ਜਗਤ ਗੁਰੂ ਨਾਨਕ ਦੇਵ
ਪੰਜਾਬ ਸਟੇਟ ਓਪਨ ਯੂਨੀਵਰਸਿਟੀ
ਪਟਿਆਲਾ

The Motto of Our University
(SEWA)

SKILL ENHANCEMENT
EMPLOYABILITY
WISDOM
ACCESSIBILITY

JAGAT GURU NANAK DEV
PUNJAB STATE OPEN UNIVERSITY, PATIALA
(Established by Act No. 19 of 2019 of the Legislature of State of Punjab)

B.COM

CORE COURSE (CC)

SEMESTER-I

BCB31102T
FINANCIAL ACCOUNTING

Head Quarter: C/28, The Lower Mall, Patiala-147001
Website: www.psou.ac.in

SELF-INSTRUCTIONAL STUDY MATERIAL FOR JGND PSOU

The Study Material has been prepared exclusively under the guidance of Jagat Guru Nanak Dev Punjab State Open University, Patiala, as per the syllabi prepared by Committee of Experts and approved by the Academic Council.

COURSE COORDINATOR AND EDITOR:

DR. Pooja Aggarwal

Assistant Professor in Commerce

JGND PSOU, Patiala

LIST OF CONSULTANTS/ CONTRIBUTORS

Sr. No.	Name
1	DR. RABINDRA KUMAR SWAIN
2	DR. TULKA BAL
3	DR. NEERAJ GOYAL
4	DR. NAVJOT KAUR
5	AP. HIMANSHU AGGARWALL
6	AP CHANDRIKA PRASAD DASS

JAGAT GURU NANAK DEV PUNJAB STATE OPEN UNIVERSITY, PATIALA
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PREFACE

Jagat Guru Nanak Dev Punjab State Open University, Patiala was established in December 2019 by Act 19 of the Legislature of State of Punjab. It is the first and only Open University of the State, entrusted with the responsibility of making higher education accessible to all, especially to those sections of society who do not have the means, time or opportunity to pursue regular education.

In keeping with the nature of an Open University, this University provides a flexible education system to suit every need. The time given to complete a programme is double the duration of a regular mode programme. Well-designed study material has been prepared in consultation with experts in their respective fields.

The University offers programmes which have been designed to provide relevant, skill-based and employability-enhancing education. The study material provided in this booklet is self-instructional, with self-assessment exercises, and recommendations for further readings. The syllabus has been divided in sections, and provided as units for simplification.

The University has a network of 10 Learner Support Centres/Study Centres, to enable students to make use of reading facilities, and for curriculum-based counselling and practicals. We, at the University, welcome you to be a part of this instituition of knowledge.

Prof. G.S. Batra
Dean Academic Affairs

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CORE COURSE (CC)

SEMESTER-I

BCB31102T: FINANCIAL ACCOUNTING

MAX. MARKS: 100
EXTERNAL: 70
INTERNAL: 30
PASS: 35%
Credits: 6

Objectives:

The objective of this paper is to help students to acquire conceptual knowledge of the financial accounting and to impart skills for recording various kinds of business transactions..

INSTRUCTIONS FOR THE CANDIDATES:

Candidates are required to attempt any two questions each from the sections A and B of the question paper and any ten short questions from Section C. They have to attempt questions only at one place and only once. Second or subsequent attempts, unless the earlier ones have been crossed out, shall not be evaluated.

SECTION A

Theoretical Framework : Accounting as an information system, the users of financial accounting information and their needs. Qualitative characteristics of accounting, information. Functions, advantages and limitations of accounting. Branches of accounting. Bases of accounting; cash basis and accrual basis.

The nature of financial accounting principles – Basic concepts and conventions: entity, money measurement, going concern, cost, realization, accruals, periodicity, consistency, prudence (conservatism), materiality and full disclosures.

Financial accounting standards: Concept, benefits, procedure for issuing accounting standards in India. Salient features of First-Time Adoption of Indian Accounting Standard (Ind-AS) 101. International Financial Reporting Standards (IFRS): - Need and procedures.

Accounting Process**:** From recording of a business transaction to preparation of trial balance including adjustments.

Final Accounts, Capital and revenue expenditures and receipts: general introduction only. Preparation of financial statements of non-corporate business entities.

Business Income**:** Measurement of business income-Net income: the accounting period, the continuity doctrine and matching concept. Objectives of measurement.

Revenue recognition**:** Recognition of expenses. The nature of depreciation. The accounting concept of depreciation. Factors in the measurement of depreciation. Methods of computing depreciation: straight line method and diminishing balance method; Disposal of depreciable assets-change of method.

SECTION B

Accounting for Hire-Purchase and Instalment Systems: Journal entries and ledger accounts in the books of Hire Vendors and Hire purchaser for large value items including Default and repossession.

Consignment: Features, Accounting treatment in the books of the consignor and consignee.

Joint Venture**:** Accounting procedures: Joint Bank Account, Records Maintained by Coventurer of (a) all transactions (b) only his own transactions. (Memorandum joint venture account).

Accounting for Inland Branches: Concept of dependent branches; accounting aspects; debtors system, stock and debtors system, branch final accounts system and whole sale basis system. Independent branches: concept accounting treatment: important adjustment entries and preparation of consolidated profit and loss account and balance sheet.

Accounting for Admission, Retirement and Death of a partner in Partnership Firm.

Accounting for Dissolution of Partnership Firm: Accounting of Dissolution of the Partnership Firm Including Insolvency of partners, sale to a Limited company and piecemeal distribution.

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SEMESTER: I

BCB31102T: FINANCIAL ACCOUNTING

COURSE COORDINATOR AND EDITOR: DR. POOJA AGGARWAL

SECTION A

UNIT NO.	UNIT NAME
UNIT 1	THEORETICAL FRAMEWORK OF ACCOUNTING
UNIT 2	GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) AND BUSINESS INCOME
UNIT 3	FINANCIAL ACCOUNTING STANDARDS
UNIT 4	ACCOUNTING PROCESS
UNIT 5	FINAL ACCOUNTS (NON-CORPORATE BUSINESS ENTITIES)
UNIT 6	DEPRECIATION

SECTION B

UNIT NO.	UNIT NAME
UNIT 7	ACCOUNTING FOR HIRE PURCHASE AND INSTALLMENT SYSTEMS
UNIT 8	CONSIGNMENT ACCOUNTING
UNIT 9	JOINT VENTURE
UNIT 10	ACCOUNTING FOR INLAND BRANCHES
UNIT 11	ACCOUNTING FOR ADMISSION OF A PARTNER, RETIREMENT AND DEATH OF A PARTNER IN PARTNERSHIP FIRM
UNIT 12	ACCOUNTING FOR DISSOLUTION OF PATNERSHIP FIRM

B. COM

SEMESTER I

COURSE: FINANCIAL ACCOUNTING

UNIT 1 – THEORETICAL FRAMEWORK OF ACCOUNTING

STRUCTURE

1.0 OBJECTIVES

After studying the Unit, students will be able to

- Define the Meaning of Accounting.
- Explain the Advantages and Limitations of Accounting.
- Distinguish between Accounting and Book Keeping
- Explain the process of Accounting.
- Distinguish between Single and Double Entry System.
- Identify the Accrual and Cash System of Accounting.
- State qualitative characteristics of Accounting.
- Define Accounting Information System

1.1 INTRODUCTION TO ACCOUNTING

Accounting is one of the most important functions of any business enterprise. It is often referred to as "Language of Business". Here when we are using the word 'Language' we mean the 'Communication'. Accounting plays a very effective role in recording the business transactions and communicating the results of economic events of the business to the various users of accounting information. In Business goods may be sold on credit basis to a number of persons persons. In such case the buyer would pay the price of the goods to the vendor at some later date. So, the vendor is always interested to know, from time to time that what amount is due and from various buyers. However, how much strong may be one's memory, one cannot remember all the details of the transactions that took place in the business. Further, the one of the main objective of business is to earn profits; and every businessman likes to know at the end of a financial year that how much profit he has earned during the course of the year. For this purpose, he needs some factual information that can be derived from written records of transactions, which can give him glimpse of the amount earned by him during the year. This information can be derived only if such records have been properly maintained by the business. As such, proper maintenance of books of accounts is very important for any business. This maintenance of records can be done with help of accounting. Now a day's accountancy is helpful not only to businessman but also to clubs, societies, educational institutions, hospitals, professionals and individuals in their household monetary affairs. The scope of accountancy hat so much widened that has entered the areana of both the trading and non-trading institutions

1.2 EVOLUTION OR DEVELOPMENT OF ACCOUNTING

Accounting enjoys a remarkable heritage. The evolution of accounting is as old as civilisation. The seeds of accounting were most likely first sown in Babylonia and Egypt around 4,000 B.C. who recorded transactions of payment of wages and taxes on clay tablets. Historical evidences reveal that Egyptians used some form of accounting for their treasuries where gold and other variables were kept. The incharge of treasuries had to send day wise reports to their superiors known as Wazirs (the Prime Minister) and from there month wise reports were sent to Kings
Babylonia known as the city of commerce, used accounting for business to uncover losses taken place due to frauds and lack of efficiency. In Greece, accounting was used for apportioning the revenues received among treasuries, maintaining total receipts, total payments and balance of government financial transactions. Romans used memorandum or day book where in receipts and payments were recorded and where from they were posted to ledgers on monthly basis (700 B.C. to 400 A.DJ China used sophisticated form of government accounting as easily as 2000 B.C.

Even in India, the use of accounting could be traced to ancient times. In the book Arthashastra, written by kautilya, the minister of the King Chandra Gupta Maurya, around 4th Century BC, there was a separate chapter on "the Business of Keeping up Accounts in the office of Accountants" which described how accounting records had to be maintained. The old method of accounting called "Nama' is still in use, these are now popularly known as Marwari, Managaric' or the Desi" method.

Accounting has existed for many centuries. Although the beginning of accounting could be traced to the period as early as in 443 B.C., the real development of accounting, i.e., the modern system of accounting based on double entry principles, took place only after the year 1450. The first publication on modern accounting system, viz., the double-entry system, came out in Venice in 1494. In that year Luca De Bargo Pacioli, an Italian Monk, wrote a book called "Summa de arithmetica geometric proportioneet proportionalita" or popularly called "Summa" in Italian language. This book was primarily a book on mathematics. A portion of this book contains knowledge of business and book-keeping. In his book, he used the concepts used in Italian terminology, Debit comes from the Italian Debit which comes from the Latin Debita and debeo which means owed to the proprietor Credit comes from the Italian Credit which comes from the Latin 'Credo' which means trust or belief in the proprietor or owed by the proprietor In explaining double entry system, Pacioli wrote that all entries have to be double entries, that for every on creditor you make, you also make one debtor'. By stating the principles of double-entry book-keeping, this book laid the foundation of the modern double entry system of book-keeping and its author Luca De Bargo Pacioli came to be regarded as the founder or father of the modern double-entry system of book-keeping.

Luca De Bargo Pacioli wrote his book in Italian language and later it was translated by Hugh Old Castle in English language and was published in in 1543. Later, James Pule improved the systems of accounting for the purpose of accounts of debtors and creditors. Thereafter, many books were published on accounting. The most important of these was the one published in 1795 by Edward Jones.

In the succeeding year, many improvements took place in accounting, particularly in England. The great expansion of industry trade and commerce, brought about by the industrial Revolution in the eighteenth century led to further improvements in accounting particularly in Europe and USA. Today accounting is highly developed, and is in use in almost all the countries of the world several new accounting concepts have been introduced, and many sew accounting practices and procedures have been developed.

1.3 MEANING OF BOOK-KEEPING

A businessman carries out a number of business transactions in the daily life. However, it is not possible for a person to remember all the transaction that he has carried out. Bookkeeping is a tool that can help us recording these transactions and whenever we are in need of information, we can retrieve the information from books of accounts. Book-keeping is a composite term made of ' Book' and ' Keeping'. The words Book refers to a set of books or book of account and keeping' refers to maintenance in a systematic manner. Thus, Book-keeping is the art of recording the financial transactions of a business or an individual, in terms of money, in a set of books accurately and systematically in order to obtain necessary information other required. Moreover recording the information will help the businessman in controlling the expenditures and also to plan the future activities. The records maintained by the business are also required by the various Agencies like taxation authorities etc. We can define bookkeeping as follows:

"***Book-Keeping is an art and science of recording Business Transactions of Financial nature in a systematic manner and in chronological order.***"

Various authors have defined the term Book-Keeping in different ways. Following are some of the definitions of Book-Keeping:

"Book-keeping is the science and art of correctly recording in books of account all those business transactions that result in the transfer of money or money's worth". R.N. Carter)

""Book-keeping is the art of recording in a suitable form a person's business dealing, so that, at any time their nature and effect may be clearly seen. Thus, Book-keeping is the practical aspect involving the recording of business transactions systematically." (L.C. Cropper)

1.4 FEATURES OF BOOK-KEEPING

On the basis of definitions given above we can churn out some more of the following features of bookkeeping:

1. Bookkeeping is one of the basic activities of business that deals with recording business transactions.
2. It is very important to analyse all the Business Transactions before these are recorded in books of accounts.
3. In bookkeeping only transactions capable of being measured in monetary terms are been recorded, any transaction not being capable of recording in monetary terms is not recorded in book. Any event that cannot be expressed in monetary terms is not recorded in the books of accounts. For example, the employees of the business are very hardworking and honest, but this information cannot be measured in monetary terms, so it will not be recorded in books of accounts.
4. Bookkeeping is an Art as well as Science. It is neither pure art nor it is exact science.
5. All type of business organisation whether Sole Proprietor, a Firm, Company or a Cooperative Society, maintain the books of accounts.
6. Even those organisations which are carrying various activities not with the objective of earning profits also maintain books of accounts. For example, non-profit organisations also maintain accounts.
7. In Book Keeping accounts are maintained in a systematic manner. In other words we can say that there must be proper system of recording transactions in the books of accounts. Now a days normally accounts are maintained using the Double Entry System.
8. Transactions are recorded in the chronological order. In other words, we can say that transaction that take place first is recorded first and the transaction taking place later is also recorded later.

1.5 ADVANTAGES OF BOOK KEEPING

1. **CONTROL OVER ASSETS** - Accounting tells us how much cash is left, how much is deposited in the bank, how much stock is there in the warehouse, how much amount is to be taken from different debtors. Based on this information, proper control can be managed over the asset.
2. **FACILITY IN PREPARING FINANCIAL STATEMENTS** - Financial statements (Profit & Loss Account, and Balance Sheet) are prepared on the basis of accounting records. Based on the details, necessary information is obtained regarding the profitability and financial condition of the organization.
3. **INFORMATION TO STAKEHOLDERS** - The interested parties of accounting such as Owner, Manager, Lender, Creditor gets information from the books maintained by the business. This information helps them in making decisions.
4. **MANY TYPES OF ASSISTANCE TO MANAGERS** - Based on accounting information, managers can take appropriate decisions. Based on this information, they help in planning and controlling all business activities. Financial information and data are needed for cost ascertainment, planning, budgeting and forecasting.
5. **CONVENIENCE IN COMPARATIVE STUDIES** - If a trader has kept his account in proper manner, then he can compare the income and expenditure of the current year with the profit and loss of the previous years.
6. **LEGAL REQUIREMENT -** In many instances, maintenance of books of accounts is legal requirement. For example it is necessary for all the companies under Companies Act of maintain books of accounts.
7. **TAX CALCULATION -** In the income-tax and GST, etc., keeping accounts in the proper manner is required for calculation of the tax liability.
8. **ACT AS EVIDENCE** -The records of the bookkeeping act as an evidence in the court of law. There are many instances when court seek the books of account as evidence and on base of that they give the decision
9. **CONVENIENCE IN SELLING THE BUSINESS** - If a Businessman want to sell his business, then the actual value of business can be determined through the books of account. Therefore, by selling the business, one can get a fair price.
10. **OWNERSHIP AND MANAGEMENT IS BEING DIFFERENT**: In case of company form of organisation, ownership is with shareholders and management is in the hands of Board of Directors. Written records supported by documentary evidence are essential to avoid any mistrust or doubt among owners and managers.

1.6 TEST YOUR UNDERSTANDING (A)

1. Define the term Book-Keeping.

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2. State three features of Book-Keeping.

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3. Give five advantages of Book-Keeping.

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4. Fill up the Blanks.

a. Accounting is also called ....of Business.
b. Double Entry system was given by ……………………………………
c. In Book-Keeping transactions are recorded in... terms.
d. Book-Keeping act as.....................................in the court of law.

1.7 MEANING OF ACCOUNTING

Like we use any language to convey our feelings or communicate with others, Accounting is also the language of the business that convey all the records and performance of the business. The language of accounting is used to communicates the results of business transaction to various parties that has some interest in the business like, proprietor, employees' creditors, lenders, investors, regulators, government and other agencies. The function of accounting is to provide quantitative information primarily of financial nature about economic entities that is needed to be useful making economic decisions. The important definitions of accounting are as follows:

According to R.N. Anthony, "Nearly every business enterprise has accounting system. It is a means of collecting summarising, analysing and reporting in monetary terms information about business"

According to American Institute of Certified Public Accountants, Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money transactions and events which are in part at least of a financial character and interpreting the result thereof From the above it is clear that only recording of transactions is related to book-keeping. Hence, accounting may be considered as beginning where book-keeping leaves off. Never-the-less, book-keeping is essential part and foundation of accounting.

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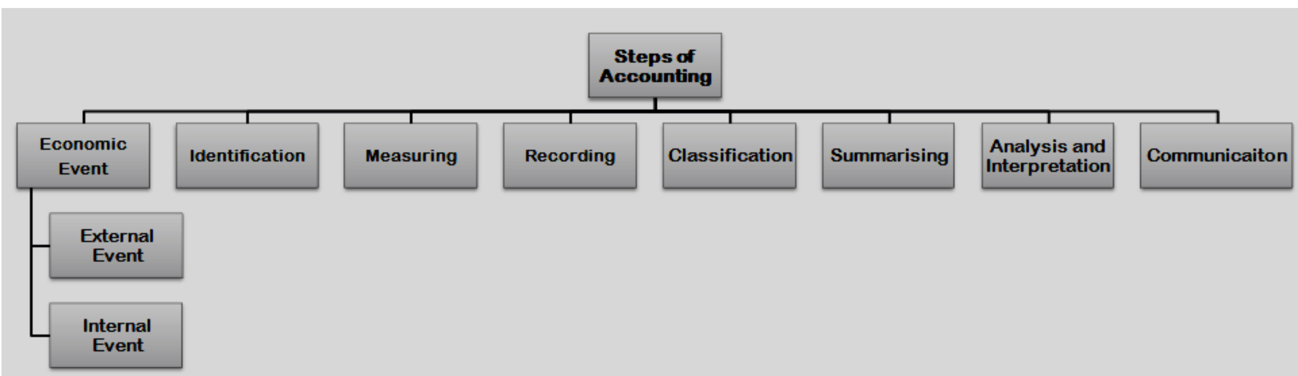
1.8 PROCESS OF ACCOUNTING



1. **ECONOMIC EVENTS**: Economic event is a happening of consequence' of carrying out some activity. These can be divided into two parts viz:
   - **INTERNAL EVENTS**: It is an economic event that occurs entirely within business e.g, Supply of raw materials or equipment by the Stores Department to the Manufacturing Department. Normally these types of events are not recorded in Business.
   - **EXTERNAL EVENTS**: An external event is a transaction which involves the transfer or exchange of something for value between two (or more) persons. For example, Payment of salary to employees, Purchase of goods from supplier, taking Loan from Bank etc.
2. **IDENTIFYING:** Accounting records only those transactions and events which are of a Financial character, therefore, it is necessary to identify recordable economic events. For example if we have purchase goods from supplier it is economic event. But in case we have just placed order for purchase of goods with supplier, it is not the event that is to be recorded in books of accounts.
3. **MEASUREMENT:** Next step is to measure the value of transaction in monetary terms. It means finding the value of transaction. For example if we have Purchase some goods have

list price Rs. 10,000 but supplier offered us a trade discount of 10%, in this case transaction will not be recoded as 10,000, rather it will be recorded at Rs. 9,000.

4. **RECORDING:** Once the economic events are identified and measured in financial terms, they are recorded in an orderly and systematic manner first in the books of accounts, known as recording. Thus, an event the recognition of which gives rise to an entry in books of accounts, is called a transaction. The process of accounting begins with recording all the transactions in the books of initial entry. This book of initial entry is called "Journal". This book can be classified, such as Cash Journal, for recording cash transactions, Purchase Journal, for recording goods purchased, etc.
5. **CLASSIFICATION -** This is the second stage of accounting. Its purpose is to collect transactions or entries of the same nature in a sequential manner at one place. The book in which this work of classification is done is called "Ledger". Accounts are opened on different pages of this book with different heads, under which all financial transactions of similar nature are collected in one place.
6. **SUMMARISING -** Under this the classified data is presented in such a way that they can be understood properly. In this process the following details are prepared: (i) Trial Balance (ii) Income Statement, and (iii) Balance Sheet. This step is very important as it gives the result of business activities.
7. **INTERPRETATION OF RESULTS:** This is the next stage of the accounting process. In this, the results obtained from the final account are analysed. Accounting Ratios are conducted for this analysis, in which information about the profitability, prosperity and liquidity of the business is obtained. This analysis is very useful for managers, investors, banks, creditors etc.
8. **COMMUNICATION:** There are many parties that are interested in accounting information. These include Shareholder, Creditors, Lender, and Taxation Authorities etc. Business communicate the results obtained from books of accounts to these parties. This is also known as reporting.

1.9 ADVANTAGES OF ACCOUNTING

1. **PROVIDES COMPLETE RECORD.** Businessman cannot remember all the information of the business. Accounting maintains complete record of financial transactions during the accounting period of a business. So, we need not to remember each and every information.
2. **INFORMATION REGARDING PERFORMANCE OF BUSINESS:** Accounting reveals how much profit has been earned by the business or how much loss is incurred by the business. This can be ascertained from Profit and Loss Account. Further Balance Sheet gives us financial position of the Business.
3. **COMPARISON OF PERFORMANCE:** Financial accounting helps in making comparison of performance over a period of time. We can compare our performance of this year with the performance of past. Moreover we can make comparison of our performance

with the performance of our competitors. This will help us in improvement of our performance.

4. **MEETING STATUTORY REQUIREMENT:** There are many regulations under different acts and imposed by different authorities which makes the maintenance of accounts necessary. So proper maintenance of accounts helps us in meeting statutory requirement.
5. **FINDING TAX LIABILITY:** Business deals with various tax authorities' value like income tax, GST, Custom etc. These require filing of periodic returns and submitting proof of activities. Records maintained under accounting system help in preparing such returns. Also such records when audited are trusted by the authorities.
6. **PROOF IN COURT OF LAW:** Sometime we have to prove our claim against Debtors or Creditors etc in the court. In such case accounts are used as a proof in the court.
7. **FUTURE PLANNING:** Business managers has to plan for future. But such planning cannot be done in vacuum. It needs lot of data and information. Such information can be obtained from accounts.
8. **BUSINESS VALUATION:** If a Businessman wants to sell his business, then the actual value of business can be determined through the books of account. Therefore, by selling the business, one can get a fair price.
9. **HELPS IN RAISING FINANCE:** Every business needs funds for its growth and expansion. Such funds are raised from institutions like commercial banks; financial institutions in the form of loans. These institutions before sanctioning loans analyse various statements prepared by business such as final accounts, cash flow statements etc.
10. **BENEFITS TO OWNERS:** Accounting helps the owner in knowing whether their funds are used judiciously or not. Like shareholder can see from financial records whether appropriate use of their funds is there or not and whether they are getting fair return or not.
11. **DETECTION OF ERRORS AND FRAUDS:** There can be many errors is maintenance of books of accounts. Similarly there can be some frauds in the business also. Accounting helps us in detection of these errors and frauds.

