,00,000, General Reserve Rs. 50,00,000. Development Rebate Reserve Rs. 40,00,000. Company seeks your advice whether these shares can be redeemed out of profits, If not, whether other alternative is available.

(v) If redemption is made from proceeds of fresh issue of shares, then net amount received against issue of share will be used in case, when issue made at discount. But if issue made at premium, premium can be used for redemption hence nominal value can be used, because securities premium account is not available for redemption. If issue made at par proceed can be used for redemption.

Activity J

A Company wants to redeem its 10,000 preference shares of Rs. 100 each at Rs. 90. The Company wants to issue adequate equity shares of Rs. 10 each issued at 10% discount. Suggest the number of shares to be issued:

(vi) If Company is interested to redeem preference shares by issue of new shares as-well-as out of profits. Then there may be two situations: **1.** when number of fresh shares to be issued is given then, after using net proceeds of fresh shares (excluding premium, if any) remaining amount will be utilised from profits, which are available for dividend. **2.** When, question says, available profits will be fully utilised then for remaining amount fresh issue will be made, in that case number of shares to be issued will be calculated by dividing the remaining nominal value of redeemable shares from net proceeds of fresh issue per share (excluding premium, if any on issue.)

18.5 Accounting Treatment for Redemption out of Profit

When company decides to redeem preference shares out of profits available for distribution of dividend, the following entries will be passed:

(a) If, final call on redeemable preference share yet to be demanded:

Redeemable Preference Share Final Call A/c Dr. (Final call money)
    To Redeemable Preference Share Capital A/c
(Being final call due)

(b) On receipt of above final call:
Bank A/c   Dr.   (Call money)
    To Redeemable Preference Share Final Call A/c
(receipt the final call from ..... shares)

(c) To write off premium payable on redemption (if redemption made on premium)
Securities Premium A/c   Dr.   (From Premium Amount)
Revenue Profit A/c (G.R., P&L A/c etc). Dr. (From premium amount)
    To Premium on Redemption of Preference Share A/c
(Being Premium on redemption of Preference Shares written off)

(d) Making provision "out of profit" for redemption:
Revenue Profits A/c Dr. (Face value of redeemable shares)
    To Capital Redemption Reserve A/c
(Being provision made from distributable profits as per Sec. 80 of the Companies Act by transferring such amount to Capital Redemption Reserve)

(e) On Redemption of Preference Shares
Redeemable Preference Share Capital A/c Dr. (Face Value)
Premium on Red. of Preference Share A/c Dr. (if any)
    To Preference shareholders A/c
(Being redemption payment transferred to holders account)

Note: If redemption is at discount, discount should be credited, if redemption at par then "Premium on Red." will not be debited.

(f) On payment:
Redeemable Preference Shareholders A/c Dr.
    To Bank A/c
(Being payment made on redemption)

Note: 1 As per the Companies Act all preference shares are redeemable, hence, we can write "Preference shares" instead of" redeemable preference shares".

2 If the company has called the full amount on preference shares, and few holders do not pay final call then company cannot stop the redemption procedure only because of few shares are partly called. Though the company should make provision for full nominal value of preference shares but can redeem only fully paid up shares only, hence the entry regarding redemption and payment will be made from lesser amount i.e. does not include the amount of unpaid holders.

Illustration 7: A Company redeems 10,000 12% fully paid preference shares of Rs. 100 each at a premium of Rs. 5 per share out of profits. Available balances are as follows:

	Rs.
General Reserve	5,00,000
Capital Reserve	50,000
Profit & Loss Account	4,00,000
Securities Premium Account	1,05,000
Development Rebate Reserve	1,10,000

The postal address of a holder of 100 shares is not available, hence payment is made to remaining holders. Journalise the above.

Solution **JOURNAL**

Date	Particulars		L.F.	Amount (Dr.) Rs.	Amount (Cr.) Rs.
	Securities Premium A/c	Dr.		50,000	
	To Premium on Redemption A/c				50,000
	General Reserve A/c	Dr.		5,00,000	
	Profit & Loss A/c	Dr.		4,00,000	
	Development Rebate Reserve A/c Dr.			1,00,000	
	To Capital Redemption Reserve A/c				10,00,000
	Redeemable Preference Share Capital A/c	Dr.		10,00,000	
	Premium on Redemption A/c Dr.			50,000	
	To Preference Shareholder A/c				10,50,000
	Preference Shareholders A/c	Dr.		10,39,500	
	To Bank				10,39,500

Note: 1 Payment is not made to a holder of 100 shares, whose postal address is not available with the company, but provision has been made.

18.6 Accounting Treatment for Redemption out of Proceeds of Fresh Issue of Shares

A Company can redeem its preference shares by issuing fresh shares to the public. For this purpose the net proceeds on issue of new shares will be used (excluding premium on issue, if any) equal to the amount of nominal value of shares to be redeemed. Sometimes number of fresh shares issued are given, in other cases the question says "sufficient number of shares to be issued". In that case number of fresh shares is calculated by using this formula:

$$\frac{\text{Nominal Value of Redeemable Preference Shares}}{\text{Net Proceeds of one fresh share issued (excluding premium if any)}}$$

The accounting entries will be made as follows:

(a) For demanding final call and on receipt of final call on redeemable preference shares the entries will be made as per 18.5.

(b) For issue of New Shares:

(i) Bank A/c Dr. (Amount received)
To Equity Shares Application A/c

(ii) Equity Share Application A/c Dr.
Discount on Issue of Shares A/c Dr. (if any)
To Equity Share Capital A/c (Nominal value of fresh issue)
To Securities Premium (if any)

New issue may be at par or at a discount or at premium, and then necessary account is adjusted with this entry.

(c) For Redemption:

Preference Share Capital A/c Dr.
To Preference Shareholders A/c

Note: If redemption at premium, premium should be debited and if redemption at discount, it should be credited.

Illustration 8: X Ltd. redeemed 9,00,000 12% preference shares of Rs. 10 each at a premium of Rs. 1.70 per share by issuing sufficient number of equity share of Rs. 10 each issued at discount of Re. 1 per share. Though final call has been demanded and received in previous year, but not paid by a holder of 2,000 shares. Journalise, the transactions, assuming that there is sufficient balance available in securities premium Account.