1.10 LIMITATIONS OF ACCOUNTING

On the basis of accounting, various parties make estimates regarding the profitability of the business and its financial position. Therefore, it is also necessary to have knowledge of the limitations of accounting. Accounting has the following limitations:

1. **IGNORING THE EFFECT OF NON-MONETARY FACTS** - Accounting does not take into account Non-monetary facts and events while such facts have effect the profitability, efficiency and financial stability of the Business. Information related to Employee's skill, Institution's creditworthiness, etc. are not available from the financial statements.
2. **HISTORICAL DATA:** In accounting, all assets and liabilities are evaluated on the basis of historical cost. Hence, the present value is not known from them. This is possible. that the

present value of some assets (such as buildings, machines, etc.) shown in the balance sheet should be very high.

3. **ACCOUNTING CONCEPTS AND CONVENTIONS** - Financial statements are prepared on the basis of certain accounting concepts and conventions. For this reason, the probability of the business shown in the financial statements is not fully correct. For example, permanent properties are represented on the basis of the 'Going Concern Concept' in the financial statement. This means the value of fixed assets shown in statement may not be derived from their selling price.
4. **EFFECT ON PERSONAL DECISIONS** - Many things are left to the personal decision of the accountant. For example, in terms of methods of depreciation, behaviour of Deferred Revenue Expenditure, all the considerations depend on the personal decision of the accountant.
5. **NO TIMELY INFORMATION.** Financial accounting is like post mortem. Means it provide information the year that is already finished. This information may not be of much use as we cannot control our past. Accounting does not provide any information for the period that is yet to come.
6. **NO DETAILED ANALYSIS.** The information provided by financial accounting is just aggregate of the facts and it does not give us detail. Financial accounts show only the results of business enterprise as a unit. It does not provide detailed information of the various subunits of the business. It may be offering three products in the market but accounts do not provide profitability of these three products separately.
7. **WINDOW DRESSING:** The major limitation of the accounting is presence of Window dressing. The term window dressing means showing a better picture then what exist in reality. Many a business firms does not give actual picture of their affairs in their financial statements rather they manipulate the accounts to show a better picture of the business.

1.11 DIFFERENCE BETWEEN ACCOUNTING AND BOOK KEEPING

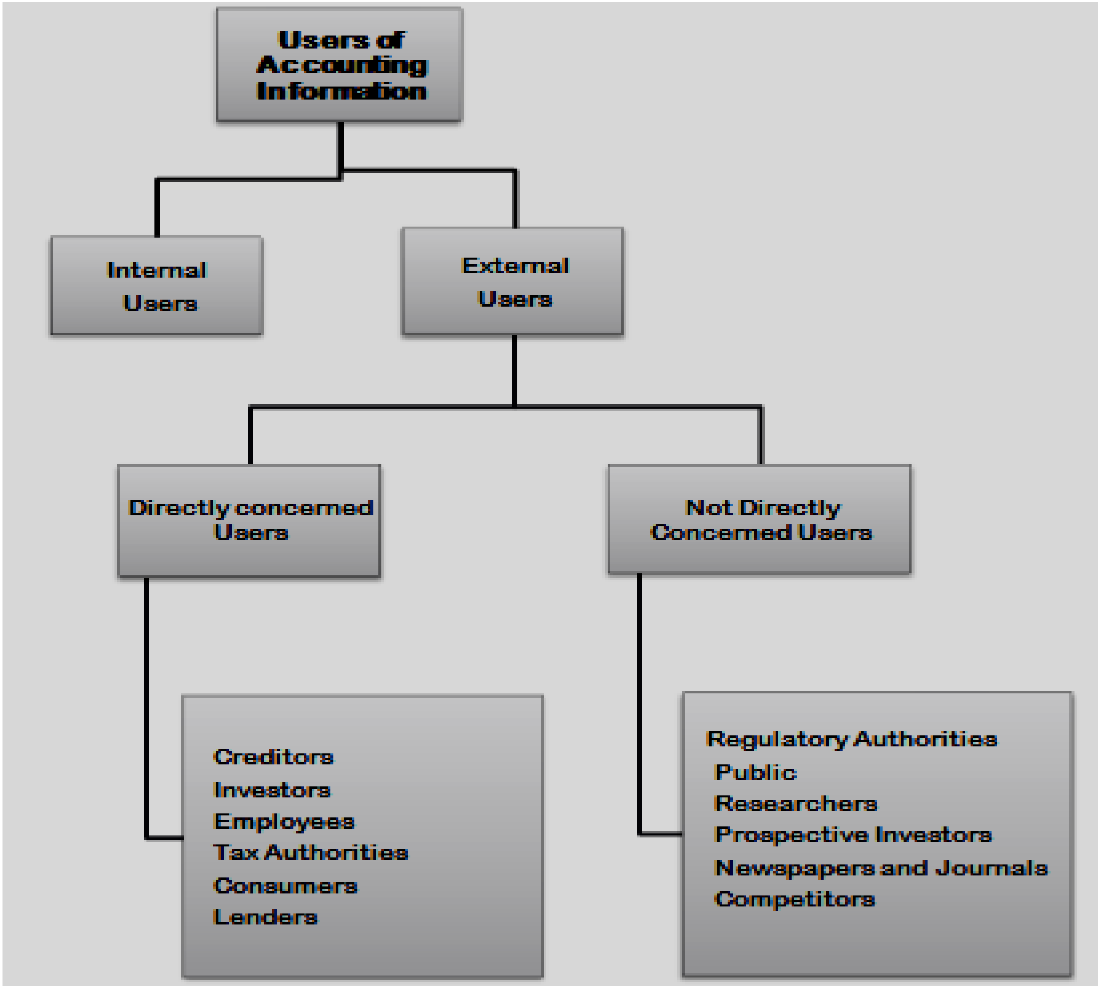
For a layman the term Accounting and Bookkeeping means one at the same thing. However, this is not reality. There is a lot of difference between the term accounting and bookkeeping. The term book keeping is a narrow concept whereas accounting is wider in nature and it includes book keeping also. Following are the main difference between accounting and bookkeeping.

Basis of Distinction	***Book keeping***	***Accounting***
1. Scope	It has narrow scope as it is part of accounting.	It has a wide scope as it covers bookkeeping also.
2. Activities	In includes recording or transaction and posting of Transaction. In other words it includes preparation of Journal	In includes recording or transaction, posting of Transaction, summarizing of transaction and interpretation of transactions. In other words it

	and Ledger only.	includes preparation of Journal, Ledger, Trial Balance and Final accounts.
3. Staff	It is done by junior staff.	It is done by senior officers.
4. Knowledge	It does not require much specialized knowledge. Simple knowledge is required.	It needs special knowledge of the staff.
5. Objective	Main objective is to maintain systematic record of Business.	Main objective is to know Profitability and Financial Position of the business.
6. Stage	It is the primary stage of accounting.	It begins where book keeping ends.
7. Financial Statement	Financial statement is not prepared.	Financial statements are prepared.
8. Time	Book Keeping is done all through the year.	Financial statements are prepared only at end of the year.

1.12 USERS OF ACCOUNTING INFORMATION

The accounts prepared by the business are not only used by owners and managers of the business, rather there are many parties that use accounting information of the business. These parties may be present inside the business like employees of the business for managers etc. However, there are many parties outside the business that use accounting information for example Banks, Government, Creditors etc. Following are some of the users of accounting information:



1.12.1 INTERNAL USERS. These are the users that are present inside the business a mainly include owners of the business, managers of the business and employees etc. These persons may be working as Top, middle and lower level executives in the business. They use accounting information for making different decisions like future planning, controlling business activities, measuring the performance of the business, raising the funds from the market etc. Owners of the use accounting information to check whether they are getting fair return on their investment or not.

1.12.2 EXTERNAL USERS. External users are those users that are not present inside the organisation. Though these users are not present inside the organisation but still they may be interested in accounting information as their interests are attached to the business. Users can be divided into two categories that is user having direct interest in the business and users not having direct interest in the business.

(i) EXTERNAL USERS HAVING DIRECT INTEREST

(a) CREDITORS. Creditors are the persons who give goods aur raw material to the business on credit basis. These may also include those persons who provide the money to the business for short duration of time. These persons are very much interested in finding the liquidity and solvency position of the business as their funds are involved in the business.

(b) INVESTORS. Investors are those persons who have invested their money in the shares of the business. Every investor is interested in accounting information as it gives him idea about safety his funds and he can also get information about the return he is getting on his funds. On basis of accounting information investor can make predictions about the future of the company also.

(c) EMPLOYEES. Employees of a business are directly affected by the performance of the business. if the business is performing well, employees can expect future growth. Similarly they are interested in the account books due to bonus schemes and security of their employment. Account books provide information to the employees regarding the profits earned by the business. On the basis of profits, employees demand bonus from their employer.

(d) TAX AUTHORITIES. Government collect a number of taxes from the business. The amount of such taxes depends upon the sales volume of the business and the profitability of the business. Government gets information regarding sales volume and profitability from the books of accounts. So, they are always interested in accounting information of the business.

(e) CONSUMERS. Consumers are the persons who buy goods and services from the business. Performance of business also affects the price of good and services that a business is offering. Consumers are interested in the accounting information with which an idea of price structure can be made. Moreover, they consume that that business is not involved in unfair pricing practices.

f) **LENDERS**: Lenders are the persons who give loan to the business-like Banks etc. Any lender before providing money to the business is interested in finding the financial position of the business so that the safety of their funds can be ensured. So they check financial statements of the business. Even after providing the funds they are interested in getting timely interest on their lending, so they again check liquidity and solvency of the business.

(ii) EXTERNAL USERS HAVING INDIRECT INTEREST

(a) REGULATORY AGENCIES. Government and their agencies regulate the functioning in various forms of business. There are many agencies that put control over the business. For example, companies are regulated by SEBI or Banks are regulated by RBI.

(b) PUBLIC. Business is part of society. It affects the society and is also affected by the society. The general public is also interested in accounting information as they want to know what business is contributing to the society. Whether business is taking care of social concerns or not.

(c) RESEARCHERS. There are many persons who conduct research in the field of business or finance. For conducting their research they need some data. The financial statements, provide such data to the researchers. These statements are, therefore, of great interest to scholars undertaking research in accounting theory as well as business affairs and practices.

(d) NEWSPAPERS AND JOURNALS: Newspapers and Journals publish lot of information about the business. They publish the achievements, performance and problems of companies. Accounting provides the required information to such newspapers.

(e) PROSPECTIVE INVESTORS: Prospective or Potential investors are the persons who have not yet invested the money in the business but they are planning to invest their funds in business. Before making the investment they are interested in knowing financial position and profitability of the business. Such information is available from accounting records.

(f) COMPETITORS: Accounting records are not only important for business but for competitors also. Competitors also keep an eye on accounts of the business to know the strengths and weakness of the business, so that they can plan their own strategy.

1.13 TEST YOUR UNDERSTANDING (B)

1. Explain Difference between Book-Keeping and Accounting.

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2. Give four limitations of Accounting.

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3. State whether following are True of False.
   a. Book-Keeping is broader than Accounting.
   b. Accounting helps in Future Planning.
   c. Accounting deals with Historical Data.
   d. Creditors are internal users of Accounting.

4. State which stakeholder is interested in following:
   a. Amount of profit for the purpose of Tax. …………………..
   b. Amount of Profit for purpose of Bonus ………………………
   c. Amount of Profit for purpose of Dividend ………………………
   d. Contribution by Business towards society ………………………

1.14 BRANCHES OF ACCOUNTING

There are different branches of Accounting. Following are some of the branches of accounting:

1. **FINANCIAL ACCOUNTING**: Financial accounting is oldest form of accounting. It is the accounting that is maintained by almost every business. Whether it is small business or large business, sole proprietorship, partnership firm, company, manufacturing business or service provider, everybody maintains financial accounts. In Financial accounting, all the transactions of the business are recorded in monetary terms. The main objective of financial accounts is to provide information about the amount of profit earned by business or loss incurred by business during a period. It also gives information about financial position of the business. In many situations maintenance of financial accounts is also a legal obligation for the business. There are different group of people inside the business and outside the business, who are interested in accounting information of the business.
2. **COST ACCOUNTING**: Cost accounting is comparatively a new branch of accounting. Cost accounts are not maintained by every business, rather only manufacturing concerns maintain their cost accounts. This branch of accounting deals with ascertaining cost of product or service of the business. Cost accounts also helps business in fixing the price of the product or to make the quotation for supply of the product. Cost accounts not only helps in maintaining cost information but also helps in controlling the cost of the product. There are many techniques in cost accounting like Budgetary Control or Standard Costing that helps us in control and management of costs.
3. **MANAGEMENT ACCOUNTING**: As the name suggests, management accounting is the branch of accounting that helps the management of the business in managing the functions of the business. Management accounting generate accounting information related to position of funds in the business, cost of the business, assets and liabilities of the business. It tries to draw useful information for the management by analysis and interpretation of the financial statements. Management accounting not only help in management of the business rather it also helps in taking useful decisions. Technique like marginal costing is very useful in decision making. Management accounting also helps in planning the future activities of the business. It helps in forecasting and control. Technique like budgetary control is one such a technique that helps in forecasting and control.

1.15 QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

Accounting information is useful for interested users only if it possess the following characteristics:

1. **RELIABILITY:** Reliability of the information is one of the important characteristic of useful accounting information. The term 'Reliability' means, the information provided in the books of accounts must be traceable and verifiable from the source documents. In Business, some documents are maintained on basis of which information is recorded in the books of accounts and such documents are known as source documents. These source documents helps auditor to verify the information recorded in books of accounts. These documents include invoice, Cash Receipts, Debit Note, Credit Note etc. If some information is recorded but it is not verifiable then it will lose its credibility. All the information recorded in accounts is not equally reliable. For example, amount of plant and machine recorded in Balance Sheet is less reliable than amount of Cash Balance recorded in Balance Sheet. This is due to the fact that the value of plant shown in Balance Sheet may not be realised when it is sold in the market. But this is not the case of Cash Balance.

2. **RELEVANCE:** Relevance is one of the most important qualitative characteristic of accounting information. The term relevance here is very closely associated with the concept of usefulness of the accounts. Relevance characteristics says that only such information must be reported in the books of accounts, that makes our decision making more accurate and useful. However, the term 'relevance' is a relative term, as some information may be relevant for one person but it may not be relevant for other person. So, while reporting we must present that information which is relevant for most of the user. For example, if we make payment to employee for salary, this information is relevant for the business, so it must be recorded in books of accounts. But where amount is spent by the employees is not relevant for the business, so it must not be reported in books of accounts.

3. **UNDERSTANDABILITY:** Accounts are used by different parties for getting some information relevant to them, so it is very important that accounts are presented in a manner that every party is in a position to understand the information provided in the books of accounts. The information presented in accounts must be simple to understand. It must be presented in the manner that even a person of non-accounting background is in a position to understand this information. Wherever the need arise, relevant explanatory notes must also be provided. The data must be provided in the clear and concise men.

4. **COMPARABILITY:** Any information becomes useful if it is comparable with other information like information of previous year or information of other persons. Accounting information is not the exception, so comparability is very important qualitative characteristic of accounting information. A business firm can make it's Inter Firm or Intra Firm Comparison of accounting information. In Intra Firm Comparison, we compare the results of present period with the results of some past period. This can be done by providing figures of current year as well as previous year in Profit and Loss Account and Balance Sheet. Inter Firm Comparison is when we make comparison our

results with results of some other business firm in same industry. This can be done using Ratio Analysis.

1.16 SYSTEMS OF ACCOUNTING

There are different systems of accounting, broadly we can divide these into two categories that are

- Double Entry System
- Single Entry System

1.17 DOUBLE ENTRY SYSTEM

Double Entry System is very old and popular system of accounting. This system of accounting is very scientific in nature. Double entry system is based on the notion that every transaction has two aspects and both these aspects are recorded separately in the books of accounts. Every transaction on one hand give rise to the claims in favour of business and on the other hand it also gives rise to the claims against the business. So every transaction is recorded at least at two places, one in the debit and other in the credit. The amount of debits and credits is always equal in the books of accounts.

1.17.1 DEFINITION

"The double entry system seeks to record every transaction in money or money's worth in its double aspect the receipt of a benefit by one account and the surrender of a like benefit by another account, the former entry being to the debit of the account receiving, the latter to the credit of the accounting surrendering."

1.17.2 FEATURES OF DOUBLE ENTRY SYSTEM

Following are the main features of double entry system:

(1) Every transaction in double entry system is based on the notion that there are two parties, where the one party is providing the benefit and other party is getting the benefit.
(2) Two parties involved in the accounting transactions have opposite interest but with the same amount.
(3) Each transaction is recorded in at least two accounts of the business.
(4) In account transactions are recorded from the angle of the party, whose books are to be recorded.
(5) Each account has two sides — left (debit) and right — (credit).
(6) For each transaction, debit amount is equal to the credit amount.

1.17.3 ADVANTAGES OF DOUBLE ENTRY SYSTEM

(i) Double entry system maintains complete record of the business transactions. In this system not only, personal accounts but also impersonal accounts are maintained.

(ii) As in this system each transaction is recorded at two places, one in the debit and other in the credit and the amount of debit and credit is always equal, it is easy to check the arithmetical accuracy of the accounts. This can be done by preparing Trial Balance.

(iii) The double entry system is very scientific system of maintaining the accounts. This system has got proper rules and regulations for maintaining the accounts.

(iv) The double entry system is having legal approval also. Accounts maintained on the basis of double entry system are approved by Tax Authorities, Banks, Insurance Companies and other Statutory Bodies.

(v) As the double entry system is scientific system of maintaining the accounts, it is very difficult to commit any fraud under this system.

(vi) The double entry system is very popular system of accounting. Most of the countries of the world are using this system, so it has got international recognition also.

(vii) As most of the business maintain their accounts using the double entry system, it is possible to make a comparison between different business firms.

(viii) With double entry system we can determine the amount of Gross Profit and Net Profit earned by the business.

(ix) Double entry system helps in finding the financial position of the business.

(x) This system of accounting is very useful for the management in making their decisions.

1.17.4 DISADVANTAGES OF DOUBLE ENTRY SYSTEM

1. **REQUIREMENT OF EXPERT KNOWLEDGE.** This system of accounting is complicated, so expert knowledge is required for maintaining books on double entry basis. If person is not having expert knowledge of accounting, he cannot maintain books as per this system.
2. **LENGTHY CUMBERSOME PROCESS.** The process of maintaining accounts under Double Entry System is very lengthy, as first information is recorded in Journal and then it is posted to Ledger.
3. **EXPENSIVE.** As this system need qualified and trained staff, this system of accounting is very expensive also.
4. **NOT USEFUL FOR SMALL CONCERNS.** The double entry system is more useful for large concerns who have resources and expert manpower, but small business does not find this system much useful.
5. **NOT ABSOLUTELY CORRECT**: Though double entry system is based on scientific principle but still it does not absolutely guarantee the accuracy of accounts. Even if the trial balance of business agrees, there may be some errors in accounts.
6. **LOT OF PAPERWORK.** This system of accounting involves a lot of paper work. Heavy documentation is required in this system.

1.18 SINGLE ENTRY SYSTEM

Single entry system of accounting is a system under which both aspects of the transactions are not recorded in books of accounts. In some cases both aspects are recorded, while in others either one aspect is recorded or a transaction is not recorded at all. This, is also known as incomplete Double Entry System. Under this system we normally maintain the records of personal accounts and the record of Cash and Bank only. Impersonal accounts are not recorded in this system. This system of accounting is very useful for small scale business, which is normally interested in knowing the position of cash and the amount due from Creditors or due to from Debtors. However, single entry system is not scientific system of maintaining the accounts and does not provide complete information about the business. Moreover it is not possible to find the profitability of the business or financial position of the business on basis of this system of accounting. Further it is very difficult to locate any error in this system.

Difference between single entry system and double entry system

The following are differences between the two systems:

Basis	***Single entry system***	***Double entry system***
(I) Accuracy	As double aspect is note recorded, it is not possible to check the accuracy of accounts.	The accuracy of accounts can be checked by preparing trial balance.
(Ii) Suitable	This system is very useful for small scale firms.	This system is very useful for all types of business firms.
(Iii) Position	It is very difficult to find financial position of the business.	Financial position of a business can be ascertained very easily.
(Iv) Records	Only personal account and cash book is maintained under this system.	All transactions relating to personal, real and nominal accounts are recorded in this system.
(V) Method	It is not a scientific system and only incomplete records of business.	It is a scientific system and provides complete records of business.
(Vi) Fraud	There are more chances of fraud in this system.	Chances of fraud are less in this system.
(Vii) Approval	Not approved for tax purpose and other statutory compliance.	Approved for tax purpose and other statutory compliance.

(Vii)Profitability	Findinag profitability of business in not easy.	Easy to find the profitability of the business.

1.19 ACCRUAL AND CASH BASIS 0F ACCOUNTING:

1.19.1 ACCRUAL BASIS OF ACCOUNTING

In double entry system accounts can be maintained on Accrual Basis or Cash Basis. Accrual system is more commonly used method of Double Entry System and most of the organisations use this method of accounting. Accrual Basis of Accounting is a method of recording business transactions in which all the items of accounting whether Incomes, Expenses, Assets or Liabilities are shown in the accounts in the period with which such items are related. Under this method Incomes are recorded in the books of account in the period in which these are earned ignoring the fact that whether these are actually received in cash or not. Similarly, expenses are also charged to the financial statements in the period with which these expenses relate irrespective of the fact whether the payment is made for these expenses or not. In other words, under Accrual system all items of incomes and expenses, are recorded in period with which these items are related. So, any expense which is not related to the period is not recorded even if payment is made for the same e.g. Prepaid Expenses. This system shows the true and fair view of the business affairs as all items of the period are reflected in the financial statements. All items are shown in statements after making appropriate adjustments. This basis of accounting is also known as Mercantile Basis of accounting. Under the Companies Act 2013, it is mandatory for all companies o maintain the books of accounts according as per this system of accounting.

1.19.2 CASH BASIS OF ACCOUNTING

This system of accounting is either used by small business firms or the persons that are involved in some profession like Doctor, Architect etc. Cash Basis of Accounting is a method of recording business transactions in which all items like Incomes, Expenses, Assets and Liabilities are reflected in statements in period when actual receipt or payment is made. In this system it does not matter that whether item is related to this period or not. For example, if any belong to this period but is not paid in cash, it will not be reflected in the financial statements of this period. Contrary to this if any amount does not belong to this period but is already paid, it will be reflected in the books of accounts. So, any salary paid in advance will be shown in this period financial statement.