Solution. **JOURNAL**

Date	Particulars		L.F.	Amount Dr. (Rs.)	Amount Cr. (Rs.)
	Securities Premium A/c	Dr.		15,30,000	
	To Premium on Redemption A/c				15,30,000
	Bank A/c	Dr.		90,00,000	
	To Equity Shares Application A/c				90,00,000
	Equity Shares Application A/c	Dr.		90,00,000	
	Discount on issue of Shares A/c	Dr.		10,00,000	
	To Equity Shares capital A/c				1,00,00,000
	Preference Share Capital A/c	Dr.		89,80,000	
	Premium on Redemption A/c	Dr.		15,26,600	
	To Preference Shareholder A/c				1,05,06,600
	Preference Shareholders A/c	Dr.		1,05,06,600	
	To Bank A/c				1,05,06,600

Note: 1 Provision has been made for unpaid preference shares but payment is not made.

18.7 Accounting Treatment for Redemption out of Profits and Proceeds of Fresh Issue of Shares

In this situation, above 18.5 & 18.6 is combined, the procedure is given in point No. 18.4 (vi.) The accounting treatment is also same as per 18.5 and 18.6. It can be learnt by following example:

Illustration 9: The Directors of X Ltd in their meeting decided to redeem 10,000, 10% fully paid up Preference shares of Rs. 100 each at a premium of Rs. 2 each out of General Reserve Rs. 5,00,000, Capital Reserve Rs. 1,00,000, Securities Premium Account Rs. 25,000 and remaining by issue of sufficient new shares of Rs. 10 each at a premium of Re. 1 each. Journalise.

Solution **JOURNAL**

Date	Particulars		L.F.	Amount Dr. (Rs.)	Amount Cr. (Rs.)
	Securities Premium A/c	Dr.		20,000	
	To Premium on Redemption A/c				20,000
	General Reserve A/c	Dr.		5,00,000	
	To Capital Redemption Reserve A/c				5,00,000
	Bank A/c	Dr.		5,50,000	
	To Equity Share Application A/c				5,50,000
	Equity Share Application A/c	Dr.		5,50,000	
	To Equity Share Capital A/c				5,00,000
	To Securities Premium A/c				50,000
	Preference Share Capital A/c	Dr.		10,00,000	
	Premium on Redemption A/c	Dr.		20,000	
	To Preference Shareholders A/c				10,20,000
	Preference Shareholders A/c	Dr.		10,20,000	
	To Bank A/c				10,20,000

Note: Total amount of nominal value on redemption required = 10,00,000
(-) amount available out of Profit (General Reserve Only) 5,00,000
Of Balance new shares to be issued 5,00,000

$$\frac{\text{Rs. } 5,00,000}{10} = 50,000 \text{ Shares}$$

18.8 Redemption by Conversion of Shares

If Articles of Association permits, a Company can convert its preference shares into equity shares or debentures for this purpose, number of new shares/debentures issued can be calculated by the following formula:

$$\frac{\text{Amount payable to Preference shareholders}}{\text{Issue price of a share or debenture}}$$

Note: 1 If redemption is made on premium, then amount equal to premium on redemption should be adjusted from the balance available of securities premium account or other revenue profit account.

Note 2 When conversion is made, the amount equal to face value of redeemed shares (-) face value of new equity shares, will be transferred to CRR account out of revenue profits.

Illustration 10: Reliance Ltd. redeemed its 5,000, 10% Preference Shares of Rs. 100 each at a premium of Rs. 20 per shares. The company was given an option to convert these shares into Equity Shares of Rs. 10 each issued at Rs. 30 per share. All preference shareholders accepted this option.

Pass necessary Journal entries. Assume balance is available in general reserve account.

Solution: **JOURNAL**

Date	Particulars		L.F.	Amount Dr. (Rs.)	Amount Cr. (Rs.)
	Preference Share Capital A/c	Dr.		5,00,000	
	Premium on Redemption A/c	Dr.		1,00,000	
	To Preference Shareholders A/c				6,00,000
	General Reserve A/c	Dr.		3,00,000	
	To Capital Redemption Reserve A/c				3,00,000
	Preference Shareholders A/c	Dr.		6,00,000	
	To Equity Share Capital A/c				2,00,000
	To Securities Premium A/c				4,00,000
	Securities Premium A/c	Dr.		1,00,000	
	To Premium on Redemption A/c				1,00,000

Note1 : No. of Shares Issued: $\frac{5000 \text{ X } 120 = 6,00,000}{30}$ = 20,000 Shares

2. As new shares issued on redemption of Rs. 2,00,000 face value only hence remaining face value of redeemed shares will be transferred to capital reserve account i.e. (5,00,000-2,00,000) = Rs. 3,00,000

18.9 Disclosure in Balance Sheet

Though we have already read the presentation made in balance sheet in Unit 17, hence here additional points only are being made:

1. If final call on Redeemable Preference Shares are yet due then such shares will be shown in "Share Capital" heading of Liabilities side of the Balance Sheet till forfeiture of these shares.

2. If final call is received, but postal address of a holder is not available then balance of Redeemable Preference Share capital will be Zero and the non payment amount in preference shareholders account will be shown in the heading of "Current Liabilities" in Liabilities side. As in case illustration number 7 Rs. 10,500 will be shown in the heading of "Current Liabilities".

3. "Capital Redemption Reserve account" will be shown in the heading of "Reserve and Surplus" of the liabilities side.

4. The balance of revenue profits account, Securities Premium Account will be altered, due to utilisation.

5. Fresh issue of shares will be entered in "Share Capital" heading of liabilities side after adding in their respective type of shares.

6. Usually, redemption of preference shares are made at par or at premium, if redemption made at discount, such profit is a capital profit and should be shown by transfering it into Capital Reserve A/c. Capital Reserve account will be shown in the heading "Reserve and Surplus" of the liabilities side of the Balance Sheet.