1.19.3 DISTINCTION BETWEEN ACCRUAL BASIS OF ACCOUNTING AND CASH BASIS OF ACCOUNTING

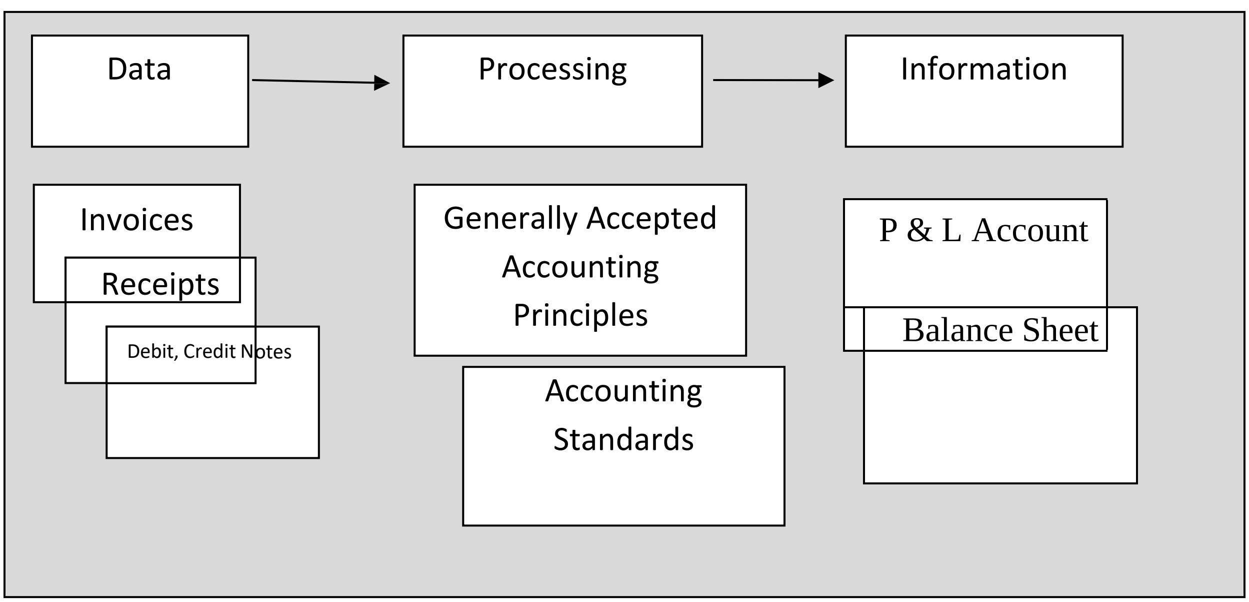
BASIS FOR COMPARISON	CASH ACCOUNTING	ACCRUAL ACCOUNTING

1. Meaning	Incomes, Expenses, Assets and Liabilities are reflected in statements in period when actual receipt or payment is made.	Incomes, Expenses, Assets or Liabilities are shown in the accounts in the period with which such items are related.
2. Nature	Records are simple as one has to see only movement of cash.	Records are complex as outstanding as well as prepaid items are to be taken in consideration.
3. Method	Not recognized method as per companies act.	Recognized method as per companies act.
4. Applicability of matching concept	Matching concept is violated.	Matching concept is not violated.
5. Recognition of revenue	Cash is received	Revenue is earned
6. Recognition of expense	Cash is paid	Expense is incurred
7. Degree of Accuracy	Accounts are less accurate.	Accounts are more accurate.
8. Recognition under the Companies Act,	This basis is not recognised under the Companies Act.	This basis is recognised under the Companies Act.
9. Suitability	For small business or Professionals.	Every business concern.

1.20 ACCOUNTING INFORMATION SYSTEM

An accounting information system (AIS) is a structure of records of business transactions that a business use to collect, store, manage, process, retrieve and report its financial data so that such information may be used by the various parties interested in the accounting information such as Managers, Employees, shareholders, Tax authorities etc. In practical life there exists different types of accounting information systems. There are a number of factors such as the type of activity, the size of the business, the number of transaction, available funds, time availability etc. Broadly we can divide the accounting systems into two parts:

1. **MANUAL ACCOUNTING SYSTEM:** Manual accounting information systems are accounting system in which accounts are maintained using paper and pen and these are mostly used by small scale businesses. This process of accounting includes four basic steps i.e. journalizing the transactions, posting to ledger accounts, making trial balance, preparation of final accounts. In Manual accounting system business records are maintained by accounting employees of the business using books of accounts paper and pen and records are maintained in physical form. We can define manual accounting as: "A traditional system of accounting in which all the basic steps of accounting i.e. Journal, Ledger, Trial Balance and Final Accounts are recorded by accountant using accounting books and pen". Generally, not much number of machines are used in Manual accounting system and even if some machines are used, these are basic machines such as calculators etc.
2. **COMPUTERIZED ACCOUNTING SYSTEM:** Traditionally accounts were maintained manually but with passage of time Computers and Software were developed, which are capable of performing accounting functions. Refinements in computer technology made it possible to develop of new accounting software such as Quick Books, Tally etc. which are very easy to operate and are also capable of performing not only basic accounting steps but can also perform functions like inventory management, tax compliance, payroll accounting etc. We can define computerized accounting as "A computerized Accounting System is the accounting information system that helps in processing the financial transactions and events as per Generally Accepted Accounting Principles and leads to generation of reports as per the requirements of the users with minimum human intervention."



3.3 Features of Computerized Accounting System

1.21 TEST YOUR UNDERSTANDING (C)

1. Briefly Explain various Branches of Accounting.

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2. Explain following Qualitative characteristics of Accounting.

   a. Relevance……………………………………………………………………………..…

   ……………………………………………………………………………………………………

   b. Comparability……………………………………………………………………..…

   ……………………………………………………………………………………………………

3. Fill in the Blanks

   a. Arithmetical accuracy of accounts can be checked in ……………….. system of accounting.
   b. In ....basis of accounting, expenses are recognized on actual payment.
   c. …………………….. firm comparison deals with comparing the results of one business with other business.
   d. In ....system we do not maintain complete records.

1.22 LET US SUM UP

- In 1494, Luca De Bargo Pacioli, an Italian Monk, gave Double Entry System.
- Book-Keeping is an art and science of recording Business Transactions of Financial nature in a systematic manner and in chronological order.
- Accounting means of collecting, summarising, analysing and reporting in monetary terms information about business.
- Accounting is broader than Book-Keeping.
- Accounting information is used by different stakeholders such as Managers, Employees, Creditors, Lenders, Government etc.
- In Accrual system items are recorded in the period with which it related.

- In cash system items are recorded at time of actual payment of receipt.
- Single Entry system is incomplete system of Accounting.
- In Double Entry System each transaction is recorded at two places.
- Reliability, Relevance, Comparability and Understandability are qualitative characteristics of accounting information.
- Accounts can be prepared using the Manual Accounting System or Computerized Accounting System.

1.23 KEY TERMS

- **BOOK KEEPING**: Book-keeping is the art of recording and classifying the financial transactions of a business or an individual, in terms of money, in a set of books accurately and systematically in order to obtain necessary information.
- **ACCOUNTING:** Accounting is the process of recording, classifying, summarizing and interpreting the financial transactions of a business or an individual, in terms of money, in a set of books accurately and systematically in order to obtain necessary information
- **INTERNAL USERS.** These are the users that are present inside the business a mainly include owners of the business, managers of the business and employees etc. these persons may be working as Top, middle and lower level executives in the business.
- **EXTERNAL USERS.** External users are those users that are not present inside the organisation. Though these users are not present inside the organisation but still they may be interested in accounting information as their interests are attached to the business.
- **COST ACCOUNTING**: Cost accounting deals with ascertaining cost of product or service of the business. Cost accounts also helps business in fixing the price of the product or to make the quotation for supply of the product.
- **MANAGEMENT ACCOUNTING**: As the name suggests, management accounting is the branch of accounting that helps the management of the business in managing the functions of the business. Management accounting generate accounting information related to position of funds in the business, cost of the business, assets and liabilities of the business.
- **DOUBLE ENTRY SYSTEM:** Double entry system is based on the notion that every transaction has two aspects and both these aspects are recorded separately in the books of accounts. Every transaction on one hand give rise to the claims in favour of business and on the other hand it also gives rise to the claims against the business.
- **SINGLE ENTRY SYSTEM:** Single entry system of accounting is a system under which both aspects of the transactions are not recorded in books of accounts. In some cases both aspects are recorded, while in others either one aspect is recorded or a transaction is not recorded at all.
- **ACCRUAL BASIS OF ACCOUNTING:** Accrual Basis of Accounting is a method of recording business transactions in which all the items of accounting whether Incomes, Expenses, Assets or Liabilities are shown in the accounts in the period with which such items are related.

1.24 REVIEW QUESTIONS

1. Distinguish between Accounting and Book-Keeping.
2. Write in brief History of Accounting.
3. Give various features of Book-Keeping.
4. Explain how Book-Keeping is beneficial for Business.
5. Write various steps involved in the process of Accounting.
6. Explain in detail various advantages and limitations of Accounting.
7. What is Double Entry System. How it is different from Single Entry System. Give its advantages and limitation.
8. Explain various Branches of Accounting.
9. Explain various qualitative characteristics of Accounting.
10. Who are the various users that are interested in accounting information.
11. Explain the cash and Accrual system of Accounting.
12. What is Accounting Information System. Giver various types of Accounting Information System.

1.25 ANSWERS TO TEST YOUR UNDERSTANDING.

Test your Understanding A

4 (a) Language.

4(b) Luca Paciolo.

4 (c) Monetary

4 (d) Evidence.

Test your Understanding B

3 (a) False

3 (b) True.

3 (c) True

3 (d) False.

4 (a) Government.

4 (b) Employees.

4 (c) Shareholders / Investors

4 (d) General Public.

Test your Understanding C

3 (a) Double Entry
3 (b) Cash.
3 (c) Inter
3 (d) Single Entry.

1.26 FURTHER READINGS

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B. COM

SEMESTER I

COURSE: FINANCIAL ACCOUNTING

UNIT 2 – GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) AND BUSINESS INCOME

STRUCTURE

2.0 OBJECTIVES

After studying the Unit, students will be able to

- Define the Generally Accepted Accounting Principles.
- State the basic Accounting Assumptions.
- State various concepts and conventions used in Accounting.
- Understand the meaning of Business Income.
- Calculate Business Income of a period
- Describe the concept of Revenue recognition.
- Understand the basic provisions of AS-9.
- Describe the Principles of recognition of expenses.

2.1 MEANING OF ACCOUNTING PRINCIPLES

In subjects like mathematics, physics and natural sciences certain set principles and rules are to be followed necessarily. Similarly, even in accountancy, one has to observe and adopt certain rules, regulations, norms and standards. These rules and regulations may not be exact and permanent as in case of exact sciences. They may be subject to constant research and change depending upon change in customs, conventions, traditions and influence of society and the govt., etc. Nevertheless, such rules are necessarily to be adopted while cording, interpreting and reporting the business transactions. These rules are known as 'accounting principles

2.2 DEFINITIONS OF ACCOUNTING PRINCIPLES

(1) According to R.N. Anthony, "The conventions and rules followed in accounting are commonly referred as Accounting principles.

(2) According to Johnson, "Generally speaking, accounting principles are the assumptions and rules followed in accounting, including methods and procedure followed in accounting and application of various rules, methods and procedures in the actual practice of accounting."

2.3 CHARACTERISTICS OF ACCOUNTING PRINCIPLES

1. Accounting principles are various guidelines of Accounting.
2. These principles are based on general rules of Accounting.
3. Accounting principles are not developed by particular person or body rated emerged over a period of time.
4. These principles have general acceptance. In other words most of the people all over the world follow these principles.

5. These principles are man-made and are not like natural principle of Physics etc like Law of Gravity.
6. These principles are mainly based on three criteria that are Relevance, Objectivity and Feasibility.

2.4 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

We can say that accounting is the language of the Business. As a good language is one which convey same meaning to different persons. Similarly, a good accounting system is one which convey true and fair information to all the stakeholders. In order to make accounts more relevant, all over the world some Accounting Principles are followed known as Generally Accepted Accounting Principles (GAAP). These principles are developed to maintain uniformity and consistency in various accounting records. These accounting principles are described in various ways such as concepts, conventions, assumptions, postulates, modifying principles, etc. These accounting principles have not been given by particular person or body rather came into existence over a period of time on the basis of past experience, business traditions, usages, rules of professional bodies and various regulation fixed by government for accounting. However, these principles are not fixed and are bound to be changed with the changes in the legal, environment, technical environment of the place.

1. Generally Accepted are develop with the objective of maintenance of uniformity and consistency in accounting practices in different businesses and different countries.
2. These rules or principles have general acceptance among accounting professionals.
3. Different persons call these rules by different names such as accounting principles, accounting concepts, conventions of accounting, accounting postulates etc.
4. The term 'Principle' has been defined by AICPA as 'A general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice'.
5. The word 'Generally' here means 'in a general manner', that means which is applicable to different persons, different situations, different places.
6. So, Generally Accepted Accounting Principles (GAAP) are the guidelines or rules adopted by the accountants for maintaining the record of business transaction and reporting the result of business transactions, so that there uniformity in the preparation of financial statements and reporting could be done in comprehensive manner.
7. GAAP brings in objectivity in the accounting process, removes biasness and makes financial statements more acceptable for various stakeholders.
8. These Principles are not developed overnight rather these have been evolved over a long period of on basis of business practices, experiences of the accountants and accounting customs.
9. These principles are not static and could undergo change with the passage of time. There are many social, legal or technological factors that have impact on GAAP.
10. In normal accounting terminology GAAP are also referred as Concepts and Conventions. The term concept means necessary assumptions that are fundamental to various accounting

practice, and the term convention referes customs or traditions that are devolved over a period of time.

2.5 TYPES OF ACCOUNTING PRINCIPLES

Accounting principles are also called as concepts, conventions, assumptions, postulates, etc. Briefly speaking these accounting principles can be classified in the following manner:

- Basic Concepts or Assumptions
- Basic Principles
- Modifying Principles
- Accounting Standards

2.6 BASIC CONCEPTS OR ASSUMPTIONS

Accounting is a language of business so accountants all over the world have agreed to follow a number of assumptions while preparing the financial statements. These, assumptions provide a foundation for the accounting process. No business can prepare its final accounts without considering these assumptions or concepts. The accounting profession has developed certain principles to be followed while recording the business transactions. Following are the basic assumptions or concepts:

1. GOING CONCERN CONCEPT

This is one of the fundamental assumptions of accounting. Under this assumption we assume, that the business will continue for a long period of time and it is not going to be liquidated in the near future. This assumption helps us to record the value of assets in the books of accounts. On the basis this assumption, we record all the fixed assets at its original cost and not at the realizable value. Depreciation is also charged on the fixed asset based on its estimated life as we assume that the business is not going to be e liquidated in the near future and we will use these fixed assets over its useful life. This is also one of the reasons that business makes long term plans and acquires fixed assets. Following are some of the importance of Going Concern assumption

- This is the option helps us to record fixed assets at its historical cost less the amount of depreciation on the assumption that business will use these assets for indefinite period and is not going to sell the assets in near future.
- The fluctuations in market price of the assets are not going to affect the business and can be ignored in the books of accounts.
- Business could have long term plan.
- Deferred expenses or incomes are adjusted in the books over the future period.
- Prepaid expenses are treated as assets though these are not realizable in cash.

2. CONSISTENCY ASSUMPTION

In double entry system we record all the transactions of the business using the rules of debit and credit. These rules of debit and credit are same everywhere in the world. However, still there are some areas of accounting where one has to make personal judgment. For example, while charging depreciation on assets, there are various methods through which one can charge the depreciation. Similarly, for valuation of inventory there are many methods that can be adopted. In case business unit adopts one method this year and shift to another method next year, it will create confusion in the minds of accountants and will also make accounts incomparable. According to the concept of consistency business must try to adopt the same accounting practices year after year. In other words we can say that the accounting practice adopted one must not be changed over a period of time. For example if a business has adopted straight line method of charging the depreciation in the first year than it must continue with the same method next year. Business must not shift to written down value method next year. This is known as consistency.

Consistency does not mean that change in method is not at all possible. In case business finds that change in method could result into better presentation of financial statements, it could change its method of accounting. Similarly, in case there is any change in rules & regulations of the government which necessitates change in accounting practice, then also accounting practice may be changed. However, in case of any change in accounting method, the fact must be disclosed in books of accounts along with old and new practice and effect of such change of practice. Following are implications of consistency concept.

- Consistency makes account free from personal biasness.
- In case consistency is followed we can compare financial statements of one year with the financial statements of previous year.
- Consistency makes the accounts more objective and reliable.
- With consistency any confusion in the mind accountants is removed

3. ACCRUAL ASSUMPTION

While preparing accounts with Double Entry System, there are two methods which can be adopted i.e. Cash System of accounting and Accrual System of Accounting. The accrual system of accounting is more accurate, reliable and scientific system of maintaining the accounts. Accrual assumption is one of the fundamental assumptions of accounting. Accrual assumption states that a business must follow Accrual System of accounting as far as possible. It does not mean that a business cannot follow cash system of accounting, it only means that in case accrual system is not followed while preparing the accounts, the fact must be disclosed in books of accounts. If nothing is disclosed in books of accounts, it will be assumed that business is using accrual system of accounting.

Accrual Basis of Accounting is a method of recording business transactions in which all the items of accounting whether Incomes, Expenses, Assets or Liabilities are shown in the accounts in the period with which such items are related. Under this method Incomes are recorded in the books of account in the period in which these are earned ignoring the fact that whether these are actually received in cash or not. Similarly, expenses are also charged to the financial statements in the period with which these expenses relate irrespective of the fact whether the payment is made for these expenses or not. In other words, under Accrual system all items of incomes and expenses, are recorded in period with which these items are related. So, any expense which is not related to the period is not recorded even if payment is made for the same e.g. Prepaid Expenses. This system shows the true and fair view of the business affairs as all items of the period are reflected in the financial statements. All items are shown in statements after making appropriate adjustments. Following are implications of accrual system of accounting:

- Accrual system is more practical and scientific in nature.
- This system of accounting shows accurate results of a period.
- In case a business is not following accrual system of accounting, the fact must be disclosed in financial statements of the business.

2.7 ACCOUNTING CONVENTIONS

(1) RELEVANCE

The Convention of relevance states that only such information must be recorded in books of accounts that is relevant for the business means that is having some usefulness for the business and have some bearing on the decision making. The term relevance here is very closely associated with the concept of usefulness of the accounts. Relevance characteristics says that only such information must be reported in the books of accounts, that makes our decision making more accurate and useful. However, the term 'relevance' is a relative term, as some information may be relevant for one person but it may not be relevant for other person. So, while reporting we must present that information which is relevant for most of the user. For example, if we make payment to employee for salary, this information is relevant for the business, so it must be recorded in books of accounts. But where amount is spent by the employees is not relevant for the business, so it must not be reported in books of accounts. Following are some of the implications of convention of convention of Relevance.

- Business records only such information that is related to the business-like Purchase of good, Payment of Expenditure, Purchase of Assets and Payment of Liabilities etc.
- Information not associated with business is not recorded in books for example what it employees have done with the salary paid to them by business is not relevant for the business.
- Convention of Relevance remove burden of reporting unnecessary items in the books of accounts.

(2) OBJECTIVITY

Accounting record all the transactions that take place in the business. However, Convention of 'Objectivity' states that the transactions recorded in the books of accounts must be backed by some objective proof which is verifiable. In other words we can say that every transaction recorded in the books of accounts must have some proof of transaction which can be verified by any person carrying out verification of accounts. For example, any purchase made by the business must be supported by invoice of purchase, any payment made by the business must be supported with cash memo, all banking transactions must be supported by bank statement, all the goods returned must be supported by debit note or credit note etc. In case business transactions are not supported by verifiable documents, records will not be trustworthy, it will lack confidence of the users and there will be chances of manipulations also. More over taxation authorities cannot check the authenticity of records.

(3) MATERIALITY

We can say that financial accounting is a science of recording business information. However this is not exact science as the principles of financial accounting are not as strict as principles of pure sciences. Convention of materiality says that while recording the business transactions we must analyse time, labour and cost involved in recording the transaction. In case the time and cost involved in recording the transaction outlays the benefits derived from recording the transactions, there must not be detailed disclosure of the item in financial statements. Material items are those items which have some bearing on our decision making. In case any item is not material, it need not to be disclosed separately in the books of accounts. For example purchase of machine is a material item, so must be disclosed in books of accounts. But purchase of dustbin is not material item so it need not to be disclosed separately in balance sheet even though it may be having life exceeding one year.

2.8 ACCOUNTING CONCEPTS

1. BUSINESS ENTITY CONCEPT

Entity concept is one of the important concept of accounting and it is base of recording information in the books of accounts. According to this concept, we assume that business is having a separate entity than its owner. In other words, we treat business and owner of the business as two separate unit. The records are maintained for the business and not for the Owner of the business. This is the reason that we record only those transactions that take place in business and not those transactions that take place at owner's household. Due to this fact any amount invested by owner in the business is treated as liability for the business.

However, it is important to mention here that this distinction between owner and business lies only in the accounts and not in the eyes of law. As far as legal rules are concerned, these treat business and owner as one and the same thing and if anything happens in business which is not according to the rules of law, Owner will be responsible for the same. Following are implications of business entity concept.

- The owner is assumed as a creditor of the business and amount invested by him is treated as liability.
- Business may pay interest on capital to the owner.
- Any private expenses incurred by owner from business fund is not treated as business expenditure rather it is assumed as drawing out of capital by the owner.
- This concept of business entity is not only applicable to joint stock companies rather to sole proprietorship and partnership firm as well.

2. MONEY MEASUREMENT CONCEPT

In accounting, we record all the business transactions in the books of accounts. Now a question arise that what unit should be used for recording business information in the books of accounts. There is no single unit that can record all items of the business. For example, Land is measured terms of yards, Stock in kilogram, Furniture in number of items etc. All these units are heterogeneous, so cannot be used for recording items of the business. Money is the only available unit in which all business transactions can be recorded. According to this principle, only those transactions are recorded in books of accounts that can be measured in terms of money. Non-monetary events like strike in the factory, death of the employee etc. are not recorded in books of accounts. A good unit of measurement is one which remains stable over a period of time. However, we cannot treat money as a good unit of measurement, as its value does not remain same over a period of time. But, there is no choice before business, as money is the only unit that can measure all the items. So, in accounting we assume that the value of money is stable over a period of time. Following are some of the limitation of money as a unit of measurement:

- It ignores the qualitative aspect of the business.
- The value of money does not remain same over a period of time.
- There are many items that are difficult to measure in terms of money such as goodwill.
- Different countries use different units of money. So, it becomes difficult to maintain accounts by multinational companies.

3. ACCOUNTING PERIOD CONCEPT:

In business we assume that business is a Going Concern and will continue for an indefinite period of time and we are not going to close our business in the near future. Though business is a Going Concern but its accounts are maintained for one accounting period. Once the accounting period is over, we close our books of accounts, prepare the financial statements and find out results of the business. This accounting period maybe one quarter, half year or one complete year. However, normally accounts are maintained for one year. In India most of the business follow 1st April to 31st March as accounting year. In olden times this period was followed from Diwali to Diwali. Following are implications of accounting period concept:

- Accounts are prepared for one accounting period.
- Normally this period is one year.
- After end of accounting period, final accounts are prepared and results of business are determined.
- Due to accounting period concept we divided items into capital and revenue.

4. COST CONCEPT:

The cost concept is very important in accounting and it is closely associated with Going Concern Concept. According to this concept, assets are recorded in the books at its cost, which include amount spent on acquisition of asset and all other expenses incurred before asset is ready for use. In other words, we may say that cost provide the basis for recording the assets. Any asset is originally recorded at cost and later depreciation is charged on cost of the Asset. This concept is based on the notion that business is not going to sell its assets in near future, so there is no need of recording assets at its market price. Following are implications of cost concept:

- In business assets are originally recorded at its cost.
- The cost of asset is also known as historical cost.
- Cost include original cost and all expenses incurred before asset is put to use.
- Depreciation is charged on original cost of the Asset.