18.10 Summary

A Company can forfeit its shares if call money is not received after issuing notice of 14 days to them. On forfeiture, Share Capital Account is always debited with the called up amount. These forfeited shares can be reissued either at premium or at par, or at discount, but discount cannot be more than balance of share forfeiture account, if forfeited shares are already issued at discount and new re-issue is also on discount, then discount upto original discount amount will be transferred to "Discount on issue of Shares Account" and remaining discount is charged from Share Forfeiture Account. The balance of Share Forfeiture Account, after re-issuing these shares, will be transferred to Capital Reserve account. If parts of forfeited shares are re-issued then proportionate amount of forfeiture account will be transferred to Capital Reserve Account.

At present all the preference shares issued by the company should be redeemable. The redemption can be made out of profits or out of fresh issue or partly by both or by conversion. A Capital Redemption Reserve Account is created out of revenue profits if redemption is made "out of profits". A company cannot redeem partly paid preference shares. A Company cannot stop redemption procedure only because of few shareholders, who could not make the payment of calls money. No capital profits can be used for redemption purpose, only revenue profits can be used.

18.11 Key Words

1. Forfeiture of Shares: Means cancelling the shares for non-payment of calls due as a final action against the defaulting shareholders.

2. Re-issue of Shares: Share forfeited becomes the property of the company and the directors have the authority to re-issue them either at par, at premium or at discount.

3. Capital Redemption Reserve Account: A reserve is created out of revenue profits available at the time of redemption of preference shares equal to nominal value of redeemed shares, when redemption is made out of profits.

4. Capital Reserve: A reserve which is created out of capital profits. It is not free for distribution of dividend and can be used to write-off capital losses.

18.12 Self Assessment Questions

1. What do you understand by the term "Forfeiture of Shares"?

2. What will be the accounting treatment when shares are forfeited.?

3. What do you mean by re-issue of shares?

4. What will be the maximum permissible discount on re-issue of shares, if these shares originally issued at discount?

5. What will be the accounting treatment on re-issue of forfeited shares?

6. What accounting treatment will be made for the balance of share forfeiture account after re-issue of these shares either partly or wholly.?

7. Can a company redeem its redeemable preference shares out of the following:

(i) Out of sale of investments

(ii)

ut of revenue profits.

8. State the provisions of the Companies Act, 1956 regarding redemption of preferences shares.

9. Discuss the different methods of redeeming the redeemable preference shares. Also give journal entries under each method, giving imaginary figures.

10. Z Ltd's., Balance Sheet as on 31st March, 2010 was as follows:

Liabilities	**Amount Rs.**	**Assets**	**Amount Rs.**
Share Capital :		Fixed Assets	6,90,000
1300 8% Pre.shares of 100 each fully paid up	1,30,000	Investment	37,000
9000 Equity Shares of Rs. 50 each fully paid up	4,50,000	Bank	62,000
Reserve and Surplus:			
Profit and Loss Account	96,000		
Current Liabilities :			
Creditors	1,00,000		
Outstanding Expenses	13,000		
	7,89,000		**7,89,000**

In order to facilitate the redemption of preference shares, the company decided : (a) to sell investments for Rs. 32,000. (b) to finance part of the redemption from company funds, subject to leaving a balance of Rs. 24,000 in the profit and loss Account, and (c) to issue sufficient number of equity shares of Rs. 50 each at a premium of Rs. 13 per share to raise the balance of fund required.

The issue of equity shares was fully subscribed and preference shares were redeemed on due date. Pass necessary journal entries to record above transactions.

11. XY Ltd. invited applications for 1,00,000 equity shares of Rs. 10 each, payable as Rs. 2 on application, Rs. 3 on allotment and the balance on first and final call. Application were received for 3,00,000 shares and the shares were allotted on a pro-rata basis. The excess application money was to be adjusted against allotment only. B, a shareholder, who had applied for 3000 shares, failed to pay the call money and his shares were accordingly forfeited and re-issued at Rs. 8 per share as fully paid. Pass the necessary journal entries.

18.13 Reference Books

R.L. Gupta : Advanced Accountancy

P.C. Tulsian : Financial Accounting

Agrawal, Sharma, Agrawal, Shah. : Corporate Accounting

J.R. Monga : Accounting

Unit - 19 Company Accounts - Issue and Redemption of Debentures

Structure of Unit:

19.0 Objectives

After completing this unit you would be able to understand:

- What is debenture?
- The various types of debentures;
- Accounting entries for issue of debentures for cash;
- Accounting entries for issue of debentures for consideration other than cash;
- Accounting process for debentures issued as collateral security;
- About presentation of items related to debentures in the Balance Sheet;
- Procedure of writing off loss on issue of debentures and discount on issue;
- Treatment of interest on debentures in the books;
- Methods of redemption of debentures.

19.1 Meaning and Types of Debentures

A debenture is a written acknowledgement of debt by the company under common seal, and is a contract for repayment of the principal sum at a specified date and payment of interest at a fixed rate until the principal sum is repaid. Generally debentures are secured by floating charge on company's assets, Debenture holders have no voting right. Bond is also an instrument like debenture.

Types of Debentures: A company may issue various types of debentures, which are dealt here with:

(A) On the basis of Security: (i) Secured (mortgage) Debentures: The debentures which are secured on a particular asset are called as fixed charge and which are secured on all assets or no specific assets then called as floating charge. **(ii)** Unsecured Debentures: No assets are pledged by the company with debenture holders.

(B) On the basis of Interest Rate: (i) Specific Rate: When rate of interest on debentures is specified, then it is called as fixed rate debentures. **(ii)** Zero Interest Debentures: No interest rate is specified, hence to compensate, these are issued at heavy discount.

(C) On the basis of Convertibility: **(i)** Fully Convertible: The holders have a right to convert these debentures into shares or new debentures. It may be fully convertible or partly convertible. SEBI has issued guidelines that the conversion should be made within 36 months of the issue. **(ii)** Non-Convertible: The holders have no right to convert them into shares or new debentures.