5. MATCHING CONCEPT:

The matching concept is very important in finding the business income earned during a period. According to this concept we match all the revenues earned during an accounting period with the expenses incurred during that accounting period to find out profits of the period. This concept helps us to find profit as when our revenues are more than our expenses, there is net profit in the business. Similarly, if expenses exceed revenue of the period, then there is net business loss. Following are some of the implications of Matching Concept:

- Outstanding and prepaid expenses are determined by the business.
- Business determines the amount of accrued income and income received in advance.
- Depreciation is charged on the fixed assets.
- Distinction is made between capital and revenue items.
- Valuation and accounting is done for closing stock.

6. PRUDENCE / CONSERVATISM CONCEPT

In business, sometime we have to make anticipation of the items that are likely to occur in the future course. The concept of conservatism says that we should not anticipate any profits rather anticipation must be done only for the losses. According to this concept, business must make provision for all probable losses but probable gains must not be provided in books of accounts. The rationale behind this principle is that the business must note overstate the profits earned by it. Following are some of the implications of this concept:

- Provision is created for bad and doubtful debts.
- Closing stock is valued at Cost Price or Net Realisable Value whichever is less.
- Value of assets must not be overestimated in books of accounts.

7. FULL DISCLOSURE CONCEPT

According to this concept, business must fully disclose all its information which is material and relevant for stakeholders in its financial statements. The financial statements of business must reflect ‘True and Fair view’ of its affairs and there must not be any ‘window dressing’ in the books of accounts. Business must not hide any material information from its stakeholders. Objective behind this concept is to make accounts complete, meaningful and transparent. Following are some of the implications of this concept:

- Contingent liabilities are shown with help of note along the financial statements.
- Disclosure is made regarding any change in accounting policy.
- Market value of investments is also disclosed along with cost price of Investments.

8. REALISATION CONCEPT

This concept is related with the recognition of revenue in the business. According to this concept, any income should be considered in books of accounts only when such income is realised. Any unrealised income should not be recognised in books of accounts. Now a question arises, what we mean by the term realisation of income. According to legal terms, any income is realised when we get legal right of claiming such income. For example, in case of sale of goods, income is realised when ownership is transferred to the other person and not at the time when such amount is received. Because immediately after transferring the ownership of item business becomes eligible for claiming the value of that item.

9. DUAL-ASPECT CONCEPT

Dual concept may be stated as "for every debit, there is a credit". Dual Aspect concept is based on the notion that every transaction has two aspects and both these aspects are recorded separately in the books of accounts. Every transaction on one hand give rise to the claims in favour of business and on the other hand it also gives rise to the claims against the business. So every transaction is recorded at least at two places, one in the debit and other in the credit. The amount of debits and credits is always equal in the books of accounts. This concept give rise to accounting equation which states that at any point of time the assets of any business must be equal to the total of owner's funds and liabilities payable to outsiders. This may be expressed in the form of equation:

A — L = C

Where

A = Assets of the business

L = Liabilities of the business

C = Capital of the business

Following are the main implications of Dual Aspect Concept:

- Each transaction is recorded in at least two accounts of the business.
- In account transactions are recorded from the angle of the party, whose books are to be recorded.
- Each account has two sides — left (debit) and right — (credit).
- For each transaction, debit amount is equal to the credit amount.

2.9 CHECK YOUR UNDERSTANDING (A)

No.	Description	Accounting Concept
1	Business must anticipate only Losses but not profits	
2	The Capital introduced is liability of the business.	
3	Method of Stock valuation must remain same year after year	
4	We do not show Increase or Decrease in the market value of an asset	
5	Our employees are honest, it cannot be accounted	
6	Transactions must be supported by verifiable source document	
7	Salary is shown even if it is outstanding	

2.10 MEANING OF BUSINESS INCOME

8.	The Businessman and Business are separate persons	
9	For every debit there is a equal credit	
10	Business will continue over a long period of time	
11	Stock is shown in books at least of cost price or net realizable value.	
12	Depreciation of fixed assets is charged to P/L Account	
13	Final accounts are prepared at the end of every year.	
14	Sales is recorded when the title of goods passes	
15	Profit = Revenue – Expenses	
16	Closing stationery is not shown as asset	
17	Business shows Contingent liabilities also	
18	Personal transactions of the owner are not shown in accounts	
19	Business information should not have any bias	
20	Closing stock is shown on credit side of Trading A/c	

Business is economic activity, the main objective of which is to earn maximum profits through production and distribution of Goods and Services on regular basis. The amount generated by business from distribution of Goods and Services is the base of business income. In other words, we can say that Business Income refers to amount realised by business from sale of Goods and Services over the cost of generation of Goods and Services. It is excess of revenue over the expenditure incurred by the business.

There is no single definition given by any expert clearly defining the term Business Income. However, for the purpose of our discussion the definition given by American Accounting Association is appropriate, which define the term business income as

"The realized net income of an enterprise measures its effectiveness as an operative unit and is the change in its net assets arising out of a (a) the excess or deficiency of revenue compared with related expired cost, and (b) other gains or losses to the enterprise from sales, exchange or other conversion of assets:"

For the purpose of measuring Business Income only such income is considered that is realised. If income is not realized, it is not treated as income. For example, the value of Land is increased and the land is sold on such increased value, it is treated as income because amount is already realised. If there is increase in value of land, but it is not yet sold, it cannot be treated as income because amount is not yet realised.

2.11 FEATURES OF BUSINESS INCOME

1. Business income depends upon the transactions carried on by business.
2. Business income is always calculated for a particular accounting period. This period may be one month, one quarter, half year or one year.
3. The amount of business income depends upon method adopted for recognition and measurement of the revenue of business.
4. For calculating business income, all business expenses are also required to be measured.
5. Business income is calculated on base of matching principle. It means for calculating business income, we match the revenue and expenses of same accounting period. If revenue exceeds expenses then it is business profit and if expenses exceeds revenue then it is net business loss.
6. In other words, we can say that business income is increase in net worth of the business during one accounting period.
7. While calculating business income, we consider only those amounts that are realised. Amounts which are not yet realized, are not considered as business income.

2.12 OBJECTIVES OF MEASURING BUSINESS INCOME

1. Measuring business income helps us to calculate return on investment. Return on investment gives us the idea that's how profitably our fund been invested in the business.
2. Calculation of business income in making future projections also. If we have knowledge about business income of past few years, on basis of this we can make future projections.
3. Knowledge of business income is necessary for finding the amount of tax payable by Business to the government.
4. Business income can be used as a yardstick for measuring the overall performance of the business.
5. Knowledge of business income helps us in decision making. There are many decisions like Capital Budgeting etc. that depends upon business income.
6. Calculation of business income is important for determining the amount payable to shareholders in form of dividends.

7. The amount payable to employees bonus etc. also depends upon amount of business income.
8. Measurement of business income helps us in optimum use of our scarce resources.

2.13 PROCEDURE FOR MEASUREMENT OF BUSINESS INCOME

1. **SELECTION OF ACCOUNTING PERIOD**: The first step in measurement of business income is to select the accounting period. Business income is always calculated for accounting period. Though this period may be one month, one quarter, half year or one year, but in general practice we calculate business income for one year. Further, normally this period starts from 1st April and ends with 31st March. However, it is not necessary to follow April to March as accounting period, any other period could also be considered like January to December.
2. **IDENTIFICATION OF REVENUE:** Next step in measurement of business income is identification of revenue of the accounting period. While recognising revenue, care must be taken to consider only those items of revenue that are realized during the accounting period. Items that are not realized during the accounting period must not be considered.
3. **IDENTIFICATION OF COSTS**: The measurement of business income not only depends upon revenue, it also depends upon the amount of cost incurred by the business. Only expenses related to that accounting period must be considered while calculating Business Income. Further both cash and non-cash expenses like depreciation etc. must be taken into account.
4. **MATCHING THE REVENUE AND EXPENSES**: The last step in measurement of business income is to match the revenue and expenses of that accounting period. If the amount of revenue is more than expenses of the accounting period then balance amount is known as Net business profit. In case amount of expenses is more than revenue of the period the balance amount is net business loss.

2.14 METHODS OF COMPUTATION OF BUSINESS INCOME

For calculating the business income there are mainly two methods that are used in practical life.

1. **BALANCE SHEET APPROACH / NET WORTH APPROACH**: The Balance Sheet or Net Worth Approach is simple method of finding the business income. Under this method, business income is measured by deducting value of capital employed at the beginning of the year from the capital employed at end of the period. However, any fresh capital introduced during the must be deducted from balance and any amount distributed as dividend or drawing must be added to such balance. Following example will make this concept clear.

   EXAMPLE: If a business has capital of Rs. 8,00,000 as on 31st March 2021, while the same amount on 1st April, 2020 was Rs. 6,00,000. The amount withdrawn during the year is Rs. 1,00,000 and further capital introduced is Rs. 50,000. Find out amount of profit earned by the business.

STATEMENT OF PROFIT OR LOSS

Particulars	Rs.
Capital as on March 31, 2021	8,00,000
Add : Drawings during the year	1,00,000
	9,00,000
Less : Additional Capital Introduced during the year	(50,000)
Less : Capital as on April 01, 2020	(6,00,000)
Profit made during the year 2020-21	**2,50,000**

2. **TRANSACTION/ MATCHING APPROACH**: This is second method of measuring business income. Transaction method is more detailed and scientific method of measuring business income. Under this method we match the revenue and expenses of the accounting period. In case revenue of the accounting period is in excess of expenses of the accounting period the balance amount is treated as Net business profit. Vice versa if amount of expenses exceeds revenue, then balance amount is net business loss.

2.15 ACCOUNTING CONCEPT AND INCOME MEASUREMENT

The measurement of Business Income depends upon a number of Accounting Concepts and Conventions. Following are some of the accounting concepts related to measurement of Business Income:

1. **GOING CONCERN CONCEPT:** This is one of the fundamental assumption of accounting. Under this assumption we assume, that the business will continue for a long period of time and it is not going to be liquidated in the near future. This assumption help us to record the value of assets in the books of accounts. On the basis this assumption, we record all the fixed assets at its original cost and not at the realizable value. Depreciation is also charged on the fixed asset based on its estimated life as we assume that the business is not going to be e liquidated in the near future and we will use these fixed assets over its useful life. This is also one of the reason that business make long term plans and acquires fixed assets. Following are some of the importance of Going Concern assumption.
2. **ACCOUNTING PERIOD CONCEPT:** In business, accounts are maintained for one accounting period. Once the accounting period is over, we close our books of accounts, prepare the financial statements and find out results of the business. This accounting period maybe one quarter, half year or one complete year. However, normally accounts are maintained for one year. In India most of the business follow 1st April to 31st March as accounting year
3. **MATCHING CONCEPT:** The matching concept is very important in finding the business income earned during a period. According to this concept we match all the revenues earned during an accounting period with the expenses incurred during that accounting period to find out profits of the period. This concept helps us to find profit as when our revenues are more than our expenses, there is net profit in the business.

Similarly, if expenses exceed revenue of the period, then there is net business loss.

2.16 MEASUREMENT OF BUSINESS INCOME

As discussed earlier business income is difference between the revenue earned by the business and incurred by it. For measurement of business income we have to understand these two concepts.

2.17 MEASUREMENT OF REVENUE (REVENUE RECOGNITION)

Revenue is the amount generated by business from sale of goods rendering the services to the consumers. In other words, it may be said that it is the consideration received by business from sale of goods and services. There are two bases of measurement of revenue:

1. **ACCRUAL BASIS:** Accrual Basis is a method of revenue recognition in which all the items of accounting are shown in the accounts in the period with which such items are related. Under this method Incomes are recorded in the books of account in the period in which these are earned ignoring the fact that whether these are actually received in cash or not. This system shows the true and fair view of the business affairs as all items of the period are reflected in the financial statements. All items are shown in statements after making appropriate adjustments.
2. **CASH BASIS OF ACCOUNTING:** This system of accounting is either used by small business firms or the persons that are involved in some profession like Doctor, Architect etc. Cash Basis of Accounting is a method of recording business transactions in which all Incomes are shown in the accounts in the period in which actual receipts or actual payments are made. In this system it does not matter that whether item is related to this period or not.

TIME OF REVENUE RECOGNITION

Depending upon the criteria adopted by business for revenue recognition, revenue can be recognised in books of accounts at different timings. Following are the criteria mostly followed in business in recognition of revenue:

1. **POINT OF SALE:** This criteria revenue is recognised at the moment ownership of the goods is transferred by seller to the buyer. Immediately after ownership of goods transferred by seller to buyer he becomes eligible for charging the amount from buyer, so revenue is recognised in the books of accounts. This criterion is based on realisation concept of accounting.
2. **PROVISION OF SERVICES**: This criteria is applicable when person is involved in providing services to the consumer. Under this criteria revenue is recognised immediately after service is provided, no matter whether amount is yet received or not. This criteria is based on accrual concept of accounting.
3. **RECEIPT OF AMOUNT**: This criteria of revenue recognition is based on cash basis of accounting. Under this criteria amount is recognised in the books at the time of receipt of payment and not at the time of sale of goods or rendering of services.
4. **INSTALMENT METHOD**: Sometime goods are sold on instalment basis, under which

buyer makes the payment not in one go, rather amount is paid by him in periodic instalments. This system is mainly used durable goods are sold. Under this criteria seller has two options, first to treat instalment sale as credit sale and recognise whole revenue. Second option is to recognise only that part of revenue for which instalment is due.

5. **CONTACTS**: In case of contracts, it is difficult to recognise the revenue as sometime the duration of contract is very long. In this case revenue is recognised according to the Degree of completion of the contract. Under this we calculate percentage of work that is completed during the year and only that portion of revenue is recognised which pertains to completed work.
6. **MINING**: In case of mining revenue is recognised in the accounting period when mining is done not at the time when amount is received.

2.18 ACCOUNTING STANDARD 9 - REVENUE RECOGNITION

Accounting standard number 9 issued by Institute of Chartered Accountants of India deals with revenue recognition of the business. Following are main provisions of AS 9.

1. **MEANING OF REVENUE**: As per AS 9 'Revenue is gross inflow of cash receivable consideration arising from activities pop up business like providing services, selling goods receiving interest, dividend etc'.
2. **TIMING OF REVENUE RECOGNITION**: Any revenue earned from sale of goods or rendering of services must be recognised at the time when such sale was made for service was rendered. In case at time of sale or rendering of service is uncertainty about collection of amount of revenue, then such revenue must not be recognised until revenue became certain.
3. **APPLICABILITY OF STANDARD:** AS 9 is not applicable following revenue as specific standard are there for such revenue:
   - Revenue earned from construction contracts.
   - Any revenue arising from hire purchase agreements for lease agreements.
   - Any revenue earned by way of government grants or subsidies.
   - Revenue earned by insurance companies.
   - Gain on fixed assets whether realised or unrealised.
4. **REVENUE FROM SALE OF GOODS:** Revenue from sale of goods is recognised when ownership of the goods is transferred to the buyer. However, in following cases revenue is recognised as per rules
   - In case goods need to be installed by seller, revenue is recognised after installation.
   - In case goods are sold on approval basis, revenue is recognised after such approval is communicated.
   - In case of guaranted sales, revenue must be recognised as per agreement of sale after reasonable period has expired.
   - In case of warranty sale, revenue is recognised immediately but provision is kept for warranty.

- In case of consignment revenue is recognised after sale is made to third party.
- In case of instalment sale, revenue is recognised immediately but interest should be recognised separately according to the Time period.

5. **REVENUE FROM RENDERING OF SERVICES**: Any revenue is recognised at the time service is provided. In case of completed service, revenue is immediately recognised. In case of service not yet complete, proportionate revenue can be recognised. Following are some rules regarding services:
   - For installation fees, revenue is recognised when installation is done.
   - For advertising service, revenue is recognised when such advertisement appears before public.
   - For insurance commission, revenue is recognised after commencement of policy.
   - For Financial Service Commission, revenue is recognised when search service is rendered.
   - For admission for membership fees, revenue is recognised after admission.
   - For tuition fee, revenue is recognised over the period when instructions will be provided.
6. **INTEREST:** Any revenue earned from interest is recognised on the time proportion basis.
7. **ROYALTY:** Any revenue from royalty is recognised as per the terms of agreement of royalty.
8. **DIVIDEND:** Dividend share is recognised when such dividend is declared by the company.
9. **UNCERTAINTY OVER REVENUE COLLECTION**: In case of any uncertainty over collection of revenue, revenue is recognised only after it became certain.
10. **SUBSEQUENT UNCERTAINTY**: In case of uncertainty arise after revenue is recognised, provision should be made for such uncertainty.
11. **DISCLOSURE:** In case revenue recognition is postponed due to some reason, the fact must be disclosed in statements along with circumstances due to which postponement was done.

2.19 RECOGNITION OF EXPENSES

MEANING OF EXPENSES

Expenses represent the amount spent by business during accounting period in order to earn some revenue. In other words, we can say that expenses are the cost incurred to earn the revenue. Though, it is not necessary that expenses are paid in cash. These may be cash expenses like Salary, Rent, Electricity Bill etc., or may be non-cash expenses like Depreciations. In accounting a business may recognise the expenses on Cash Basis or on Accrual Basis. In cash basis Expenses are recognised in the period in which these are actually paid. Whereas in Accrual Basis, expenses are recognised in the period with which it relates.

CLASSES OF EXPENSE:

Though expenses can be divided into different categories but as per accounting we can divide accounts into two categories:

CAPITAL EXPENDITURE

Capital Expenditure is incurred to acquire some long term whose useful life is at least more than one accounting period. Capital expenditure is incurred in acquiring those assets which are not for resale and is incurred to improve the present condition of an asset as it reduces the cost of production. Following are some characteristics of Capital Expenditures:

- Capital Expenditure is incurred to acquire some long term whose useful life is at least more than one accounting period.
- Capital expenditure is incurred in acquiring those assets which are not for resale.
- Capital expenditure is incurred to improve the present condition of an asset.
- In many instances these have physical existence and can be seen.
- Sometimes these are incurred to acquire right to carry on business e.g. goodwill and copy rights.
- Mostly, these expenses are be capable of repeated use.
- These may help in increasing the earning capacity of business.

REVENUE EXPENDITURE

These expenses are incurred on the day to day conduct of the business. It is expenditure on consumable items, on goods and services for re-sale, either in original or improved form. Its benefit is generally derived for one accounting year. Following are some characteristics of Revenue Expenditures.

- It is expenditure incurred on the day to day conduct of the business.
- Its benefit is generally derived for one accounting year.
- It is expenditure on consumable items, on goods and services for re-sale, either in original or improved form.
- It is incurred on maintaining the fixed assets in working order like repair etc.
- Many times, it is of recurring or repetitive nature.
- It is incurred to maintain the earning capacity of the business.
- Mostly these do not have physical existence.

RECOGNITION OF EXPENSES:

Following methods could be adopted for recognition of Expenses:

(1) MATCHING PROCESS: This is most common method of recognizing the expenses. As expenses are incurred to earn the revenue. So, there must be matching in the Revenue and expenses. Expenses must be recognised when revenue is recognised. However, some time there is direct relation between revenue and expenses, but other time direct relation may not be there. For example, the relation, be cost of goods sold and sales is direct relation. In such case cost is recognised when sale is recognised. However, some time there is no direct relation, for example a business incurs expenses on Advertisement but it does not affect the sale. In such case these are recognised when expense is incurred.

(2) SYSTEMATIC AND RATIONAL ALLOCATION: Some time the benefit of expense is not limited to one accounting period, it may be spreads over more than one accounting period. In such case we need systematic and rational allocation expense. In such situation we may allocate the expense according to benefit derived from that expense over a period of time. In absence of this information it may be spread equally over the period of use.

(3) IMMEDIATE RECOGNITION: In some circumstances we have to immediately recognize the expense. Following are such circumstances:

- If some cost in incurred but it is expected that it will not result into some future benefit. For example expenditure incurred on unsuccessful research and development.
- When cost was incurred earlier period but now it is expected that it will not provide future benefit. For example, machine became obsolete due to change in technology.

2.20 CHECK YOUR UNDERSTANDING (B)

1. Write various objective of calculating business income.

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2. Name various concepts related to calculation of Business Incomes.

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3. Give various revenue where AS-9 is not applicable.

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4. What are Revenue Expenses.

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5. If a business has capital of Rs. 10,00,000 as on 31st March 2021, while the same amount on 1st April, 2020 was Rs. 5,00,000. The amount withdrawn during the year is Rs. 2,00,000 and further capital introduced is Rs. 1,00,000. Find out amount of profit earned by the business.

2.21 LET US SUM UP

- Generally Accepted are develop with the objective of maintenance of uniformity and consistency in accounting practices in different businesses and different countries.
- GAAP are not fixed rather these are flexible in nature.
- GAAP are not the rules decided by the government.
- Going Concern, Consistency and Accrual are basic accounting assumptions.
- Business Entity says owner and business are separate.
- Money measurement says accounts are recorded in terms of money.
- Conservatism says provision is created for losses not for profits.
- Full Disclosure says accounts are prepared for one accounting period.
- Accounting period says book are closed at end of the accounting period
- Business Income is difference between revenue and expenses.
- Business income can be calculated according to cash basis or accrual basis.
- Various accounting concepts are used in calculation of business income.
- AS-9 deals with recognition of revenue.

2.22 KEY TERMS

- **ACCOUNTING PRINCIPLES**: Accounting principles are the various conventions and rules followed while preparing the accounts.
- **GAAP:** . In order to make accounts more relevant, all over the world some Accounting Principles are followed known as Generally Accepted Accounting Principles (GAAP).
- **ACCRUAL BASIS** Accrual Basis of Accounting is a method of recording business transactions in which all the items of accounting whether Incomes, Expenses, Assets or Liabilities are shown in the accounts in the period with which such items are related.
- **BUSINESS INCOME:** Business Income refers to amount realised by business from sale of Goods and Services over the cost of generation of Goods and Services. It is excess of revenue over the expenditure incurred by the business.
- **NET WORTH APPROACH**: The Balance Sheet or Net Worth Approach is simple method of finding the business income. Under this method, business income is measured by deducting value of capital employed at the beginning of the year from the capital employed at end of the period.

- **MATCHING APPROACH**: Under this method we match the revenue and expenses of the accounting period. In case revenue of the accounting period is in excess of expenses of the accounting period the balance amount is treated as Net business profit.
- **REVENUE**: As per AS 9 'Revenue is gross inflow of cash receivable consideration arising from activities pop up business like providing services, selling goods receiving interest, dividend etc'.
- **EXPENSES:** Expenses represent the amount spent by business during accounting period in order to earn some revenue. In other words, we can say that expenses are the cost incurred to earn the revenue.
- **ACCRUAL BASIS OF ACCOUNTING:** Accrual Basis of Accounting is a method of recording business transactions in which all the items of accounting whether Incomes, Expenses, Assets or Liabilities are shown in the accounts in the period with which such items are related.

2.23 REVIEW QUESTIONS

1. What are Accounting Principles? Give its basic features.
2. What are Generally Accepted Accounting Principles? Give its characteristics.
3. Give basic Accounting assumption used while making accounts.
4. What are accounting Conventions? Give various conventions of accounting.
5. Give various concepts used in accounting.
6. What is business income. Why it is calculated.
7. Give various methods of calculating business income.
8. Explain the process of calculating business income.
9. Give provisions of AS-9 related to revenue recognition.
10. Give various accounting concepts that are used while calculating business income.
11. Give various methods of revenue recognition.
12. What are expenses. How these are recognized.