(D) On the basis of Redemption: (i) Redeemable: Which are redeemable in a specified time **(ii)** Irredeemable: Which are not repayable in life time of a company, now these type of debentures cannot be issued as per SEBI guidelines.

(E) On the basis of Record: (i) Registered: The debentures which are duly entered into register of a company. The transfer can be made and interest is payable to such person whose name appears in the register of debenture holders **(ii)** Bearer: Which are transferable by mere delivery. The company does not keep the record. The interest is payable on production of coupons attached with the debenture certificate.

Difference between Shares and Debentures:

1. Share represents a part of capital, but debenture represents a part of debt.

2. A shareholder is a owner of company but debenture holder is a creditor of a company.

3. Share cannot be converted but debentures may be converted into shares or new debentures.

4. Shares can be forfeited for non-payment of call money but debentures cannot be forfeited though calls due.

5. At the time of liquidation, shareholders will receive payment after payment to debenture holders. Hence debenture holders have a right to get payment prior to shareholder.

6. Dividend is payable on shares if sufficient profits earned by the company, but interest is payable on debentures either company earns profits or not.

19.2 Issue of Debentures for Cash and for Consideration other than Cash

The board of directors have the power to raise the capital by issue of debentures under section 29 of the Companies Act. If total value of debentures issued so far and offered is more than the aggregate amount of paid up capital free plus reserve then directors have to take permission of the shareholders in their meeting.

Issue of Debentures for Cash: Debentures can be issued at par, at a premium or at a discount. The premium received is credited to Securities Premium Account and the utilisation thereof can be for the purposes specified in section 77A and 78 of the Companies Act. It is a capital receipt and cannot be utilised for dividend. Debentures can be issued at discount and rate of discount can be decided by the company there is no restrictions on maximum rate of discount.

Activity A:

1. Premium received on issue of debentures can be used for any purpose. Do you agree? If not. Specify.
2. A company decides to issue its debentures at 15% discount. Company seeks your advice whether it is a violation of section 79? Explain with reasons.

Journal entries of issue of debentures for cash are same as those of issue of shares which are as follows:

On receipt of application money : Bank A/c Dr. (Application money received)
To Debenture Application A/c

On acceptance of application : Debenture Application A/c Dr. (application money on allotted)
To Debenture A/c

On making allotment money due : Debenture Allotment A/c Dr. (allotment money)
Discount on issue of Deb.A/c Dr. (discount on Allotment)
To Debenture A/c (Face value on the allotment)
To Securities Premium A/c (Premium Amount)

If issued at par, premium & discount will not be shown, if issued at discount "Securities Premium" will not be shown, if issued at premium "Discount on issue of Debenture should not be shown. On adjustment of excess money and refund of excess money (if any):

Debentures Application A/c Dr. (Excess money)
To Bank A/c (refund)
To Debentures Allotment A/c (adjustment with allotment)

On receipt of allotment money : Bank A/c Dr. (money recd. on allotment)
To Debentures allotment A/c

On making calls : Debenture call A/c Dr. (call due)
To Debentures A/c

On receipt of call money : Bank A/c Dr. (call money received)
To Debentures Call A/c

Note: Amount of premium is presumed to be demanded along with allotment, if not stated otherwise and discount on issue is adjusted at allotment.

Journal entries for issue of debentures for consideration other than cash are same as those of shares issued for consideration other than cash. Entires are as follows:

On purchases of Assets by issuing debentures:

Sundry Assets A/c Dr.
To Vendor

Vendor A/c Dr.
To Debentures A/c

Note: If debentures issued at discount it will be debited and if issued at premium, premium will be credited in above entry.

Activity B:

1. A company purchased a machine worth Rs. 480000 and decide to issue new debentures of Rs. 100 each at Rs. 120. How much debentures should be issued.

19.3 Issue of Debentures as Collateral Security

"Collateral security" means security provided to the lender over and above the principal security. It is realised only when principal security fails to meet the liability of loan. The holder will return this security after repayment of loan, he has no right to get interest on such debentures. There are two ways for recording in the books:

First method: No entry is recorded however; the fact of issue is disclosed under the heading secured loan in the liabilities side of Balance Sheet.

Balance Sheet (Relevant Part only)

Liabilities	Amount Rs.	Assets	Amount Rs.
Secured Loans: Bank Loan (secured by the issue of 5000 10% Debentures of Rs. 10 each as collateral securities)	40,000		

Second method: The following Journal entry is recorded in the books :

Debentures suspense A/c Dr.
To Debentures A/c (Face Value of Deb. issued as collateral security)

When loan is paid the above entry is cancelled by making reverse entry. Disclosure in balance sheet is as follows:

Balance Sheet

Liabilities	Amount Rs.	Assets	Amount Rs.
Secured Loans: 5000 10% Debentures of Rs. 100 each (issued as collateral security) Bank Loan (secured by 5000 10% Debentures issued as collateral security)	 5,00,000 4,00,000	Miscellaneous Expenditure: Debentures suspense A/c	 5,00,000

Activity C:

1. A company issued 5000 10% Debentures of Rs. 100 each as collateral security to bank against loan of Rs. 4,00,000. A building is mortgaged to bank as prime security of loan. The company is not able to pay loan and bank sold the building and fetch Rs. 3,00,000. Now bank wants to sell the debentures to open market for payment of his dues. Whether bank can do so?

19.4 Disclosure in Balance Sheet

Items related to debentures are disclosed in the balance sheet in following manner:

1. Debentures Account: In liabilities side of the balance sheet under the heading of “Secured Loans” with nominal value of the debentures.

2. Premium on Redemption of Debentures: It is shown in the liabilities side of the balance sheet under the heading of “Current Liabilities and Provisions” until debentures are repaid. It is a liability payable in future; hence it is a personal account.

3. Loss on Issue of Debentures: It is equal to discount on issue and premium on redemption. It will appear in the asset side of the balance sheet under the heading of “Miscellaneous Expenditure” till fully written off. It is a nominal account.

19.5 Writing off of Discount on Issue of Debentures and Premium on Redemption

The total amount of loss on issue of debentures equal to discount on issue of debentures plus premium on redemption. It should be written off against capital profits i.e. securities premium or by debiting profit and loss account. There are two methods for writing off.