2.24 ANSWERS TO TEST YOUR UNDERSTANDING.

TEST YOUR UNDERSTANDING A

1. Conservatism
2. Business Entity
3. Consistency
4. Cost concept
5. Money measurement
6. Objectivity / Verifiability
7. Matching / Accrual
8. Business Entity

9. Dual Aspect
10. Going Concern
11. Conservatism
12. Matching Concept
13. Accounting Period
14. Revenue Recognition
15. Matching Concept
16. Materiality
17. Full Disclosure
18. Business Entity
19. Objectivity
20. Matching Concept

TEST YOUR UNDERSTANDING B

5. Rs. 6,00,000

2.25 FURTHER READINGS

1. Robert N Anthony, David Hawkins, Kenneth A. Merchant, *Accounting: Text and Cases*. McGraw-Hill Education, 13th Ed. 2013.
2. Charles T. Horngren and Donna Philbrick, *Introduction to Financial Accounting*, Pearson Education.
3. J.R. Monga, *Financial Accounting: Concepts and Applications*. Mayur Paper Backs, New Delhi.
4. M.C.Shukla, T.S. Grewal and S.C.Gupta. *Advanced Accounts. Vol.-I. S.* Chand & Co., New Delhi.
5. S.N. Maheshwari, and. S. K. Maheshwari. *Financial Accounting*. Vikas Publishing House,NewDelhi.
6. Tulsian, P.C. *Financial Accounting*, Pearson Education.

B. COM

SEMESTER I

COURSE: FINANCIAL ACCOUNTING

UNIT 3 – FINANCIAL ACCOUNTING STANDARDS

STRUCTURE

3.0 OBJECTIVES

after studying the unit, students will be able to

- Understand the Meaning of Accounting Standards.
- Discuss the benefits of Accounting Standards.
- Understand the History of Accounting Standards.
- Understand the limitations of Accounting Standards.

- Explain the procedure of Standard Setting in India.
- Describe the meaning of IFRS
- Differentiate between Accounting Standards and IFRS.
- Explain the scope of IFRS.
- Understand the procedure of Convergence of IFRS in India.
- Discuss the concept of Ind AS.
- Explain the procedure of first time adoption of IFRS.

3.1 INTRODUCTION

Accounting concepts and conventions are the principle that emerged in the field of accounting Over a period of time. Businesses all over the world are using these accounting conventions and concepts while preparing their accounts. As there were no standard guidelines for preparing the accounts it was appropriate on behalf of business to prepare accounts using various concepts and conventions. However, this lead to different treatment it of various accounting item by the different businesses. In other words we can say that that same item of accounting was treated differently by the business. As a result, accounting as a tool of business information became less relevant. So that need was felt that there should be some Universal guidelines in preparation of accounts which could remove this limitation. A result accounting standard came into the picture.

3.2 MEANING OF ACCOUNTING STANDARDS

According to dictionary the term "'Standard' means 'Technical document design in a way that can be used as a rule or as a guideline. it is a level of quality which may be considered as acceptable or desirable. It is a level of quality achievement of which may be considered as acceptable or desirable. So, in terms of accounting we can say that accounting standards are the codification of Generally Accepted Accounting Principles. It covers detail rules to be adopted for accounting treatment of various items before the presentation of financial statements. We may regard it as a source of law guideline that helps a business in preparation of financial statements. accounting standards are the policy documents issued by the recognised accounting body related to various aspects of measurement, treatment and disclosure of accounting transactions in the business.

3.3 HISTORY OF ACCOUNTING STANDARDS

The credit of development of accounting standard goes to people of England who introduced the terms Standard by setting up Accounting Steering Committee in the year in 1969. This was first time that they used the term 'Standard' instead of 'Principle'. However, the evolution of international accounting standard was started in 1966 when the suggestion was made to set up a worldwide study group. As a result a study group was formed that started publishing various papers on the different accounting topics. These papers form the basis of accounting standards that came into existence later. In 1973, the International Accounting Standards Committee was formed which aimed at development of various accounting standards. Initially 16 countries became the member of International Accounting Standards Committee, this include Australia, Canada, Japan, Germany, Netherland, United Kingdom, France and the United States etc. Between 1973 and 2001, International Accounting Standards Committee issued various International accounting standard (IAS) numbered from 1 to 41. In 2001 International Accounting Standards Committee was replaced by International Accounting Standard Board (IASB). The Accounting Standards Board (IASB) announced that new set off international accounting standard will be issued called International Financial Reporting Standards (IFRS). The new standards will slowly replace the International Accounting Standards issued by International Accounting Standard Committee.

In India, The Institute of Chartered Accountants of India (ICAI) set up Accounting Standard Board (ASB) on 21st April 1977. The main objective of accounting standard board was to formulate accounting standards for India. Accounting Standard Board formulated 32 accounting standards in India known as in 2006, the Government of India prescribed accounting standards in consultation with National Advisory Committee on Accounting Standard (NACAS). The central government notified 28 accounting standard under the Companies Act, 1956 after getting recommendations from an NACAS. Government also initiated the process of convergence of Indian accounting standards with International Financial Reporting Standards (IFRS), as a result government formulated Indian Accounting Standards known as Ind AS. So now we have to set of accounting standards:

1. Existing accounting standards under Companies (Accounting Standard) Rules 2006
2. Indian accounting standards converged IFRS known as Ind A.S.

3.4 NATURE OF ACCOUNTING STANDARDS

1. **WRITTEN GUIDELINES**: Accounting Standards are guidelines issued by some professional body that help a business in preparation of accounts.
2. **UNIFORMITY AND TRANSPARENCY**: The main objective of issuing accounting standard is to bring uniformity in accounting practices all over the world and to ensure transparency in books of accounts. Statements prepared on the basis of accounting standards are also comparable.
3. **NOT LAW**: Accounting standards are the guidelines which helps in preparation of accounts but we cannot treat accounting standards as Law. Accounting standards cannot override the provisions of the law of the country
4. **BASED ON LAW AND OTHER FACTORS**: accounting standards are always prepared considering the rules and regulation of the place and other factors like economic environment etc. It is the reason that accounting standards are revised from time to time according to the law and other factors
5. **MANDATORY:** As Accounting standards are issued by the bodies controlling the accounting profession in the country, most of these are mandatory in nature specially for companies.
6. **FLEXIBLE:** Most of accounting standards are flexible in nature in a way that business

could deviate from Accounting Standard, but in such case, business has to disclose this fact in their financial statement.

3.5 ADVANTAGES OF ACCOUNTING STANDARDS

1. **REMOVAL OF CONFUSION**: Accounting Standards are guidelines issued by Professional Body for preparation of accounts. As each accounting standard deals with particular item of accounting, it removes the confusion in the mind of Accountants regarding treatment of particular item such as treatment of goodwill, valuation of stock, method of charging depreciation etc.
2. **UNIFORM ACCOUNTING PRACTICES**: As same accounting standards are issued for all the businesses, it brings uniformity in accounting practices among different businesses.
3. **LESS CHANCE OF MANIPULATION**: As accounting standard bring standardization in various accounting practices, Accountants are not left with much choice to give treatment to any item in their own way. This reduces chances of manipulation in accounting.
4. **GLOBALISED BUSINESS**: As this is the time of globalisation and multinational corporations, diverse accounting practices create problems for globalised businesses. Accounting Standards bring uniformity in accounting, thus promote globalisation of business.
5. **DISCLOSURE BEYOND LAW:** Though each country have its own rules and regulations that deals with accounting practices of the country but many times Accounting Standards ensure some disclosure that are not mandatory under the rules and
6. **IMPROVES RELIABILITY OF FINANCIAL STATEMENTS**: There are many stakeholders of a company and they rely on the financial statements for their information. The Statements prepared on the basis of accounting standards improve reliability of financial statements among stakeholders.
7. **HELPFUL TO AUDITORS**: financial statements that are prepared on basis of accounting standard makes the work of auditors easy.
8. **ACCOUNTING REFORMS**: Accounting standards and sure that best practices are followed while preparing the accounts. This helps in bringing reforms in the field of accounting.

3.6 DISADVANTAGES / LIMITATIONS OF ACCOUNTING STANDARDS

1. Accounting standard suppress creativity and it does not allow alternative treatment of various items.
2. As Rules and regulations of different countries are not same, it is very difficult to formulate Accounting Standards that can be applied to whole world.
3. As there is continuous change in rule and regulation, economic environment, there is continuous need of updation of Accounting Standards.
4. Standards are general guidelines that helps preparation of account but this cannot

override the legal provisions.

5. Accounting Standard depends more on rules and sometime lacks technical judgment.
6. Sometimes new accounting standards are issued by professional bodies that are not consistent with old standards.
7. Bodies formulating accounting standards many a time lack legal power, so they cannot make following accounting standards Mandatory.

3.7 PROCEDURE FOR ISSUING AN ACCOUNTING STANDARD

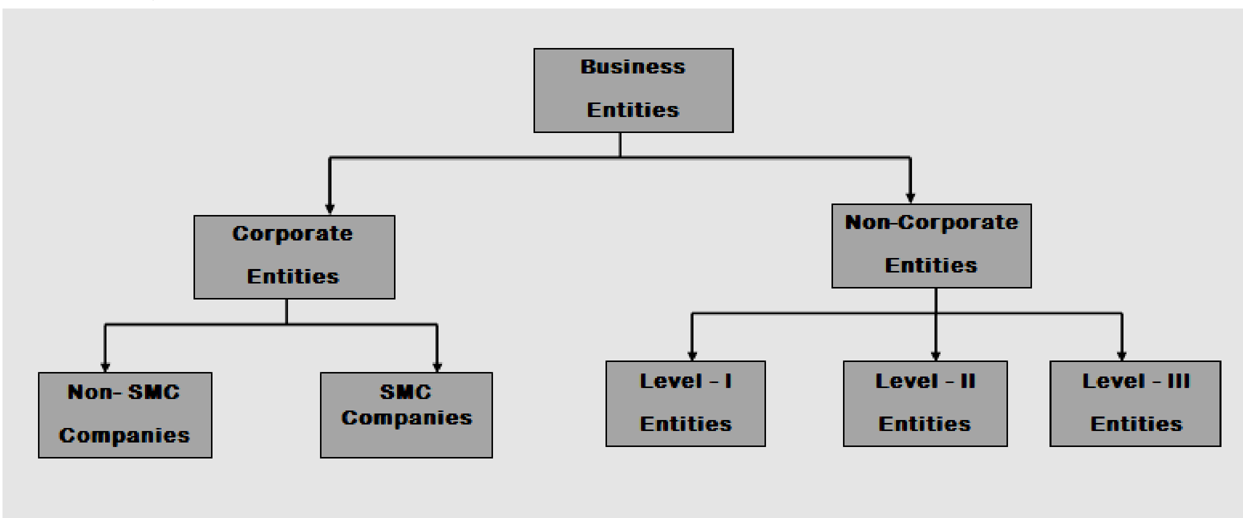
In India, Accounting Standards are issued by Accounting Standards Board which is part of Institute of Chartered Accountants of India. The ICAI constituted the Accounting Standards Board on 21st April 1977 to develop Accounting Standards for the country. ASB consists of 16 members representing persons from different fields and bodies. Following are the steps of issue of Accounting Standards by ASB.

1. First of all the ASB convenes its meeting and recognize the area in which diverse accounting practices exist and in which Accounting Standards need to be formulated.
2. After recognizing broader area a study group is formulated that will propose the draft of Accounting Standard. While forming Study Groups, ASB ensures participation of all sections related to business such as Entrepreneurs, Accountants, Legal Experts, Tax Experts etc.
3. Study Group convenes time to time meeting and prepare the Draft of the accounting Standard which include the following :
    - (a) Objective of the Standard,
    - (b) Scope of the Standard,
    - (c) Definitions of the various terms used in the Standard,
    - (d) Recognition and measurement principles,
    - (e) Presentation and disclosure requirements.
4. The draft prepared by Study Group is sent to ASB.
5. The ASB will convene meeting to consider the preliminary draft prepared by the Study Group and in case some revision is required in the Draft, same is referred back to the Study Group.
6. After revision study group will send the draft back to ASB.
7. The ASB will circulate the draft of the Accounting Standard to the Council members of the ICAI and the other specified bodies for their comments which includes :
    - (a) Department of Company Affairs (DCA)
    - (b) Central Board of Direct Taxes (CBDT)
    - (c) Comptroller and Auditor General of India (C & AG)
    - (d) The Institute of Company Secretaries of India (ICSI)
    - (e) The Institute of Cost and Works Accountants of India
    - (f) Reserve Bank of India (RBI)
    - (g) Associated Chambers of Commerce and Industry (ASSOCHAM),
    - (h) Confederation of Indian Industry (CII) and Federation of Indian Chambers of Commerce and Industry (FICCI)
    - (i) Indian Banks' Association (IBA)
    - (j) Standing Conference of Public Enterprises (SCOPE)
    - (k) Securities and Exchange Board of India (SEBI)
    - (l) Any other body considered relevant by the ASB.
8. After receiving the comments of above mentioned bodies, the ASB will hold a meeting to include relevant suggestions in the exposure draft of the proposed Accounting Standard.

9. The Exposure Draft of the proposed Standard will be issued in public domain for comments by members of the institute and general public.
10. After including useful suggestion received from members and the public, the draft of the proposed Standard will be finalised by the ASB and the same will be submitted to ICAI.
11. The Council of the ICAI will consider the final draft of the proposed Standard, and if found necessary, modify the same in consultation with the ASB. The Accounting Standard on the relevant subject will then be issued by the ICAI.
12. Initially Accounting Standard proposed by ICAI is recommendatory in nature, that means it is not necessary for the business firms to follow the accounting standard.
13. Over a period of time if ICAI feels that Accounting Standard needs some revision, it is sent to ASB and the same above procedure is followed for revision.
14. Over a period of time when standard become popular, ICAI make it mandatory in nature.

3.8 CRITERIA FOR CLASSIFICATION OF ENTERPRISES

On basis of applicability of Accounting Standards, Institute of Chartered accountants have divided the business entities into two categories i.e. Corporate Entities and Non-Corporate entities. Corporate entities are further sub divided into Small and Medium Companies SMC) and Non-Small and Medium Companies (Non-SMC). Similarly, Non-Corporate Business are divided into Level I, Level II and Level III entities.



CORPORATE ENTITIES: ICAI has divided the Corporate entities into two categories that is Small and Medium Companies (SMC) and Non-Small and Medium Companies (Non-SMC).

a. SMALL AND MEDIUM-SIZED COMPANY (SMC): The definition of Small and Medium-Sized Company (SMC) is given in the Companies (Accounting Standards) Rules, 2006, which states

"Small and Medium Sized Company" (SMC) means, a company—

i. whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

ii. which is not a bank, financial institution or an insurance company;
iii. whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;
iv. which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and
v. which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

b. NON SMALL AND MEDIUM-SIZED COMPANY (NON-SMC): Non Small and Medium-Sized Company (SMC) is one which is not SMC.

NON - CORPORATE ENTITIES: ICAI has divided the Corporate entities like Firms, HUF, Individuals into three categories that are Level I, Level II and Level III entities.

a. LEVEL-I ENTITY: Following Non-corporate entities are considered as Level-I entities:

i. Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.
ii. Banks (including co-operative banks), financial institutions or entities carrying on insurance business.
iii. All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees fifty crore in the immediately preceding accounting year.
iv. All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year.
v. Holding and subsidiary entities of any one of the above.

b. LEVEL II ENTITIES (SMES): Non-corporate entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:

i. All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees forty lakh but does not exceed rupees fifty crore in the immediately preceding accounting year.
ii. All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.
iii. Holding and subsidiary entities of any one of the above.

c. LEVEL III ENTITIES (SMES): Non-corporate entities which are not covered under Level I and Level II are considered as Level III entities.

3.9 STATUS AND APPLICABILITY OF ACCOUNTING STANDARDS

The Institute of Chartered Accountants of India so far has issued 29 accounting standards in India. However, after revision of AS 10 related to 'Property, Plant and Equipment', the AS 6 was withdrawn as its provisions were included in AS 10. Similarly, AS 8 related to 'Accounting for Research and Development' was withdrawn after issuance of AS 26 related to 'Intangible Assets'. So, at present there are 27 effective accounting standards applicable in India. As far as corporate entities are concerned, all the accounting standards are mandatory for them but some concessions are given to Small and Medium Companies from some provisions of the accounting standards. As far as non-corporate entities are concerned, application of accounting standard depends upon their level. Following table shows list of Accounting Standards issued in India and their applicability for different entities.

Accounting Standard	**Level I**	**Level II**	**Level III**
AS 1 Disclosure of Accounting Principles	Yes	Yes	Yes
AS 2 Valuation of Inventories	Yes	Yes	Yes
AS 3 Cash Flow Statements	Yes	No	No
AS 4 Contingencies and Events Occurring After the Balance Sheet Date	Yes	Yes	Yes
AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	Yes	Yes	Yes
AS 7 Construction Contracts (Revised 2002)	Yes	Yes	Yes
AS 9 Revenue Recognition	Yes	Yes	Yes
AS 10 Accounting for Fixed Assets	Yes	Yes	Yes
AS 11 The Effects Of Changes In Foreign Exchange Rates (Revised 2003)	Yes	Yes	Yes
AS 12 Accounting for Government Grants	Yes	Yes	Yes
AS 13 Accounting for Investments	Yes	Yes	Yes
AS 14 Accounting for Amalgamations	Yes	Yes	Yes
AS 15 Employee Benefits (Revised 2005)	Yes	Yes	Yes
AS 16 Borrowing Costs	Yes	Yes	Yes
AS 17 Segment Reporting	Yes	No	No

AS 18 Related Party Disclosures	Yes	No	No
AS 19 Leases	Yes	Partial	Partial
AS 20 Earnings Per Share	Yes	Partial	Partial
AS 21 Consolidated Financial Statements	Yes	No	No
AS 22 Accounting for taxes on income	Yes	Yes	Yes
AS 23 Accounting for Investments in Associates in Consolidated Financial Statements	Yes	No	No
AS 24 Discontinuing Operations	Yes	No	No
AS 25 Interim Financial Reporting	Yes	No	No
AS 26 Intangible Assets	Yes	Yes	Yes
AS 27 Financial Reporting of Interests in Joint Ventures	Yes	No	No
AS 28 Impairment of Assets	Yes	Yes	Yes
AS 29 Provisions, Contingent Liabilities and Contingent Assets	Yes	Partial	Partial

Source: icai.org

3.10 TEST YOUR UNDERSTANDING (A)

6. What are Accounting Standards?

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7. Give three points of nature of accounting standards.

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8. Give Five advantages of Accounting Standards.

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9. What are Small and Medium sized companies.

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10. . State whether following are True of False.

a. Accounting standards are issued by government.
b. Accounting standards brings uniformity in accounting practices.
c. ASB was formed in the year 1977.
d. International Accounting Standards Committee is still in existence.
e. SMC is a company having turnover less than 100 crore.

3.11 INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

As discussed earlier, International Accounting Standards committee was formed in 1973 which issued International Accounting Standards (IAS). In the year 2001, International Accounting Standards Committee was replaced by International Accounting Standards Bboard (IASB). After its formation IASB decided to issue new set of standards known as International Financial Reporting Standards (IFRS). In narrow sense IFRS refers to New number series of accounting standards issued by IASB which are different from IAS series issued by IASC. However, in broader sense IFRS are now Principle based Accounting Standards issued by IASB stating that how various items and events can be reported in statements of the business. The most important fact about IFRS is that these are principle based standards and are different from earlier rule base standards. IFRS needs the application of judgment by the person preparing the accounts on the basis of the economic substance of transactions. IFRS is entire body of pronouncement made by IASB and include:

- International Financial Reporting Standards (IFRS) – developed by the IASB ;
- International Accounting Standards (IAS) – adopted by the IASB ;
- Interpretations originated from the International Financial Reporting Interpretations Committee (IFRICs) ; and
- Standing Interpretations Committee (SICs).

3.12 FEATURES OF IFRS

1. Contrary to earlier rule-based standards, IFRS are principle based standards.
2. IFRS are comparatively drafted in simple and clear language, so are easy to understand.
3. IFRS promotes fair value measurement of Assets and liabilities than historical cost measurement of Assets and liabilities.
4. IFRS gives more focus towards right presentation of Balance Sheet, show this process sometime bring volatility in income statement.
5. Under IFRS a business firm is required to estimate useful life of the Asset time and again until search asset cease to exist in books of accounts.

3.13 SCOPE OF IFRS

1. International Financial Reporting Standards (IFRS) are new standards issued by International Accounting Standards Board (IASB).
2. However, all earlier IAS issued by IASC are still valid until these are either withdrawn by IASB or amended by IASB.
3. IFRSs are applicable to all general-purpose financial statements of entities that aims at earning profits. So these are applicable to all industrial, commercial financial Enterprises without considering their legal form.
4. Even Non- profit-oriented enterprises may also use IFRSs if they find it appropriate.
5. The term General Purpose Financial Statements ret fulfil the needs of shareholders, lender, creditors, employees, other stakeholders regarding knowledge of profitability, financial position or cash flows etc.
6. IFRSs are not only applicable to individual companies but also to consolidated financial statements.
7. The financial statements under IFRS include Balance Sheet, Income Statement, Statement of change in Equity, cash flow statement and summary of accounting policies and explanatory notes.
8. In case an IFRS allows alternative treatment of any item, business is free to adopt any alternative and it will be assumed that financial statements are conforming to IFRS.
9. IFRS will present fundamental principles in bold face type and other guidance in non-bold type.

3.14 MERITS OF IFRS

1. IFRS brings transparency in financial statement, which results into comparability of financial information and makes statement more useful for shareholder, lender, customers and other key stakeholders.
2. The adoption of IFRS brings better quality in Financial Reporting.
3. An IFRS compliant company has better access to global capital markets.

4. IFRS reduces the problems faced by Multi-national Corporations while preparing accounts in different countries.
5. Uniform accounting standards under (IFRS) makes it easy for understand the financial statements.
6. Accountants and auditors are in a position to render their services in countries adopting IFRS.
7. Accountants and auditors can save the time and money by implementation of IFRS.

3.15 LIMITATIONS OF IFRS

1. Implementation of IFRS nees trained accountants. Many of the accountants are not aware about provisions of IFRS.
2. Many rules and regulations of Companies Act does not support provisions of IFRS. So, there is need of change in rules and regulations.
3. Under IFRS, assets are measured at Fair Value, whereas under Indian GAAP valuation of assets is done at Historical Cost.
4. Full fledge implementation of IFRS needs Financial accounting software and other IT infrastructure. Many Indian companies lacks these facilities.
5. Provisions of IFRS are very detailed, so it is difficult for Small and Medium companies to follow IFRS.
6. IFRS are developed by the International Accounting Standards Board (IASB) but the responsibility of application falls on National Accounting bodies.

3.16 LIST OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

The Standards issued by the IASB are called IFRS. IASB not only issued new IFRS but also adopted IAS issued by IASC. These IAS were issued by the IASC during the period of 1973 to 2001. Presently both IAS and IFRS are in practice. Following is the list of IFRS and IAS applicable as on May 2021.

Standard No.	Standard Title
IFRS 1	First-time Adoption of International Financial Reporting Standards
IFRS 2	Share-based Payment
IFRS 3	Business Combinations
IFRS 5	Non-current Assets Held for Sale and Discontinue Operations
IFRS 6	Exploration and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures

IFRS 8	Operating Segments
IFRS 9	Financial Instruments
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint Arrangements
IFRS 12	Disclosure of Interests in Other Entities
IFRS 13	Fair Value Measurement
IFRS 14	Regulatory Deferral Accounts
IFRS 15	Revenue from Contracts with Customers
IFRS 16	Leases
IFRS 17	Insurance Contracts
IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Statement of Cash Flows
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10	Events after the Reporting Period
IAS 12	Income Taxes
IAS 16	Property, Plant, and Equipment
IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24	Related Party Disclosures
IAS 26	Accounting and Reporting by Retirement Benefit Plans

IAS 27	Separate Financial Statements
IAS 28	Investments in Associates and Joint Ventures
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 32	Financial Instruments: Presentation
IAS 33	Earnings per Share
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities, and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement
IAS 40	Investment Property
IAS 41	Agriculture

Source: IFRS.org

3.17 CONVERGENCE IFRS IN INDIA (IND AS)

IFRS are globally accepted Accounting Principles, so at the time of globalisation India cannot afford to left behind in application of IFRS. So, government of India formulated 'National Advisory Committee on Accounting Standards' (NACAS) under Companies Act 2013. NACAS along with RBI and SEBI decided to convert Indian accounting standards with IFRS. convergence of IFRS with Indian Standard means, integrating IFRS with Indian standards as far as possible considering Indian laws, practices and business environment. As a result, new Indian Accounting Standards (Ind AS) Are issued by central government under the guidance of ICAI. Ind AS are numbered in the same manner as the corresponding IFRS are numbered. After notifying Ind AS, The Ministry of Corporate Affairs issued Companies (Indian Accounting Standards) Rules 2015, which gives roadmap of implementation of Ind AS converged with IFRS. As per these rules, government decided to implement Ind AS from 1st April, 2015 on voluntary basis on companies other than Banking and Insurance companies. From 1st April, 2016 Ind AS became mandatory for companies other than banking and insurance companies. Following is the list of Ind AS as notified by the government.

Sr. No.	Ind AS No.	Name of Ind AS	Corresponding IAS/IFRS
1.	Ind AS 101	First-time Adoption of India Accounting	IFRS 1

		Standards	
2.	Ind AS 102	Share based Payment	IFRS 2
3.	Ind AS 103	Business Combinations	IFRS 3
4.	Ind AS 104	Insurance Contracts	IFRS 4
5.	Ind AS 105	Non-Current Assets Held for Sale and Discontinued Operations	IFRS 5
6.	Ind AS 106	Exploration for and Evaluation of Mineral Resources	IFRS 6
7.	Ind AS 107	Financial Instruments : Disclosures	IFRS 7
8.	Ind AS 108	Operating Segments	IFRS 8
9.	Ind AS 109	Financial Instruments	IFRS 9
10.	Ind AS 110	Consolidated Financial Statements	IFRS 10
11.	Ind AS 111	Joint Arrangements	IFRS 11
12.	Ind AS 112	Disclosure of Interests in Other Entities	IFRS 12
13.	Ind AS 113	Fair value Measurement	IFRS 13
14.	Ind AS 114	Regulatory Deferral Accounts	IFRS 14
15.	Ind AS 115	Revenue form contract with customers	IFRS 15
16.	Ind AS 1	Presentation of Financial Statements	IAS 1
17.	Ind AS 2	Inventories	IAS 2
18.	Ind AS 7	Statement of Cash Flows	IAS 7
19.	Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors	IAS 8
20.	Ind AS 10	Events after the Reporting Period	IAS 10
21.	Ind AS 11	Construction Contracts	IAS 11
22.	Ind AS 12	Income Taxes	IAS 12
23.	Ind AS 16	Property, Plant and Equipment	IAS 16
24.	Ind AS 17	Leases	IAS 17
25.	Ind AS 18	Revenue	IAS 18
26.	Ind AS 19	Employee Benefits	IAS 19
27.	Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance	IAS 20
28.	Ind AS 21	The Effects of Changes in Foreign Exchange Rates	IAS 21
29.	Ind AS 23	Borrowing Costs	IAS 23
30.	Ind AS 24	Related Party Disclosures	IAS 24

31.	Ind AS 27	Consolidated and Separate Financial Statements	IAS 27
32.	Ind AS 28	Investments in Associates	IAS 28
33.	Ind AS 29	Financial Reporting in Hyperinflationary Economies	IAS 29
34.	Ind AS 32	Financial Liability and Equity	IAS 32
35.	Ind AS 33	Earnings per Share	IAS 33
36.	Ind AS 34	Interim Financial Reporting	IAS 34
37.	Ind AS 36	Impairment of Assets	IAS 36
38.	Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets	IAS 37
39.	Ind AS 38	Intangible Assets	IAS 38
40.	Ind AS 40	Investment Property	IAS 40
41.	Ind AS 41	Agriculture	IAS 41

3.18 INDIAN ACCOUNTING STANDARD (IND AS) 101: FIRST-TIME ADOPTION OF INDIAN ACCOUNTING STANDARDS

As discussed earlier The Ministry of Corporate Affairs issued Companies (Indian Accounting Standards) Rules 2015, which gives roadmap of implementation of Ind AS converged with IFRS. As per these rules, government decided to implement Ind AS from 1st April, 2015 on voluntary basis on companies other than Banking and Insurance companies. From 1st April, 2016 Ind AS became mandatory for companies other than banking and insurance companies.

However, whenever a business follows Ind AS for the first time, it face many difficulties and challenges in implementation. The Ind AS 101 which deals with 'First time Adoption of Indian Accounting Standards' deals with such problems and challenges. The standard guides a business firm how it can adopt Ind AS for the first time. It also states that how a firm can opening balance sheet after adoption of Ind AS. As per the roadmap issued by the MCA, it is quite clear that once an entity opts to follow Ind AS voluntarily or mandatorily, it has no option to discontinue the same. Hence, the entity can be first-time adopter of Ind AS and apply Ind AS 101 only once during its life time.

OBJECTIVE

- To ensure that an entity's first Ind AS financial statements, and its interim financial reports for part of the period covered by those financial statements, contain high quality information that-
  (a) is transparent for users and comparable over all periods presented;

(b) provides a suitable starting point for accounting in accordance with Indian Accounting Standards; and

(c) can be generated at a cost that does not exceed the benefits.

SCOPE

The Ind AS 101 is applicable to-

1. The first set of financial statements prepared by a person as per provisions of Ind AS; and
2. All other interim financial statements that are prepared as per Ind AS 34.

TIMELINE FOR FIRST-TIME ADOPTION OF IND AS

As per Ind AS 101 an entity must adopt Ind AS 101 not only for Reporting date but also for Transition date

1. **THE REPORTING DATE** is the end date of our reporting period when first time we decided to prepare statements as per Ind AS. For example if we decided to adopt Ind AS from year 2016-17 than our reporting date will be 31st March 2017.
2. **THE TRANSITION DATE –** As an entity is supposed to give financial statements of pervious period also for comparison purpose, the transition date will be 1st date of last financial year For example if we decided to adopt Ind AS from year 2016-17 than our reporting transition date will be 1st April 2015.

So any business who first time adopts IND AS financial statements has to prepare following financial statements or reports:

1. Three Balance Sheets;
2. Two Profit and Loss Statement;
3. Two Cash Flows statements;
4. Two Statement of Changes in Equity and related notes.

Following table shows the List Financial statements that need to be prepared for first time adoption of Ind AS for the Reporting Year 2016-17

Financial Statements as per Ind AS with reporting date 31st March 2017	1st April 2015 (Date of Transition to Ind AS)	31st March 2016 (Comparative Period 2015-16)	31st March 2017 (Reporting Date)
Balance Sheet	Yes	Yes	Yes
Statement of Profit & Loss	No	Yes	Yes
Statement of Cash Flows	No	Yes	Yes
Statement of Changes in Equity	No	Yes	Yes
Related Notes and Comparative Information	No	Yes	Yes

PROCESS OF TRANSITION TO IND AS

1. The first time in adoption of Ind AS is to select the Accounting Policy that comply with provisions of Ind-AS. Firm must leave the policies that are not consistent with Ind AS.

2. Next step is to prepare Opening Balance Sheet as per Ind-AS taking the date of transition as starting point. Following are steps for this purpose:
   - Some of the assets may not be recognized by entity as per previous Accounting Standards. So, first of all Recognize all those assets and liabilities which were not previously recognized such as
     - Defined Benefit Pension Plan
     - Deferred Taxation
     - Provision where there is a legal or a construction Obligation
     - Derivative Financial Instruments
     - Shares Based Payments
   - Similarly some Assets or Liabilities were recognized as per previous Accounting Standards, now business must derecognize those assets and liabilities, such as
     - Provisions where there is no legal or constructive Obligation
     - Internally generated Intangible Assets
     - Deferred tax Assets where recovery is not probable.
     - Provision for dividend
     - Preliminary & Preoperative Expenses
   - Some of the items need reclassification as the classification of items under GAAP and Ind AS may be different. Following are examples of such items:
     - Investments accounted for in accordance with Indian Accounting Standards.
     - Certain Financial Instruments previously qualified as equity.
     - Any assets & Liabilities that have been offset where the criteria for offsetting in Ind AS are not met.
     - Non-Current Assets held for sale as per Ind AS 105.
     - Non-Controlling Interest
   - Similarly need may arise to remeasure the value of some items as per Ind-AS such as:
     Receivables
     - Inventory (Ind AS -2)
     - Employee benefit Obligations (Ind AS-19)
     - Deferred Taxation (Ind AS-12)
     - Financial Instruments
     - Investment Property (Ind AS -40)
     - Property Plant & Equipment (Ind AS -16)
3. After all this is done the next step is to items in entity's first Ind-AS Financial Statements and according disclosures are made.

3.19 TEST YOUR UNDERSTANDING (B)

1. What are IFRS.

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2. Give three features of IFRS.

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3. Give limitations of IFRS.

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4. What are Ind AS.

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5. State whether following are True of False.

   a. IFRS are issued by IASB.
   b. After introduction of IFRS all IAS has been removed.
   c. IFRS and Ind AS are one and the same thing.
   d. Ind AS 101 deals with first time adoption of IFRS.
   e. Ind AS have been notified under the Companies Act.

3.20 LET US SUM UP

- Accounting standards are guidelines that helps to bring uniformity and transparency in accounts.
- These guidelines are prepared by some professional bodies.
- At international level IAS were given by IASC that was formed in 1973.
- In India ICAI formed ASB for preparing accounting standards in 1977.
- ICAI has done categorization of business in corporate and non-corporate.

- Companies are divided into Level I, Level II and Level III entities.
- ICAI has issued 29 accounting standards out of which AS 6 and AS 8 has been withdrawn.
- IASC was replaced by IASB in 2001.
- After that IASB decided to replace IAS with IFRS.
- IAS that has not been yet replaced by IFRS is still in practice.
- India also decided to converge accounting standards with IFRS and issued Ind AS.
- Ind AS 101 deals with first time adoption of IFRS.

3.21 KEY TERMS

- **Accounting Standards:** accounting standards are the policy documents issued by the recognised accounting body related to various aspects of measurement, treatment and disclosure of accounting transactions in the business.
- **IFRS:** In the year 2001, International Accounting Standards Committee was replaced by International Accounting Standards Bboard (IASB). After its formation IASB decided to issue new set of standards known as International Financial Reporting Standards (IFRS).

3.22 REVIEW QUESTIONS

1. What are Accounting Standards? Give its history.
2. What is procedure of issuing Accounting standards in India.
3. Give nature of Accounting Standards.
4. What are advantages and limitations of Accounting standards.
5. Give criteria decided by ICAI for classification of enterprises.
6. What are IFRS? Give its features and scope.
7. What are advantages and limitations of IFRS.
8. Explain the process of convergence of IFRS in India.
9. Give provisions of Ind AS 101 related to First time adoption of IFRS.

3.23 ANSWERS TO TEST YOUR UNDERSTANDING.

TEST YOUR UNDERSTANDING A

5 (a) False

5 (b) True

5 (c) True

5 (d) False

5 (e) False

TEST YOUR UNDERSTANDING B

5 (a) True

5 (b) False

5 (c) False
5 (d) True
5 (e) True

3.24 FURTHER READINGS

1. Robert N Anthony, David Hawkins, Kenneth A. Merchant, *Accounting: Text and Cases*. McGraw-Hill Education, 13th Ed. 2013.
2. Charles T. Horngren and Donna Philbrick, *Introduction to Financial Accounting*, Pearson Education.
3. J.R. Monga, *Financial Accounting: Concepts and Applications*. Mayur Paper Backs, New Delhi.
4. M.C.Shukla, T.S. Grewal and S.C.Gupta. *Advanced Accounts. Vol.-I. S.* Chand & Co., New Delhi.

B. COM

SEMESTER I

COURSE: FINANCIAL ACCOUNTING

UNIT – IV: ACCOUNTING PROCESS

STRUCTURE

4.0 OBJECTIVES

After studying this chapter, you should be able to:

- define an account and explain various types of accounts;
- understand a journal and outline the steps in journalizing;

- explain different types of journal entry;
- define ledger and understand the procedure of posting;
- make a subdivision of journal;
- understand the meaning and need for subsidiary books;
- explain the important subsidiary books maintained by an organization;
- explain a cash book;
- know the meaning, objectives and preparation of a trial balance; and
- outline the reasons for disagreement in trial balance and rectification of errors.

4.1 INTRODUCTION

This unit introduces you to various stages of accounting process and recording of transactions. All the organisations have monetary transactions. Every transaction involves transfer of money or money's worth between two accounts. We have to record both the receiving and giving aspects in each transaction in the books of accounts. The process of recording in the journal and posting into the ledger are the basic steps in accounting process. At the end of the accounting period, it is essential to prepare the trial balance for ascertaining the arithmetical accuracy of the books of accounts.

4.2 ACCOUNTS AND THEIR CLASSIFICATION

An account is a statement where similar transactions that occur in a particular period are accumulated and summarised. For better understanding, we need to classify the accounts. There are two approaches for classification, which are as follows:

- Traditional Classification:
    1) Personal Account: Each person with whom the business deals
    2) Real Account: Each property or asset
    3) Nominal Account: Each item of income and expense
- Modern Classification:
    1) Capital Account
    2) Liabilities Account
    3) Assets Account
    4) Expenses Account
    5) Income Account

Personal accounts refer to the individuals, firms or companies. Personal accounts can be further sub-divided into natural person's account, artificial person's account and representative person's account. Accounts relating to human beings are termed as **natural personal account**. Example: Shyam account, Gopal account, etc. **Artificial personal account** refers to the artificial persons like the companies, associations, firms, educational institutes, etc. Example: RIL, NALCO, M/s Sahu & Associates, etc. **Representative personal account** represents person or group of persons. Example: prepaid rent, accrued interest, outstanding salary, etc.

Real accounts refer to the assets and liabilities of the organisation. Real accounts can further be classified as tangible real accounts and intangible real accounts. **Tangible real accounts** consist of the assets that can be touched, seen and measured. For example: cash, plant and machinery, etc. The assets or the properties that cannot be seen or touched but can have a monetary value is referred to as **intangible real accounts**. For example: goodwill, patent, copyright, etc.

Nominal accounts refer to the expenses, losses, incomes and gains. For example: rent, wages, commission earned, interest earned, etc.

Assets are the items of value owned by the organisation. These are the resources which helps to generate income for the organisation. Assets can be further classified as fixed asset and current asset or tangible and intangible asset. For example- cash, furniture, goodwill, patents, etc.

Liabilities refer to the debts payable to outsiders. These can further be classified as current and non-current liabilities. Example- rent payable, loan from bank, interest payable, etc.

Capital includes the funds invested by the owner and the profits generated in the business. Capital may be in the form of cash or assets.

Expense accounts deal with the costs incurred to generate revenues. Example: rent, administrative expenses, interest paid on loan, salary, etc. Money received by providing goods or services or making investments are referred to as **income** accounts. Example: sales, rent received, interest received, etc.

4.3 JOURNAL

A journal is a book in which daily transactions are recorded chronologically. It is called the book of prime entry or original entry because all business transactions are entered first in this book. It shows the debit and credit aspect of each transaction. It also gives an explanation or narration of each transaction. The process of recording transactions in journal is known as journalising.

STEPS INVOLVED IN JOURNALISING:

1) **IDENTIFICATION OF THE ASPECTS INVOLVED IN A TRANSACTION*:*** Each transaction has a debit and a credit aspect. These two aspects are to be identified. For example, in the transaction, purchase of machinery by giving cash, the two aspects are cash and machinery.
2) **DETERMINATION OF ACCOUNTS:** The accounts involved in the transaction are identified. In the above example the two accounts are cash account and machinery account.
3) **IDENTIFY THE NATURE OF ACCOUNTS:** The accounts are then classified based on their nature, i.e., personal, real and nominal account, or asset, liability, income, expense and capital account.

4) **APPLY THE RULES*:*** The rules of debit and credit can be applied by following the three traditional rules or the rules for modern classification.

TRADITIONAL RULES OF DEBIT AND CREDIT:

Personal Account	Debit the receiver
	Credit the giver
Real Account	Debit what comes in
	Credit what goes out
Nominal Account	Debit all expenses and losses
	Credit all incomes and gains

Here, both cash and machinery account are real account. The rules for the real account is 'debit what comes in and credit what goes out'. Here, debit machinery account as machinery comes in and credit cash account as cash goes out.

RULES OF DEBIT AND CREDIT FOR MODERN CLASSIFICATION:

Asset	Debit the increase in asset
	Credit the decrease in asset
Liability	Debit the decrease in liability
	Credit the increase in liability
Capital	Debit the decrease in capital
	Credit the increase in capital
Expense	Debit the increase in expense

	Credit the decrease in expense
Income	Debit the decrease in income
	Credit the increase in income

Note: Whether you apply the traditional rules or modern rules, the debit and credit aspects in the journal and ledger will be the same.

5) **ENTRY IN PROPER FORMAT:** After analysing the transaction, the journal entry is recorded in the book. The following example will explain this:

Purchased machinery for cash Rs. 10,000 on 1.1.2020

Date	Particulars	Ledger folio	Debit Amount (Rs.)	Credit Amount (Rs.)
1.1.2020	Machinery A/c Dr. To Cash A/c (Being machinery purchased)		10,000	 10,000

Notes:

- *Narration* is a brief explanation of the nature of transaction in the journal.
- *Ledger folio* (L.F.) is the page number of the ledger on which the particular account is maintained.

6) **COMPOUND JOURNAL ENTRY:** At times there are more transactions of the same nature taking place on the same date. So instead of separate entries, we can make one compound entry by debiting or crediting more than one account.
Example: Cash paid to Harish Rs. 5000 in full and final settlement of his account Rs. 5,100 on 1.4.2020.

Date	Particulars	Ledger folio	Debit Amount (Rs.)	Credit Amount (Rs.)
1.4.2020	Harish A/c Dr. To Cash A/c To Discount A/c (Being cash paid in full settlement)		5,100	 5,000 100

ILLUSTRATION 1:

Mr. Ansari carried out the following transactions on 15 Jan, 2020. Prepare journal entries.

	Rs.
Purchased goods	30,000
Purchased goods from Sunny on credit	12,000
Sold goods for cash to Subham	18,000

Sold goods to Anil on credit 10,000

Returned goods to Sunny 2,000

SOLUTION:

JOURNAL

Date	Particulars	LF	Debit (Rs.)	Credit (Rs.)
15.1.2020	Purchase A/c Dr. To Cash A/c (Being cash purchase of goods)		30,000	30,000
15.1.2020	Purchase A/c Dr. To Sunny A/c (Being credit purchase of goods)		12,000	12,000
15.1.2020	Cash A/c Dr. To Sales A/c (Being sold goods for cash)		18,000	18,000
15.1.2020	Anil A/c Dr. To Sales A/c (Being goods sold on credit)		10,000	10,000
15.1.2020	Sunny A/c Dr. To Return outward A/c (Being goods returned to Sunny)		2,000	2,000

Notes:

- For recording all cash and credit purchase of goods, we use 'Purchase Account' and for all cash and credit sale of goods we use 'Sales Account'.
- When any transaction says 'bought goods' or 'sold goods' without stating clearly whether it is a credit or cash transaction, then treat those as cash transactions. In case of credit transactions, the name of the concerned party is always given.
- When purchase or sale of goods is on credit, then terms like 'on account' and 'on credit' are used. But in some cases, these terms are not mentioned, for example goods sold to Mr. Tilak. These kinds of transactions are also treated as credit transaction.

ILLUSTRATION 2:

Mr. Sanjib carried out the following transactions on 18 March, 2020. Prepare journal entries. Rs.

Received cheque from Piyush Mishra 20,000

Paid to Ram by cheque	2,500
Cash deposited in Bank	15,000
Fire Insurance premium paid by cheque	1,000
Withdrawn from Bank	7,000
Bank allowed interest on deposits	800
Bank loan taken	50,000

SOLUTION:

JOURNAL

Date	Particulars	LF	Debit (Rs.)	Credit (Rs.)
18.03.2020	Bank A/c Dr. To Piyush Mishra (Being cheque received)		20,000	20,000
18.03.2020	Ram A/c Dr. To Bank A/c (Being paid to Ram)		2,500	2,500
18.03.2020	Bank A/c Dr. To Cash A/c (Being cash deposited in bank)		15,000	15,000
18.03.2020	Fire Insurance Premium A/c Dr. To Bank (Being insurance premium paid)		1,000	1,000
18.03.2020	Cash A/c Dr. To Bank A/c (Being cash withdrawn from bank)		7000	7000
18.03.2020	Bank A/c Dr. To Interest A/c (Being bank interest received)		800	800
18.03.2020	Bank A/c Dr. To Bank Loan A/c (Being loan taken from bank)		50,000	50,000

Note: Bank account can be treated like an asset account or as a personal account. When anything leads to increase in bank balance, like 'cheque received' or 'cash deposited in bank' then bank account is to be debited and when anything leads to decrease in bank balance, like 'cheque payment' or 'bank charges paid', then bank account needs to be credited.

ILLUSTRATION 3:

Enter the following transactions done on 1st April 2020 in the journal.

	Rs.
Commenced business with a capital of	1,00,000
Proprietor withdrew goods for personal use	10,000
Paid Office expenses	3,000
Paid for advertisement by cheque	5,000
Received Commission by cheque	1,500
Purchased machinery	10,000
Took a loan from Mr. Sahu	35,000
Distributed good in cyclone affected areas	7,000

SOLUTION:

JOURNAL

Date	Particulars	LF	Debit (Rs.)	Credit (Rs.)
1.10.2019	Cash A/c Dr. To Capital A/c (Being capital brought in)		1,00,000	 1,00,000
1.10.2019	Drawings A/c Dr. To Purchase A/c (Being goods withdrawn for personal use)		10,000	 10,000
1.10.2019	Office Expenses A/c Dr. To Cash A/c (Being office expenses paid)		3,000	 3,000
1.10.2019	Advertisement Expenses A/c Dr. To Bank A/c (Being advertisement expenses paid)		5,000	 5,000
1.10.2019	Bank A/c Dr. To Commission A/c (Being commission received)		1,500	 1,500
1.10.2019	Machinery A/c Dr. To Cash A/c (Being machinery purchased)		10,000	 10,000
1.10.2019	Cash A/c Dr. To Loan from Mr. Sahu (Being loan taken from Mr. Sahu)		35,000	 35,000

1.10.2019	Charity A/c Dr. To Purchase A/c (Being goods distributed as charity)		7,000	 7,000

Note: Drawings account is debited when either cash or goods are withdrawn for personal use.