First method: When debentures are to be redeemed after a fixed period in total, then such loss is distributed equally to these years.

Note: If redemption is made at discount, due to prudence concept, such unrealised gain should not be recorded at the time of issue of debentures.

Second method: When debentures are redeemed in instalments, then such loss should be written off each year in the proportion to the debentures outstanding at the beginning of each year.

It can be explained by following illustration.

Illustration 1: A company issues its 7000, 10% Debentures of Rs. 100 each at Rs. 92, and redeemable at Rs. 102 on 1st April 2006. Redemption will be in following manner: face value of Rs. 2,00,000 at the end of second year, face value of Rs. 3,00,000 at the end of forth year and remaining at the end of 5th year. Securities premium account shows a balance of Rs. 5000 at the time of issue of debentures. Calculate the amount to be written off and Journal entries for issue and writing off the loss. Accounting year closes on 31st March every year.

Solution: **JOURNAL**

Date	Particulars		L.F.	Amount Dr. (Rs.)	Amount Cr. (Rs.)
2006 April 1	Bank A/c	Dr.		6,44,000	
	To Debenture Application A/c				6,44,000
2006 April 1	Debenture Application A/c	Dr.		6,44,000	
	Loss on issue of Debenture A/c	Dr.		70,000	
	To 10% Debentures A/c				7,00,000
	To Premium on redemption of Deb. A/c				14,000
2006 April 1	Securities Premium A/c	Dr.		5,000	
	To Loss on issue of Debentures A/c				5,000
2007 March, 31	Profit and Loss A/c	Dr.		17,500	
	To Loss on issue of Debentures A/c				17,500
2008 March, 31	10 % Debentures A/c	Dr.		2,00,000	
	Premium on Redemption of Debentures A/c	Dr.		4,000	
	To Bank A/c				2,04,000
2008 March, 31	Profit and Loss A/c	Dr.		17,500	
	To Loss on issue of Debentures A/c				17,500
2009 March, 31	Profit and Loss A/c	Dr.		12,500	
	To Loss on issue of Debentures A/c				12,500
2010 March, 31	Profit and Loss A/c	Dr.		12,500	
	To Loss on issue of Debentures A/c				12,500
2010 March, 31	10 % Debentures A/c	Dr.		2,00,000	
	Premium on Redemption of Debentures A/c	Dr.		4,000	
	To Bank A/c				2,04,000
2011 March, 31	10% Debentures A/c	Dr.		3,00,000	
	Premium on Redemption of Deb. A/c	Dr.		6,000	
	To Bank A/c				3,06,000
2011 March, 31	Profit and Loss A/c	Dr.		5,000	
	To Loss on issue of Debentures A/c				5,000

Working Note: Total Loss = (Discount 8% of Rs. 7,00,000 + 2% of Rs. 7,00,000 (Premium on Red.) = Rs. 70,000. Net Loss after writing off from Securities Premium Account. 70,000-5000 = Rs. 65,000

Statement Showing the amount of loss to be written off

Year	Amount of Debentures Outstanding (Face Value) Rs.	Loss to be Written off Rs.
31.03.07	7,00,000	7/26 X 65,000 = 17,500
31.03.08	7,00,000	7/26 X 65,000 = 17,500
31.03.09	5,00,000	5/26 X 65,000 = 12,500
31.03.10	5,00,000	5/26 X 65,000 = 12,500
31.03.11	2,00,000	2/26 X 65,000 = 5,000
	26,00,000	

19.6 Interest on Debentures

It is calculated on its face value and payable as per information given, normally half yearly. It is a charge on profit. The company will pay after deducting tax deducted at source (if any) to the debenture holders.

Note 1: Interest Accrued and due but not paid is called as interest outstanding and appears under the head "Secured Loans" below the Debentures amount in balance sheet.

Note 2: Interest accrued and not due on the date of closure of books and such "Accrued Interest" is to be recorded on the accounting date and appears under the sub-head "Current liabilities & Provisions". This position will be when accounting date and payment date is different. Journal entries regarding interest are as follows:

When Interest is due:

Debentures Interest A/c Dr. (Gross Interest)
    To Deb. Holders A/c (Net Amount)
    To Income Tax Payable A/c (TDS)

When Interest and TDS is paid:

Debenture Holders A/c Dr. (Net Amount)
Income Tax Payable A/c Dr.
    To Bank A/c

Note: Balance of debenture holders account is "Interest accrued and due but not paid".

On transfer of Interest on Debenture Account:

Profit & Loss A/c Dr. (Gross Amount of Interest)
    To Debenture Interest A/c

If Interest accrued but not due (at the end of accounting year)

Debenture Interest A/c Dr. (Accrued Amount)
    To Accrued Interest A/c

At the beginning of the next year for such accrued Interest but not due:

Accrued Interest A/c Dr.
    To Debenture Interest A/c

Activity D:

1. A company issued 10,000, 12% Debentures of Rs. 100 each at Rs. 95 redeemable at Rs. 96 after 5 years. Company has a balance in Securities Premium Account on the date of issue Rs. 40,000. Company seeks your advice, whether loss on issue of debenture should be transferred to Profit and Loss Account in first year in what so manner. State clearly.

19.7 SEBI Guidelines and Company Law on Redemption of Debentures

Redemption of Debentures means the repayment of the amount of debentures to discharge of the liability on account of debentures. The company can be authorised by its Articles of Association and terms of issue to redeem before the maturity date but normally it is redeemed on the due date. A company can raise funds for redeeming debentures by issue of new Shares, Debentures or sale of assets or by utilising surplus funds or retained profits. Securities and Exchange Board of India (SEBI) issued the guidelines for redemption of debentures are as follows. It should be kept in mind before redemption process starts.

1. A company shall create Debenture Redemption Reserve (DRR) equivalent to 50% of the amount of face value of debentures issued before redemption commences.