ILLUSTRATION 4:

Pass the necessary journal entries for the following transactions on 31 March, 2020:

- Borrowed from Ram by cheque Rs 50,000 and from SBI Rs. 2,00,000
- Allowed 5% interest on capital of Rs. 1,00,000
- Charged 7% interest on drawings of Rs 20,000
- Machinery purchased for Rs. 50,000 and installation charges paid Rs. 2,500
- Goods worth Rs 4,000 were distributed as free samples
- Salaries due for the month of March Rs. 30,000 is outstanding
- Paid to Sanu Rs 900 in full settlement for Rs. 1000

SOLUTION:

JOURNAL

Date	Particulars	LF	Debit (Rs.)	Credit (Rs.)
2020 March 31	Bank A/c Dr. To Ram's Loan A/c To SBI Loan A/c (Being loan taken from Ram and SBI)		2,50,000	 50,000 2,00,000
March 31	Interest on Capital A/c Dr. To Capital A/c (Being interest on capital given)		5,000	 5,0000
March 31	Drawings A/c Dr. To Interest on Drawings A/c (Being interest on drawings charged)		1,400	 1,400
March 31	Machinery A/c Dr. To Cash A/c (Being machinery purchased and installation charged)		52,500	 52,500
March 31	Advertisement A/c Dr. To Purchase A/c (Being goods distributed as free samples)		4,000	 4,000
March 31	Salaries A/c Dr. To Outstanding Salaries A/c (Being salaries outstanding for March)		30,000	 30,000
March	Sanu A/c Dr.		1000	

31	To Cash A/c To Discount received A/c (Being cash paid in full settlement)			900 100

OPENING ENTRIES:

In case of continuing business, the opening entry is passed by debiting all the assets and crediting all the liabilities brought from the previous year. The difference between the asset and liabilities is taken as the balance of capital account.

ILLUSTRATION 5:

Chandrasekhar has the following assets and liabilities as on 31st December 2019. Pass the opening entries on 1st January 2020.

	Rs.		Rs.
Cash	5,000	Sundry Debtor	6,000
Bank	8,000	Sundry Creditor	3,000
Stock	4,000	Bills Payable	2,000
Furniture	2,000		
Building	20,000		

SOLUTION:

JOURNAL

Date	Particulars		LF	Debit (Rs.)	Credit (Rs.)
2020	CashA/c	Dr.		5,000	
Jan. 1	BankA/c	Dr.		8,000	
	StockA/c	Dr.		4,000	
	Furniture A/c	Dr.		2,000	
	BuildingA/c	Dr.		20,000	
	Sundry Debtors A/c	Dr.		6,000	
	To Sundry Creditors A/c				3,000
	To Bills Payable A/c				2,000
	To Capital A/c (Note)				40,000

Note: Capital Account = Total Assets – Total Liabilities = Rs. 45,000 - 5,000 = Rs. 40,000

CLOSING ENTRIES: At the end of the year all the nominal accounts are closed by transferring to Trading and Profit and Loss Account. For example, if there is a total of Rs. 5,000 in wage account and Rs. 12,54,000 in salary account at the end of the year then at the time of preparation of final accounts, the wage account and salary account will be closed by transferring the amount to Trading Account and Profit and Loss Account respectively as follows by passing the closing journal entries:

Trading A/c Dr. Rs. 5,000

To Wages A/c Rs. 5,000

and

Profit and Loss Account Dr. Rs. 12,54,000

To Salaries A/c Rs. 12,54,000

4.4 LEDGER

'Ledger' is the main book that contains all the accounts of the business organisation. It gives full information regarding assets, liabilities, capital, incomes and expenses of the organisation. In a ledger account, 'debit' means the left side, and 'credit' means the right side. A detailed format of ledger is as follows:

Dr. ------------------ **Account** Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount

Note: Folio or the journal folio column is used to list the page number of the journal in which the transaction was initially recorded.

PROCEDURE OF POSTING FROM JOURNAL:

Entries must be posted from the day book or the journal to the ledger. Posting of the entries must be date wise. The page number of the journal from where the entry is posted must be written in folio column of the account and page number of the ledger account must be written in ledger folio column of the journal.

1) The first step of posting of entries is locating the concerned accounts of the ledger. For Example: Furniture purchased for cash Rs. 10,000 on 1.4.2020. Here the concerned accounts are furniture account and cash account.

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
1..4.2020	Furniture A/c Dr. To Cash A/c (Being furniture purchased)	25 1	10,000	 10,000

2) Posting will be made on debit side of the account which has been debited in the journal entry and, similarly, on the credit side of the account which has been credited in the journal entry. In the above example, the furniture account is debited in the journal, so we have to enter 'To Cash A/c' in the debit side of the furniture account as follows:

Furniture Account **(Folio-25)**

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
1.4.20	To Cash A/c	1	10,000				

Now, the credit entry will be posted to the credit side of the concerned account with a prefix 'By' with the name of the account debited.

Cash Account

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
				1.4.20	By Furniture A/c	25	10,000

3) Posting of Compound entry: Example: Cash paid to Harish Rs. 5000 in full and final settlement of his account Rs. 5100 on 1.4.2020.

Journal

Date	Particulars	Ledger folio	Debit Amount (Rs.)	Credit Amount (Rs.)
1.4.2020	Harish A/c Dr. To Cash A/c To Discount A/c (Being cash paid in full settlement)		5,100	 5,000 100

The posting will be as follows:

All the accounts credited will be posted to the debit side of the account debited. All the accounts debited are posted to the credit side of the account credited with corresponding amounts.

Dr. **Harish A/c** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
1.4.20	To Cash A/c To Discount A/c		5,000 100				

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

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
				1.4.20	By Harish A/c		5,000

Dr. **Discount A/c** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
				1.4.20	By Harish A/c		100

4) Then balancing of the accounts should be done. Balancing of an account is the process of finding out the difference between totals of the two sides of an account and recording it on the shorter side of the account. When the total of the debit side is more than the total of the credit side, the account is said to have a **debit balance** and the difference amount is put on the credit side under 'By balance c/d'. When the total of credit side is more than the total of the debit side, the account is said to have **credit balance** and the difference is put on the debit side of the account under 'To balance c/d'. Balancing any personal account indicates whether the party concerned owes to the business or the business owes to the party. Real accounts are normally balanced at the end of the accounting period. All real accounts show a debit balance. In actual practice, nominal accounts are not balanced, rather they are closed by transferring them to "Trading A/c" or "Profit & Loss A/c". Accounts relating expenses or losses will show debit balance whereas accounts relating to incomes and gains will have credit balance.

ILLUSTRATION 6:

On 1st April 2020, the following were the ledger balances of Mishra & Sons:

	Rs.
Cash in hand	9,000
Cash at Bank	21,000
Soni (Cr.)	5,000
Zahir (Dr.)	12,400
Satish (Dr.)	4,500
Prasad (Cr.)	3,000
Stock	20,000
Motor car	50,000
Bank Loan	40,000

Transactions during the month of April were as follows:

Rs.

April 2 Bought goods from Prasad	8,000
April 3 Sold goods to Satish	15,000
April 5 Bought goods on cash	13,600
April 7 Goods taken for personal use	1,200
April 13 Received from Zahir in full settlement	12,000
April 20 Paid full amount to Soni	
April 22 Paid cash for stationary	500
April 23 Paid to prasad by cheque in full settlement	2,800
April 30 Rent due to Landlord	1,500

Journalise the above transactions and post them to ledger accounts.

SOLUTION:

JOURNAL

Date	Particulars	LF	Debit (Rs.)	Credit (Rs.)
April 1, 2020	Cash A/c Dr. Bank A/c Dr. Zahir A/c Dr. Satish A/c Dr. Stock A/c Dr. Motor A/c Dr. To Soni A/c To Prasad A/c To Bank Loan A/c To Capital A/c (Note) (Being the opening entries)		9,000 21,000 12,400 4,500 20,000 50,000	 5,000 3,000 40,000 68,900
April 2	Purchase A/c Dr. To Prasad A/c (Being goods purchased from Prasad)		8,000	 8,000
April 3	Satish A/c Dr. To Sales A/c (Being goods sold to Satish)		15,000	 15,000
April 5	Purchase A/c Dr. To Cash A/c (Being goods purchased on cash)		13,600	 13,600
April 7	Drawing A/c Dr. To Purchase A/c		1,200	 1,200

	(Being goods taken for personal use)			
April 13	Cash A/c Dr. Discount A/c Dr. To Zahir A/c (Being 12,000 received in full settlement of his dues of Rs 12,400)		12,000 400	 12,400
April 20	Soni A/c Dr. To Cash A/c (Being cash paid towards her dues in final settlement)		5,000	 5,000
April 22	Stationary A/c Dr. To Cash A/c (Being stationary purchased on cash)		500	 500
April 23	Prasad A/c Dr. To Bank A/c To Discount Received A/c		3000	 2800 200
April 30	Rent A/c Dr. To Outstanding rent A/c		1,500	 1,500

Note: Capital A/c = Total Asset – Liabilities = 116,900-48,000 = 68900

LEDGER POSTING

Dr. **Cash Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 1	To Balance b/d		9,000	April 5	By Purchase A/c		13,600
	To Zahir A/c		12,000	April20	By Soni A/c		5,000
				April 22	By Stationary A/c		500
				April 30	By Balance c/d		1,900
			21,000				21,000
	To Balance b/d		1,900				

Dr. **Bank Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 1	To Balance b/d		21,000	April 23	By Prasad A/c		2,800
				April 30	By Balance c/d		18,200
			21,000				21,000
May 1	To Balance b/d		18,200				

Dr. **Motor Car Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 1	To Balance b/d		50,000	April 30	By Balance c/d		50,000
			50,000				50,000
May 1	To Balance b/d		50,000				

Dr. **Stock Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 1	To Balance b/d		20,000	April 30	By Balance c/d		20,000
			20,000				20,000
May 1	To Balance b/d		20,000				

Dr. **Zahir Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 1	To Balance b/d		12,400	April 13	By Cash A/c		12,000
					By Discount allowed A/c		400
			12,400				12,400

Dr. **Satish Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 1	To Balance b/d		4,500	April 30	By Balance c/d		19,500
	To Sales A/c		15,000				
			19,500				19,500
May 1	To Balance b/d		19,500				

Dr. **Bank Loan Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 30	To Balance c/d		40,000	April 1	By Balance b/d		40,000
			40,000				40,000
				May 1	To Balance b/d		40,000

Dr. **Capital Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 30	To Balance c/d		68,900	April 1	By Balance b/d		68,900
			68,900				68,900
				May 1	To Balance b/d		68,900

Dr. **Soni Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 20	To Cash A/c		5,000	April 1	By Balance b/d		5,000
			5,000				5,000

Dr. **Prasad Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 23	To Bank A/c		2,800	April 1	By Balance b/d		3,000
April 23	To Discount received A/c		200	April 2	By Purchases A/c		8,000
April 30	To Balance c/d		8,000				
			11,000				11,000
				May 1	By Balance b/d		8,000

Dr. **Purchase Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 2	To Bank A/c		8000	April 7	By Drawings A/c		1,200
April 5	To Cash A/c		13,600	April 30	By Balance c/d		20,400
			21,600				21,600
May 1	To Balance b/d		20,400				

Dr. **Sales Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)

April 30	To Balance c/d		15,000	April 3	By Satish A/c		15,000
			15,000				15,000
				May 1	By Balance b/d		15,000

Dr. **Discount Received Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 30	To Balance c/d		200	April 23	By Prasad A/c		200
			200				200
				May 1	By Balance b/d		200

Dr. **Drawings Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 7	To Purchase A/c		1,200	April 30	By Balance c/d		1,200
			1,200				1,200
May 1	To Balance b/d		1,200				

Dr. **Discount Allowed Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 13	To Zahir A/c		400	April 30	By Balance c/d		400
			400				400
May 1	To Balance b/d						

Dr. **Stationery Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 22	To Cash A/c		500	April 30	By Balance c/d		500
			500				500
May 1	To Balance b/d		500				

Dr. **Rent Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 30	To Outstanding rent A/c		1,500	April 30	By Balance c/d		1,500
			1,500				1,500

	To Balance b/d		1,500				1,500

Dr. **Outstanding Rent Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
April 30	To Balance c/d		1,500	April 30	By Rent A/c		1,500
			1,500				1,500
				May 1	By Balance b/d		1,500

CHECK YOUR PROGRESS A

1. Why journal is called as the book of prime entry?
2. Explain features of a journal.
3. State the need for ledger accounts.
4. What is debit balance and credit balance?
5. Fill in the blanks:
   i. Journal is a book of --------- entry
   ii. When goods are withdrawn for personal use of the owner, the ------------- account is credited.
   iii. The journal entry consisting of more than two debits or credits is known as -------------- journal entries.
   iv. Wages paid for installation of machinery will be debited to------------ account.
   v. In case of a debt becoming bad, the amount should be credited to ---------------- account.
6. Choose the correct answer.
   i. Goods donated to a charitable organization should be credited to
      a) Charity account b) Purchase account
      c) Receiver's account d) Advertisement account
   ii. When debit side of an account exceeds its credit side, the account shows:
      a) Debit balance b) Credit balance
      c) No balance d) None of the above
   iii. Which of the following accounts can show credit balance
      a) Cash account b) Machinery account
      c) Bill's receivable account d) Bank account
   iv. Income earned but not received is referred to as:
      a) Accrued income b) Income

c) Income received in advance d) Revenue

v. Which of the following does not show a debit balance?

a) Carriage inward b) Carriage outward

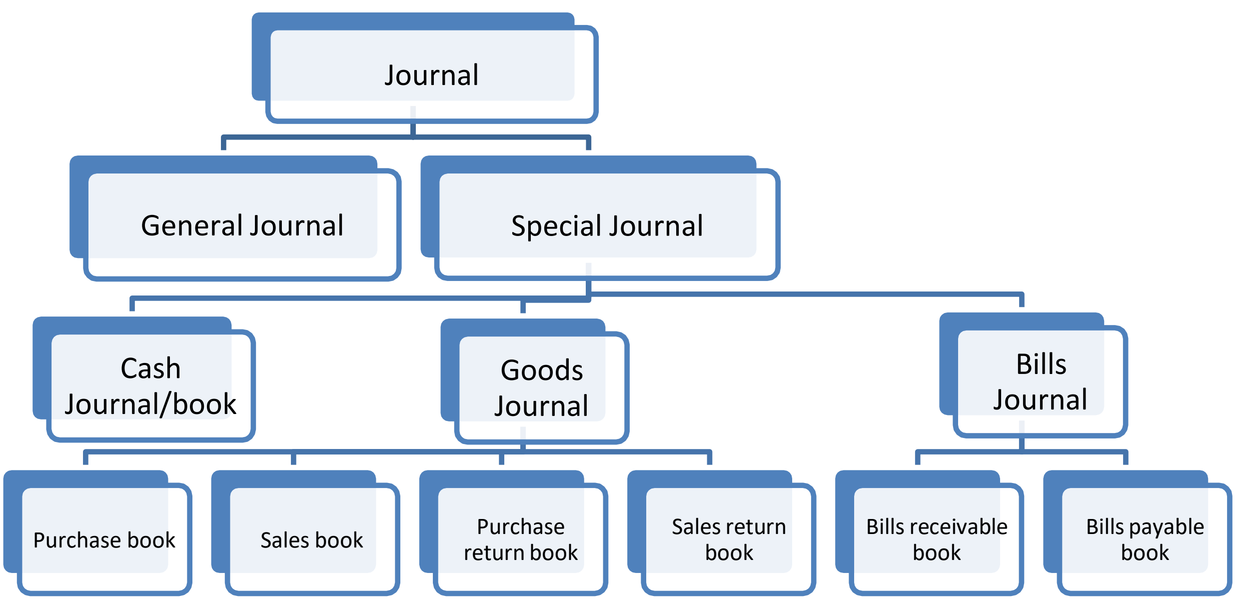
c) Return inward d) Return outward

4.5 SUB-DIVISION OF JOURNAL

Originally, all transactions were recorded in a single book called journal. But with increase in the volume of transactions, there was a need to sub-divide the journals into special journals. The special journals for recording a particular type of transactions are called subsidiary books. Such journals provide detailed information relating to a particular type of activity. Some of the advantages of sub-division of journal are as follows:

- It facilitates division of work among the staffs as different staffs can be assigned different sub-journals.
- The transactions can be traced easily by referring to the appropriate subsidiary book.
- It helps in locating errors as different persons can take up the checking work of different books simultaneously.
- As there is division of work, responsibility can be fixed on the concerned person dealing with the particular book.

Sub-division of journal can be explained with the help of following diagram:



4.6 SUBSIDIARY BOOKS

The special journals for recording a particular type of transactions are called subsidiary books. It helps better check and balance and also better collection of information. Depending on the needs, various types of subsidiary books are maintained. The subsidiary books, usually maintained by a business organization are as follows:

1. Cash Book
2. Purchase Book
3. Sales Book
4. Purchase Return Book
5. Sales Return Book
6. Bills Receivable Book
7. Bills Payable Book
8. Journal Proper

The form of any subsidiary book may vary from organization to organization.

The Cash Book has been explained in detail in the next section.

PURCHASE BOOK

The purchase book or purchase journal shows a chronological record of all goods purchased on credit only. For each credit purchase, there is an inward invoice showing full details of the goods purchased. The usual proforma of purchase book is as follows:

PURCHASE BOOK

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

SALES BOOK

The sales book or sales journal shows the recording of only the credit sale of goods. For each credit sale, the organization prepares an outward invoice showing full details of the goods dispatched. The usual proforma of sales book is as follows:

Sales Book

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

PURCHASE RETURN BOOK

Sometimes, it may be required to return the goods purchased on credit to the supplier for various reasons such as, defective goods, goods damaged in transit or excess quantity of goods supplied. All such return of goods is recorded in a separate book called purchase return book or return outward book. The usual proforma of purchase return book is as follows:

Purchase Return Book

Date	Particulars	Debit Note No.	L.F.	Details (Rs.)	Amount (Rs.)

A debit note is prepared and sent by the purchaser of the goods to the supplier when the goods are returned to the supplier. This informs the supplier that his account has been debited with the amount shown in the debit note. Debit note is prepared in duplicate. Original copy is sent to the supplier and the duplicate copy forms the basis of recording in purchase return book.

SALES RETURN BOOK

Sometimes, the customer may return the goods purchased on credit for a variety of reasons such as defective goods, inferior quality, excess quantity, etc. All such returns of good are recorded in a separate book called sales return book or return inward book. The usual proforma of sales return book is as follows:

Sales Return Book

Date	Particulars	Credit Note No.	L.F.	Details (Rs.)	Amount (Rs.)

Recording in sales return book are usually made on the basis of credit note sent to the customers. When the seller receives the debit note along with the goods returned by the customer, he has to acknowledge the same by giving a credit note. This informs the customer that his account has been credited with the amount shown in credit note. The original copy of the credit note is sent to the customer confirming the acceptance of debit note and duplicate is kept as the basis for recording in the sales return book.

BILLS RECEIVABLE BOOK

If a business organization receives a number of promissory notes, hundis or bills from the customers against credit sale of good, these transactions are recorded in a separate book called bills receivable book. The usual proforma of a bills receivable book is as follows:

Bills Receivable Book

Sl. No.	Date of Receipt	From Whom Received	Name of Drawer	Name of Acceptor	Date of Bill Drawn	Term of Bill	Date of Maturity	Where Receivable	L.F.	Amount (Rs.)

BILLS PAYABLE BOOK

If a business organization gives a number of promissory notes, hundis or bills issued in favor of suppliers or creditors against credit purchase of good, these transactions are recorded in a separate book called bills payable book. The usual proforma of bills payable book is as follows:

Bills Payable Book

Sl. No.	Date of Receipt	Name of Drawer	Name of Payee	Date of Bill Drawn	Term of Bill	Date of Maturity	Where Payable	L.F.	Amount (Rs.)

JOURNAL PROPER OR GENERAL JOURNAL

Some transactions and entries like opening entries, closing entries, transfer entries, adjusting entries, rectification entries, etc. cannot be recorded in the special journals maintained by an organization. These are recorded in a book named journal proper.

4.7 CASH BOOK

Cash book is a subsidiary book that records all the cash and bank transactions. The primary objective of maintaining cash book is to know the balance of cash in hand and cash at bank at a given point of time. Cash book is a journalised ledger. Hence, when a cash book is maintained, there is no need to have a cash account in ledger.

The various types of cash book maintained by the business organisations are:

1) Simple or single column cash book
2) Double column or two-column cash book

3) Triple column or three-column cash book

SINGLE COLUMN CASH BOOK: It has one column on each side for recording the amounts. The debit side of the cash book is used for recording all cash receipts and the credit side for all cash payments. Cash book serves the purpose of cash account. When we record transaction in cash book, no posting is required in ledger. Cash book is balanced like any other ledger account. Cash book always shows debit balance because cash payments cannot be more than cash available. The format of a single column cash book is as follows:

Dr. **Cash Book** Cr.

Date	Particulars	L.F.	Amount	Date	Particular	L.F.	Amount

DOUBLE COLUMN CASH BOOK: It has two columns on each side, one for recording cash and other for recording discount. Discount allowed and received is recorded so as to give a complete picture. The discount allowed to debtors is recorded on the debit side and discount received from creditors is recorded on the credit side. Here, only the cash columns are balanced and the discount columns are totalled. The format of a double column cash book is as follows:

Dr. **Cash Book** Cr.

Date	Particulars	L.F.	Discount allowed	Cash (Rs.)	Date	Particulars	L.F.	Discount received	Cash (Rs.)

Note: Double column cash book or a two-column cash book can also be prepared to record both cash and bank transactions.

TRIPLE COLUMN CASH BOOK:

Many business organisations settle their transactions through bank. So, in triple column cash book, additional column for bank is given on both the sides of cash book. This also serves the purpose of a bank account. A triple column cash book shows cash in hand, cash at bank, total discount received and total discount allowed. When payment is received in cash and cheque, it is recorded in the debit side of triple column cash book in cash column and bank column respectively. And all cash and cheque payments are recorded in the credit side. The format of a triple column cash book is as follows:

Dr. **s** Cr.

Date	Particulars	L.F.	Discount allowed	Cash (Rs.)	Bank (Rs.)	Date	Particular	L.F.	Discount received	Cash (Rs.)	Bank (Rs.)

***CONTRA ENTRIES*:** Contra is a latin word which means 'opposite side'. Contra entry is an entry on one side of the cash book against which another entry appears in the opposite side. Contra entry arises when both cash and bank accounts are simultaneously involved in any transaction. For example, when cash is deposited in bank and when cash is withdrawn from bank. These entries are denoted by letter 'c' in the folio column. It signifies that the double entry aspect is complete and no further posting in ledger is required.

Cash deposited in bank: Bank A/c Dr.
To Cash A/c

In this case entry is done in the bank column on the debit side and in cash column on the credit side of triple column cash book.

Dr. **Triple Column Cash Book** Cr.

Date	Particulars	L.F.	Discount allowed	Cash (Rs.)	Bank (Rs.)	Date	Particular	L.F.	Discount received	Cash (Rs.)	Bank (Rs.)
	To Cash A/c	C			xxx		By Bank A/c	C		xxx	

The entries done in triple column cash book are to be posted in their respective ledger accounts, except the contra entries. The cash and bank columns are balanced like any other ledger account. Cash account always shows debit balance whereas bank account usually shows debit balance but sometimes it may show credit balance which indicates bank overdraft.

Illustration 7:

From the following particulars prepare a triple column cash book and determine the cash in hand and cash deposited at bank on 31 January 2020:

Jan 1 Balance of cash in hand Rs. 12360 and cash at bank (Cr. Balance) Rs 4500
Jan 3 Issued a cheque of Rs 4,500 to petty cashier
Jan 5 Received a crossed cheque of Rs. 1,450 from Punit and allowed him discount Rs.50
Jan 8 Goods purchased by cheque Rs. 3,240
Jan 12 Withdrawn from bank for personal use Rs. 1000

Jan 15 Issued cheque to Shyam for Rs. 2,420 and discount received Rs. 80
Jan 20 Cash sales Rs. 7,850
Jan 25 Punit dishonoured his cheque
Jan 28 Deposited into bank Rs 2,000
Jan 29 Received interest on investment Rs. 500
Jan 31 Balance of cash at bank Rs 3,160

SOLUTION:

Dr. **Cash Book** Cr.