2. If debentures maturity period is up to 18 months, from the issue, there is no need of DRR.

3. If debentures are issued for project finance, DRR can be created from the date of commercial production either in equal instalments or higher amount, if profits so permit.

4. In case of Partly Convertible Debentures (PCD), DRR shall be created in respect of non-convertible part of debenture in above manner.

5. In case of non-convertible debentures, DRR shall commence from the year by which the company earns profits for remaining life of debentures.

6. In case of Fully Convertible Debentures (FCD), there is no need for creation of DRR.

7. Infrastructure companies are not required to create DRR.

8. The amount of DRR are not be utilised by the company except for the purpose of redemption of debentures.

9. After redemption of debentures. DRR will be transferred to General Reserve.

Section 117 C of the Companies Act

1. Every company requires creating DRR for redemption of debentures every year with adequate amount out of profits, Here the Companies Act is silent about period, hence if redemption is made within 18 months of issue of debentures though DRR will be created. It is a anomaly between SEBI guidelines and the Companies Act.

2. Listed companies are guided by the guidelines issued by SEBI as-well-as the provision of the Companies Act.

3. Unlisted companies should transfer to DRR an amount equal to 25% of face value of debentures before redemption commences.

4. The Companies Act does not make distinction between infrastructures and non-infra structure company for the purpose of DRR, Hence while solving questions, we will create DRR though infrastructure company.

Accounting entry for creation of DRR

Profit and Loss Appropriation A/c Dr.
To Debenture Redemption Reserve (DRR)

Note: Students are advised while solving the questions that they can assume following assumption if otherwise, is not mentioned in the question. (i) Every company is a listed company. (ii) An adequate amount has already been transferred to DRR.

Disclosure: The Debenture Redemption Reserve Account is shown in liabilities side of the balance sheet under the head "Reserve and Surplus". After redemption of said debentures, this account is closed by transferring it to "General Reserve Account". Accounting entry for transferring DRR after maturity of Debentures':

Debenture Redemption Reserve (DRR) A/c Dr.
To General Reserve

Activity E:

1. An infrastructure company seeks your advice, whether DRR should be created, before redemption of debentures commences.

2. An listed company issues Rs. 10,00,000, 12% Debentures on 1st April 2009. Company decides to redeem them on 30th June 2010. Company seeks your advice by which amount DRR is to be created before commencement of redemption of debentures.

19.8 Methods of Redemption of Debentures

19.8.1 On Maturity in Lump-Sum

Following entries should be passed:

(1) Creation of Debenture Redemption Reserve:
P & L Appropriation A/c Dr.
To Debenture Redemption Reserve (DRR)

(2) When debentures become due for payment:

Debentures A/c Dr. (Face Value of Redeemable Debentures)
To Debenture holders A/c

Note 1 When redemption is made on premium, premium on redemption account should be debited and if, redemption is made on discount, Profit on redemption of debentures should be credited in above said entry.

Note 2 Profit on redemption of debentures is a capital profit, if may be used to write off the amount of discount on issue of debentures, otherwise it should be transferred to Capital Reserve Account.

Note 3 Premium on redemption of debentures is a capital loss, it should be written off from capital profits. The treatment to write off such loss is shown in 19.5

(3) On Redemption:

Debenture holders A/cDr. (amount paid)
To Bank A/c

(4) Transferring DRR account to General Reserve:

Debenture Redemption Reserve A/c Dr.
To General Reserve

Illustration 2: Ramesh Ltd. issued 6000 12% Debentures of Rs. 100 each at par. Debentures were redeemed at 5% premium at the end of fifth year out of profits. There is nil balance in DRR Account. Journalise the transactions. Ignore interest entries and narration.

Solution : **JOURNAL**

Date	Particulars		L.F.	Amount Dr. (Rs.)	Amount Cr. (Rs.)
I Year	Bank A/c	Dr.		6,00,000	
	To Debenture Application A/c				6,00,000
I Year	Debenture Application A/c	Dr.		6,00,000	
	Loss on issue of Debenture A/c	Dr.		30,000	
	To 12% Debentures A/c				6,00,000
	To Premium on Redemption of Deb. A/c				30,000
I Year	Profit & Loss A/c	Dr.		6,000	
	To Loss on issue of Debentures A/c				6,000
II Year	Profit and Loss A/c	Dr.		6,000	
	To Loss on issue of Debenture A/c				6,000
III Year	Profit and Loss A/c	Dr.		6,000	
	To Loss on issue of Debenture A/c				6,000
IV Year	Profit and Loss A/c	Dr.		6,000	
	To Loss on issue of Debenture A/c				6,000
V Year	Profit and Loss A/c	Dr.		6,000	
	To Loss on issue of Debenture A/c				6,000
V Year	P & L Appropriation A/c	Dr.		3,00,000	
	To DRR A/c				3,00,000
	12% Debenture A/c	Dr.		6,00,000	
V Year	Premium on Redemption of Deb. A/c	Dr.		30,000	
	To Debentures holders A/c				6,30,000
V Year	Debenture holder A/c	Dr.		6,30,000	
	To Bank A/c				6,30,000

19.8.2 In Instalments by Draw of Lots

In this method certain portion of debentures are redeemed every year. The debenture holders are selected by draw. It can be learnt through following example. Accounting treatment are same as shown in 19.8

Illustration 3: X Ltd. issued 10,000, 15% Debentures of Rs. 100 each on 1st April 2004, redeemable at a premium of Rs. 5 per debenture as under: on 31st March 2008. 5000 debentures, on 31st march 2009, 3000 debentures and on 31st March 2010 remaining debentures. The company decide to create DRR in four equal annual instalments starting from 31st March 2005. Make Journal entries for redemption only. Ignore narration.

JOURNAL

Date	Particulars		L.F.	Amount Dr. (Rs.)	Amount Cr. (Rs.)
2005	P & L Appropriation A/c	Dr		1,25,000	
March 31	To Debenture Redemption Reserve				1,25,000
2006	P & L Appropriation A/c	Dr		1,25,000	
March 31	To Debenture Redemption Reserve				1,25,000
2007	P & L Appropriation A/c	Dr		1,25,000	
March 31	To Debenture Redemption Reserve				1,25,000
2008	P & L Appropriation A/c	Dr		1,25,000	
March 31	To Debenture Redemption Reserve15%				1,25,000
2009	Debentures A/c	Dr.		5,00,000	
March 31	Premium on Redemption of Debentures A/c	Dr.		25,000	5,25,000
	To Debenture holders A/c				
2009	Debenture holders A/c	Dr.		5,25,000	
March 31	To Bank				5,25,000
2009	15% Debentures A/c	Dr.		3,00,000	
March 31	Premium on Redemption of Debentures A/c Dr.			15,000	
	To Debenture holders A/c				3,15,000
2009	Debenture holders A/c	Dr.		3,15,000	
March 31	To Bank				3,15,000
2010	15% Debentures A/c	Dr.		2,00,000	
March 31	Premium on Redemption of Debentures A/c	Dr.		10,000	
	To Debenture holders A/c				2,10,000
2010	Debenture holders A/c	Dr.		2,10,000	
March 31	To Bank A/c				2,10,000
2010	Debenture Redemption Reserve A/c	Dr.		5,00,000	
March 31	To General Reserve A/c				5,00,000

Note: DRR is created in four equal instalments:

10,00,000 (F.V. of Deb.) X ¼ X 50 % = Rs. 1,25,000 each

19.8.3 By Purchases in the Open Market

A company can purchase its own debentures from open market. It is authorised by its Articles of Association. There are two situations:

(A) When debentures are purchased for immediate cancellation:

(1) When purchased from open market :

Own Debenture A/c Dr. (Cost of purchases of Own Debentures)
To Bank

Note: includes purchase price and purchase expenses.

(2) Cost of purchases for cancellation of own debentures:

% Debentures A/c Dr. (Face value of cancelled debentures)
To own Debentures A/c (cost of Purchases)
To Profit on cancellation of Debentures (Excess of face value over cost of purchases)

Note: Normally own debentures are purchased when these are available below the face value, if, own debenture purchased over face value, then 'Loss on Cancellation of Debentures Account" is debited in the above entry.

(3) Transfer of profit on cancellation:

Profit on Cancellation of Debentures A/c Dr.
To Capital Reserve A/c

(B) Purchases of own Debentures in the open market for investment purpose:

(1) On purchases of own Debentures:

Investment in Own Debentures A/c Dr. (Purchases Price)
To Bank

(2) Subsequently if company re-sale these debentures in the market:

Bank A/c Dr. (sale price)
Loss on sale of own Debentures A/c (excess of purchase price over sale price, if any) Dr.
To Investment in own debentures A/c (Purchases Price)
To Profit on sale of own Debentures A/c (Excess of sale price over purchases price, if any)

Note: The profit or loss on sale of investment in own debentures will be transferred to Profit and Loss Account.

(3) Subsequently if company cancel these debentures:

Debentures A/c Dr. (Face value)
To Investment in own Debentures A/c (Purchase Price)
To Profit on cancellation of own Debentures A/c
(Excess of face value over purchases price)

Note: Profit on cancellation of own debentures is a capital profits, hence it should be transferred to Capital Reserve account. If such own debentures are in hand on date of closing of books of accounts. It will appear as investment as follows. (Disclosure of 'Investment in own Debentures' in the Balance Sheet):

Balance Sheet

		Investments: Own Debentures (Face value Rs......)	---

Treatment of Interest on Own Debentures: When a company purchases its own debentures, normally they are not cancelled immediately or sell in open market. The interest may be due mean while, the company will pay interest to outsiders and interest on own debenture is retained by the company. The accounting entries are as follows:

(i) When interest becomes due:

Debenture Interest A/c Dr. (with total interest)
To Debenture holders A/c (Share of interest of outsiders)
To Interest on Own Debentures A/c (Interest on own debentures)

(ii) On payment:

Debenture holders A/cDr.

To Bank

(iii) On Transfer of debenture interest:

Profit & Loss A/c Dr.

To Debenture Interest A/c

(iv) On transfer of interest on Own Debentures

Interest on own Debentures A/c Dr.

To Profit & Loss A/c

Activity F:

1. A company has an outstanding 2000, 10% debentures of Rs. 100 each. The company purchased its 200 own debentures on April, 2009, which is not redeemed till the year ended on 31st March, 2010. Interest is payable annually on 31st March each year. The accountant of the company recorded interest on 31st March 2010 at Rs. 18,000 and not Rs. 20,000. Company seeks your advice whether it is correct, if not give correct treatment. If yes, comment.

19.8.4 Redemption of Debentures by Conversion

Sometimes, debentures are redeemed by converting them into new class of shares or debentures. If, holders seeks beneficial they can opt. The new Shares/Debentures may be issued at par, at a discount or at a premium. The accounting treatment is as follows:

(1) For amount due to debenture holders:

% Debentures A/c Dr. (Face value)

Premium on Redemption of Debenture A/c Dr.

To Debenture holders A/c

Note: If redemption at par, premium on redemption of debentures should not be debited, if at premium it should be debited, if at discount, "loss on Redemption Account" is credited in the above entry.

(2) On issue of new Debentures or Shares:

Debenture holders A/c Dr.

To Equity Shares Capital/Debentures

Note: If new Shares/Debentures issued at premium, premium should be credited and if issued at discount, discount should be debited in above entry.

Note: No transfer is required in DRR, when debentures are fully convertible.

Illustration 4: A company issued 2500, 12% Debentures of Rs. 100 each at par, redeemable at par. The holders were given a right to convert into new equity shares of Rs. 100 each at a premium of Rs. 5 per share. The holders of 1050 debentures opt the option. Calculate the number of new shares to be issued:

Solution

$$\text{No. of New shares to be issued} = \frac{\text{Amount Payable}}{\text{Issue price of shares}}$$

$$= \frac{1050 \text{ X } 100}{105} = 1000 \text{ Shares}$$

19.9 Redemption of Convertible Debentures Originally Issued at a Discount

If debentures originally issued at discount are converted into shares before maturity date of debentures then the amount to be converted will be equal to net proceeds received from such debenture holders if not do so, violation of section 79 happens. In this situation original discount should be credited while making the conversion entry.

But in case, when conversion into shares is made at the time of maturity of the debentures may be converted into face value. In this situation, no violation of 79 take place.

In case, when conversion of debentures originally issued at discount into new debentures. The face value of redeemed debentures will be converted. Here no violation of section 79, because the new issue relates to debentures not shares.

(A) Journal entries when debentures originally issued at a discount converted into shares before maturity date of these debentures:

Debentures A/c Dr. (Face value)
To Debenture holders A/c (Net proceeds received at the time of issue of such debentures)
To Discount on issue of Debentures A/c (Cancellation of discount on issue of debentures converted)

Debenture holders A/cDr.
To Equity Share/Preference Share Capital A/c (face value)
To Securities Premium A/c (Premium if any)

(B) Journal Entries when debentures originally issued at a discount converted into shares at the time of maturity of these debentures:

Debentures A/c Dr. (Face value)
To Debenture holders A/c (Face value)
Debenture holders A/cDr.
To Equity Share/ Preference share Capital A/c (face value)
To Securities Premium A/c (if any)
Debenture holders A/cDr.
To Equity Share/ Preference Share Capital A/c (face value)
To Securities Premium A/c (if any)

Illustration 5: Z ltd. redeemed 5000 10% Debentures of Rs. 100 each which are issued at a discount of 4%. These are convertible into equity shares of Rs. 10 each issued at Rs. 12. All holders opt the option before one year of the maturity date. Give Journal entires for redemption. Ignore narration.

Solution. **JOURNAL**

Date	Particulars	L.F.	Amount	Amount
	10 % Debentures A/c Dr.		5,00,000	
	To Discount on issue of Debenture A/c			20,000
	To Debenture holders A/c			4,80,000
	Debenture holders A/c Dr.		4,80,000	
	To Equity Share Capital A/c			4,00,000
	To Securities Premium A/c			80,000

Note 1: No of shares issued = $\frac{4,80,000}{12}$ = 40,000

Note 2: It is assumed that no part of "Discount on issue of Debentures" has been written off.

19.9 Summary

A debenture certificate is written acknowledgement of a debenture issued by the company under common seal. A debenture certificate is issued and made of payment of principal amount and interest is fixed and it is stated in such certificate. Interest rate is also fixed. These are usually secured by a charge on asset of the company. Debentures can be issued for cash at par, at a premium or at a discount. Debentures can be issued as collateral security to the lenders. Debentures can be issued for consideration other than cash like for purchases of machine. Interest on debenture is a charge against profit of the company. Discount on issue of debenture is a capital loss and it should be charged first from capital profits and then from revenue profits. Redemption of debenture is a process of repayment of loan taken by issue of debentures. There are four methods of redemption. SEBI guidelines should be followed while redemption takes place. An amount equal to 50% of face value of debentures should be transferred to DRR account before commencement of redemption. Unlisted companies are guided by the guidelines issued by central government accordingly an amount equal to 25% of the face value of debentures should be transferred to DRR account. Debentures can be converted into new shares or debentures, there is no need for creation of DRR, if fully convertible.

19.10 Key Words

Debenture: It is a document given by a company as debt and it is a contract for repayment of principal amount at a specified date. Interest at fixed percentage is payable till redemption.

Floating Charge: When all assets are charged as security. A holder of such charge has a preference over unsecured creditors.

Zero Coupon Bonds: It is a debt instrument, which has no specific rate of interest. It is issued at a substantial discount, so the difference between face value and issue price is treated as interest.

Collateral Security: It is a security provided to the lender over and above the original security. It can realise only when principal security fail to meet the loan.

Redemption of Debentures: It means discharge of the liability on account of debenture.

Debenture Redemption Reserve: An amount which is retained out of revenue profits made for the purpose of payment to debenture holders.

19.11 Self Assessment Questions

1. Distinguish between a debenture and a share.

2. Explain the types of debentures.

3. Explain meaning and accounting treatment of debentures issued as collateral security.

4. X Ltd. purchased, an assets worth Rs. 2 Lakh by issuing 2100 10% Debentures of Rs. 100 each at par. Journalise the transactions.

5. A company took a loan from bank worth Rs. 4,00,000 and issue 5,000 12% Debentures of Rs. 100 each as a collateral security. Explain how you will deal with the issue of debentures in the books of the company.

6. A Ltd. issued 2,000 13% Debentures of Rs. 100 each at Rs. 96. It is redeemable in four equal instalments at 10% premium commencing from the end of third year of the issue. Give Journal entries for writing off of loss on issue of debentures in relevant years.

7. C Ltd. issues 1,000 15% Debentures of Rs. 100 each at Rs. 96 on 1st April 2005 and repayable after 5 years for Rs. 105. Interest is payable half yearly. i.e. on 30th September and 31st March each year. Accounting year closes on 31st March each year. Journalise the transactions assuming TDS rate is 10%.

8. Appolo Ltd. has 5,000 11% Debentures of Rs. 100 each, due for redemption on 31st March 2010. There is a balance of Rs. 3,50,000 in DRR account on the date of redemption. Record necessary Journal entries at the time of redemption.

9. IOL Ltd. has 20,000 10% Debentures of Rs. 50 each due for redemption in five equal instalments starting from 31st March 2006. There is a balance of Rs. 3,40,000 in DRR account on 31st March 2006. Record necessary Journal entries for redemption.

10. IOC Ltd. redeemed 4,500 16% Debentures of by converting them into equity shares of Rs. 10 each issued at a discount of 4%. Journalise.

11. HP Ltd. purchases its 500 debentures of Rs. 100 at Rs. 96 for cancellation. The purchase expenses Rs. 100. Journalise.

19.12 Reference Books

Financial Accounting, Vol. I : Sehgal and Sehgal

Advanced Accountancy, Vol. I : S.N. Maheshwari

Advanced Accountancy, Vol. I : R.L. Gupta and M. Radhaswamy

Financial Accounting : Jain, Khandelwal and Pareek

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