Date 2020	Particulars	L.F	Discount allowed	Cash (Rs.)	Bank (Rs.)	Date	Particular	LF	Discount received	Cash (Rs.)	Bank (Rs.)
Jan 1	To Bal. b/d			12360		Jan 1	By Bal. b/d				4500
Jan 5	To Punit A/c		50		1450	Jan 3	By Petty cash A/c				1000
Jan 20	To Sales A/c			7850		Jan8	By Purchase A/c				3240
Jan 28	To Cash A/c	C			2000	Jan12	By Drawings A/c				1000
Jan 29	To Interest A/c			500		Jan15	By Shyam A/c		80		2420
Jan 31	To Cash A/c	C			13320	Jan25	By Punit A/c				1450
						Jan28	By Bank A/c	C		2000	
						Jan31	By Bank A/c	C		13320	
						Jan31	By Bal c/d			5390	3160
			50	20710	16770				80	20710	16770
	To bal. b/d			5390	3160						
Feb 1	To Bal. b/d										

Balance of cash at hand on 31 Jan, 2020 is Rs. 5390.
Cash deposited in bank on 31 Jan, 2020 is Rs. 13320.

4.8 TRIAL BALANCE

Under double entry system, every debit has equal and corresponding credit. The total of debit balance column must tally with the total of credit balance column. Trial balance is a statement that is periodically prepared showing the debit balances in one column and credit balances in another column. These balances are extracted from ledger accounts on a particular date. Thus, a trial balance is a summary of all the ledger account balances outstanding on a particular date.

The main objective of preparing a trial balance is to check the arithmetical accuracy of accounting entries posted in the ledger. Tallying of the columns ensures arithmetical accuracy but not accounting accuracy. Trial balance provides a basis for preparation of final accounts like profit and loss account and balance sheet.

4.9 PREPARATION OF TRIAL BALANCE

In preparation of trial balance, we only balance the various ledger accounts of the organisation and take the debit balances in the debit amount column and credit balances in the credit amount column. Cash and bank balances are taken from the cash book. When, only the list of balances is given without mentioning the nature (i.e., debit balance or credit balance) of each balance, then first determine the nature of the balance by applying the rules of debit and credit. For example: all expenses accounts will show debit balance and income accounts will show credit balance; and assets will give debit balance whereas liabilities will give credit balance. The capital account will show credit balance and drawings account will show debit balance.

ILLUSTRATION 8:

Prepare a trial balance with the following information as on March 31, 2020:

Name of the Account	Balances (Rs.)
Capital	2,00,000
Cash	1,80,000
Creditors	1,00,000
Sales	3,00,000
Stock	70,000
Debtors	3,00,000
Bank Loan	1,50,000
Purchases	2,00,000

SOLUTION:

Trial Balance as on March 31, 2020

Account Name	Debit Balance (Rs.)	Credit Balance (Rs.)
Capital		2,00,000
Creditors		1,00,000
Bank Loan		1,50,000
Sales		3,00,000
Stock	70,000	
Purchases	2,00,000	
Debtors	3,00,000	
Cash	1,80,000	
Total	7,50,000	7,50,000

ILLUSTRATION 9:

Prepare journal, ledger and the trial balance of Suresh Sahu on 31 Dec 2020 taking into account the following transactions during the month.

Dec 1 Mr. Sahu started business with cash Rs. 50,000. He purchased stationery for Rs. 3.000
Dec 2 He purchased goods for Rs. 21,000
Dec 3 Paid for postage Rs. 100
Dec 5 Sold goods for Rs 7,500 and received a cheque for the same
Dec 6 Purchase furniture from Narmada Furnitures for Rs. 5,000
Dec 11 Sold goods to Mahendra for Rs. 10,000
Dec 12 Received cheque from Mahendra for Rs. 10,000
Dec 14 Paid the dues of Narmada Furnitures by cheque.
Dec 16 Sold good to Ramesh and Co Rs. 5,000
Dec 20 Goods purchased from Sethi & Co Rs. 7,000
Dec 23 Purchased goods for Rs. 2,250
Dec 24 Goods sold to Prakash for Rs. 3,500
Dec 26 Cash received from Ramesh & Co Rs. 2,500
Dec 28 Fully settled the account of Sethi & Co by a cheque for Rs. 6,850
Dec 31 Salaries paid Rs. 12,500. Rent due for the month is Rs. 3,000

SOLUTION:

JOURNAL

Date 2020	Particulars	LF	Debit (Rs.)	Credit (Rs.)
Dec 1	Cash A/c Dr.		50,000	

	To Capital A/c (Being cash introduced by Suresh for commencing business)			50,000
Dec 1	Stationery A/c Dr. To Cash A/c (Being stationery purchased)		3,000	 3,000
Dec 2	Purchase A/c Dr. To Cash A/c (Being goods purchased)		21,000	 21,000
Dec 3	Postage Stamps A/c Dr. To Cash A/c (Being postage stamps purchased)		100	 100
Dec 5	Bank A/c Dr. To Sales A/c (Being cheque received against sales)		7,500	 7,500
Dec 6	Furniture A/c Dr. To Narmada Furniture A/c (Being furniture purchased on credit)		5,000	 5,000
Dec 11	Mahendra A/c Dr. To Sales A/c (Being sales made to Mahendra)		10,000	 10,000
Dec 12	Bank A/c Dr. To Mahendra A/c (Being cheque received from Mahendra)		10,000	 10,000
Dec 14	Narmada Furniture A/c Dr. To Bank A/c (Being cheque paid to Narmada Furniture)		5,000	 5,000
Dec 16	Ramesh & Co. A/c Dr. To Sales A/c (Being sales made to Ramesh)		5,000	 5,000
Dec 20	Purchase A/c Dr. To Sethi & Co. A/c (Being goods purchased on credit from Sethi & Co)		7,000	 7,000
Dec 23	Purchase A/c Dr. To Cash A/c (Being goods purchased on cash)		2,250	 2,250
Dec 24	Prakash A/c Dr. To Sales A/c (Being credit sales made to Prakash)		3,500	 3,500

Dec 26	Cash A/c Dr. To Ramesh & Co A/c (Being cash received from Ramesh)		2,500	 2,500
Dec 28	Sethi & Co. A/c Dr. To Bank A/c To Discount A/c (Being final settlement done)		7000	 6,850 150
Dec 31	Salaries A/c Dr. To Cash A/c (Being salary paid)		12,500	 12,500
Dec 31	Rent A/c Dr. To Rent outstanding A/c (Being rent for the month outstanding)		3,000	 3,000

LEDGER

Dr. **Cash Account** Cr.

Date 2020	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 1	To Capital A/c		50,000	Dec 1	By stationery A/c		3000
Dec 26	To Ramesh A/c		2,500	Dec 2	By Purchase A/c		21,000
				Dec 3	By Postage A/c		100
				Dec 23	By Purchase A/c		2,250
				Dec 31	By Salaries A/c		12,500
				Dec 31	By Balance c/d		13,650
			52,500				52,500

Dr. **Bank Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 5	To Sales A/c		7,500	Dec 14	By Narmada Furniture A/c		5,000
Dec 12	To Mahendra A/c		10,000				
				Dec 28	By Sethi & Co. A/c		6,850
				Dec 31	By Balance c/d		5,650
			17,500				17,500

Dr. **Capital Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 31	To Balance c/d		50,000	Dec 1	By Cash A/c		50,000
			50,000				50,000

Dr. **Stationery Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 1	To Cash A/c		3,000	Dec 31	By Balance c/d		3,000
			3,000				3,000

Dr. **Purchase Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 2	To Cash A/c		21,000	Dec 31	By Balance c/d		30,250
Dec20	To Sethi & Co.		7,000				
Dec23	To cash A/c		2,250				
			30,250				30,250

Dr. **Sales Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 31	To Balance c/d		26,000	Dec 5	By Bank A/c		7,500
				Dec 11	By Mahendra A/c		10,000
				Dec 16	By Ramesh & Co. A/c		5,000
				Dec 24	By Prakash A/c		3,500
			26,000				26,000

Dr. **Postage stamp Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)

Dec 3	To Cash A/c		100	Dec 31	By Balance c/d		100
			100				100

Dr. **Furniture Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 6	To Narmada Furniture A/c		5,000	Dec 31	By Balance c/d		5,000
			5,000				5,000

Dr. **Narmada Furniture Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 14	To Bank A/c		5,000	Dec 6	By Furniture A/c		5,000
			5,000				5,000

Dr. **Mahendra Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 11	To Sales A/c		10,000	Dec 12	By Bank A/c		10,000
			10,000				10,000

Dr. **Ramesh & Co. Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 16	To Sales A/c		5,000	Dec 26	By Cash A/c		2,500
				Dec 31	By Balance c/d		2,500
			5,000				5,000

Dr. **Sethi & Co. Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 28	To Bank A/c		6,850	Dec 20	By Purchase A/c		7,000
Dec 28	To Discount A/c		150				
			7,000				7,000

Dr. **Prakash Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 24	To Sales A/c		3,500	Dec 31	By Balance c/d		3,500
			3,500				3,500

Dr. **Discount Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 31	To balance c/d		150	Dec 28	By Sethi & Co. A/c		150
			150				150

Dr. **Salaries Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 31	To Cash A/c		12,500	Dec 31	By Balance c/d		12,500
			12,500				12,500

Dr. **Rent Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec31	To Outstanding Rent A/c		3,000	Dec 31	By Balance c/d		3,000
			3,000				3,000

Dr. **Outstanding rent Account** Cr.

Date	Particulars	F	Amount (Rs.)	Date	Particulars	F	Amount (Rs.)
Dec 31	To Balance c/d		3,000	Dec 31	By Rent A/c		3,000
			3,000				3,000

Trial Balance

Account Name	Debit Balance (Rs.)	Credit Balance (Rs.)
Cash A/c	13,650	
Capital A/c		50,000
Stationery A/c	3,000	
Purchase A/c	30,250	
Sales A/c		26,000
Bank A/c	5,650	
Postage Stamp A/c	100	
Furniture A/c	5,000	
Ramesh & Co. A/c	2,500	
Prakash A/c	3,500	
Discount A/c		150
Salaries A/c	12,500	
Rent A/c	3,000	
Outstanding Rent A/c		3,000
	79,150	79,150

CHECK YOUR PROGRESS B

1. What is debit note and credit note?
2. What is bills receivable journal?
3. What are the objectives of preparing trial balance?
4. What are compensating errors?
5. Fill in the blanks:
    i. Bills on which payment will be made by the business are recorded in ------------- book.

ii. The entry on one side of the cash book against which another entry appears on the opposite side is called--------entry.

iii. All the debit and credit balance of accounts are taken to-------- --.

iv. Any difference in the total of two columns of a trial balance is temporarily transferred to ----------- account.

v. Debit note is the basis for recording in----------- books.

6. Choose the correct answer:

i. In which subsidiary book the return of goods to supplier is recorded:

a) Journal Proper b) Purchase book
c) Purchase return book d) Sales return book

ii. Transactions are recorded in the purchase book on the basis of the source document called:

a) Invoice b) Credit note
c) Debit note d) None of the above

iii. Transactions are recorded in the Return inward book on the basis of:

a) Debit note b) Credit note
c)Promissory note d) Invoice

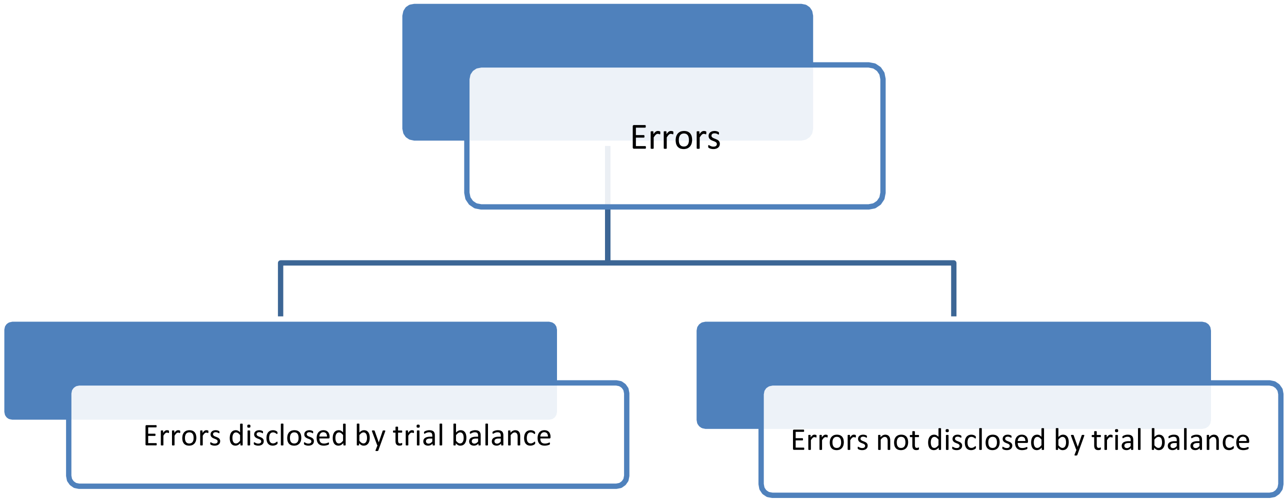
iv. The book which solves the purpose of a journal as well as a ledger is:

a) Journal Proper b) Cash Book
c)Purchase book d) Sales book

v. The entries which appear on both sides of a cash book are called:

a) Compound entries b) Closing entries
c)Contra entries d) Opening entries

4.10 ERRORS AND RECTIFICATION



ERRORS

When the trial balance does not tally, it means there are errors in the books of accounts. These are also called one sided errors. Some of the reasons for these kinds of errors are:

i. **PARTIAL OMISSION OF A TRANSACTION:** As per rule, both debit and credit aspect of the transaction must be posted in ledger accounts. But if one aspect is posted and other is not posted, then it results in mismatch of the trial balance.
ii. **WRONG TOTALLING OF SUBSIDIARY BOOKS:** If the subsidiary book is over casted or under casted, then wrong amount will be taken to trial balance and finally it will lead to a mismatch.
iii. **OMISSION OF AN ACCOUNT IN TRIAL BALANCE:** If you forget to carry an account to the trial balance, then there will be a mismatch in trial balance.
iv. **POSTING WRONG AMOUNT IN ACCOUNTS:** If you post wrong amount in the ledgers then it will show in the trial balance ultimately.
v. **POSTING IN WRONG SIDE OF AN ACCOUNT:** If an entry is posted on the wrong side, i.e., debit side instead of credit side or vice versa, it would cause disagreement in the trial balance.
vi. **POSTING WRONG AMOUNT IN TRIAL BALANCE:** If wrong amount is posted in the Trial Balance, it will lead to its mismatch.
vii. **POSTING AN AMOUNT IN THE WRONG COLUMN OF THE TRIAL BALANCE:** If any account showing credit balance is taken to debit column or vice versa, then trial balance will not tally.

There are certain errors which cannot be detected by the trial balance. These errors are two sided errors because they affect two accounts (both debit and credit account) at a time. The list of errors that do not affect the agreement of trial balance are as follows:

i. **COMPLETE OMISSION OF A TRANSACTION:** This refers to any transaction which is completely omitted in both the accounts while posting in ledger.
ii. **ERRORS OF PRINCIPLE:** When any transaction has not been recorded as per accounting principles, such errors are called errors of principles.
iii. **COMPENSATING ERRORS:** The errors whose effects are compensated by another error are called compensating errors.
iv. Recording wrong amount in subsidiary book
v. Recording in wrong subsidiary book
vi. Posting to wrong accounts

For the purpose of rectification, errors are sub divided into two categories: one-sided errors and two sided errors. One sided errors affect one side of an account. Two sided errors affect two or more accounts.

RECTIFICATION OF ONE-SIDED ERRORS:

Since one sided errors affect only one account, they cannot be rectified by passing journal entry as journal entry requires two accounts. When an one sided error is committed, it may affect either the debit side or the credit side. As a result, the debit/credit side may fall short or may be in excess. Example: Goods worth Rs. 1000 purchased from Mr. Sahu but wrongly recorded in his account as Rs. 10,000. In this case Mr. Sahu's account should have been credited Rs.1000 but it has wrongly been credited Rs. 10,000. So credit side is in excess of Rs. 9000. Excess credit can be rectified by making the statement on the debit side.

Dr. **Mr. Sahu's A/c** Cr.

	Particulars	Amount (Rs.)		Particulars	Amount (Rs.)
	To excess credit on purchases made on…. Now rectified	9000			

Electricity paid Rs. 800 posted twice in electricity account. In this case, the entry in the cash book is correct but the error lies in the repeat entry in electricity account. Here, we can rectify the error by crediting the electricity account with Rs. 800.

Dr. **Electricity A/c** Cr.

	Particulars	Amount (Rs.)		Particulars	Amount (Rs.)
				By double posting of electricity account now rectified	800

RECTIFICATION OF TWO-SIDED ERRORS: Two sided errors are mostly rectified by journal entries. In order to determine what should be the rectification entry, the following three questions should be answered:

- What entry should have been passed? (i.e., correct entry)
- What entry has been passed? (i.e., wrong entry)
- What entry should now be passed to rectify the error?

1. Cash received from Hari Rs.2000 is wrongly credited to Harish account. In this case the correct entry should have been: Cash A/c Dr. 2000
   To Hari A/c 2000

The entry passed is: Cash A/c Dr. 2000
To Harish A/c 2000

In order to cancel Harish A/c we need to debit Harish A/c and as Hari A/c is not at all credited, we need to credit it.

So, the rectification entry is: Harish A/c Dr. 2000
To Hari A/c 2000

2. An amount of Rs 5000 withdrawn by proprietor for his personal use has been debited to office expenses.

   In this case, the correct entry should have been: Drawings A/c Dr. 5000
   To Cash A/c 5000

The entry passed is: Office expenses A/c Dr. 5000
To Cash A/c 5000

Here, instead of drawings account we have debited office expenses account. So, in order to cancel office expenses account, we have to credit the account as it has been wrongly debited earlier and debit drawings account.

Rectification entry is: Drawings A/c Dr. 5000
To Office expenses A/c 5000

SUSPENSE ACCOUNT*:* If the trial balance does not tally even after rectification of errors, the difference is placed in a 'Suspense Account'. It is opened temporarily to make the two columns of the trial balance agree in spite of errors, which helps in the preparation of final accounts. When all the errors are rectified, the Suspense Account is closed.

4.11 LET US SUM UP

- Accounting process covers various stages of recording transactions in the books of accounts. It deals with recording transactions in the journal and posting them into ledger.
- The journal is the book of prime entry in which the transactions are recorded first. Each transaction is analysed to find out the two-fold aspects for journalising the transaction. In compound journal entry, more than two accounts are involved.
- All journal entries are posted into the ledger accounts. Posting is made on the debit side of the ledger account which has been debited in the journal. Similarly, posting is made on the credit side of the ledger account which has been credited in the journal. The balancing of all the ledger accounts is done to ascertain the net effects of all the postings made in an account.
- In a business organization, there is need for sub-division of journal or subsidiary books including the most important subsidiary book called Cash Book. Cash book is used to record all cash and bank transactions.
- Purchase book records all the credit purchase of the goods and sales book records the credit sales of goods. Purchase return book records goods returned to the suppliers whereas sales return book records the goods returned by the customer.
- Bills receivable book is used for recording the bills of exchange received from debtors. Bills payable book is used for recording bills of exchange issued to the creditors. Journal proper record all such transactions which are not covered in the any of the special journals.
- The number of special journals to be maintained by a business organisation will depend on its needs and nature of the transactions.
- The trial balance is prepared at the end of the accounting period to ascertain the arithmetical accuracy of the books of accounts. It is prepared before the preparation of final accounts such as Profit and Loss account and Balance Sheet.
- When the debit balances and the credit balances of a trial balance do not tally, it means that there are errors. There are also some errors which do not affect the trial balance. Efforts should be made to rectify all the errors.
- If the trial balance does not tally even after rectification of errors the difference is placed in a 'Suspense Account'. When all the errors are rectified, the Suspense Account is closed.

4.12 KEY WORDS

ACCOUNT: An account is a statement in which the transactions relating to a particular item are recorded.

BALANCING: The difference between the total debit and total credit appearing in an account.

COMPENSATING ERRORS: A group of errors wherein the effect of an error is compensated by the effect of another error.

ERRORS OF PRINCIPLE: These kinds of errors occur when we don't apply accounting principles while recording the transactions.

JOURNAL: It is a book for chronological record of daily transactions.

LEDGER: It is a book containing all the accounts of an organization in a summarized and classified form.

OPENING ENTRY: A journal entry passed at the beginning of the year to bring forward the previous year's assets and liabilities.

POSTING: A process of transferring entries from journal to ledger.

SUSPENSE ACCOUNT: An account opened to make the trial balance tally temporarily.

4.13 SOME USEFUL BOOKS

1. Maheswari S.N. and S.K. Maheswari, 2020. Introduction to Accounting, Vikas Publishing House: new Delhi.
2. Gupta R.L. and M. Radhaswamy, 2020. Advanced Accountancy, Volume 1, Sultan Chand & Sons: New Delhi.
3. Sukla, M.C. and T.S. Grewal, 2020. Advanced Accounts, S.Chand & Co: New Delhi.
4. Anthony, R.N., D. Hawkins and K.A. Merchant, 2013. Accounting: texts and Cases, 13th Ed., McGraw-Hill Education.
5. Horngren, C.T. and D. Philbrick. Introduction to Financial Accounting, Pearson Education

4.14 ANSWERS TO CHECK YOUR PROGRESS

A: 5 i) prime; ii) purchase; iii) compound; iv) Machinery; v) Debtor's account.

A: 6. i) b; ii) a; iii) d; iv) a; v) d.

B: 5. i) bills payable; ii) contra; iii) trial balance; iv) suspense; v) purchase return.

B: 6. i) c; ii) a; iii) b; iv) b; v) c.

4.15 TERMINAL QUESTIONS/EXERCISES

QUESTIONS

1. Discuss the classification of accounts with the help of example.
2. Explain the rule and procedure of recording various transaction in the journal.

3. What is a subsidiary book? Discuss in brief the various types of subsidiary books.
4. What is ledger posting. Explain the procedure of posting entries in the ledger with examples.
5. Explain double column and triple column cash book.
6. Why do we prepare a trial balance? Explain the errors which are disclosed by a trial balance.
7. Discuss the various types errors in books of accounts. Discuss the rectification of errors.

EXERCISES

1. Show the necessary journal entries in respect of the following transactions in the books of Sujit.
   a) Started business with cash Rs.40,000, goods worth Rs. 8,000, office equipment Rs. 7,000 and his personal scooter worth Rs. 15,000 which will henceforth be used for business purpose.
   b) Purchased furniture from S.K Brothers Rs 4,240 and paid cartage Rs. 500 in cash.
   c) Bought one television costing Rs.15,000 for personal use.
   d) Bought furniture costing Rs. 10,000 out of which Rs. 2,000 is for office decoration and remaining for stock.
   e) Sold old office equipment costing Rs.3,000 for Rs.5,000
   f) Sold household furniture Rs.3,000 and paid the money to the business.
   g) Paid Rs. 3,000 as rent. $1/3^{rd}$ of the premises is occupied for personal residence.
   h) Sold goods Rs. 6,000 of which Rs. 5,000 is received by cheque and Rs. 1,000 by cash. The cheque is deposited in personal bank account.
   i) Mr. S.K Brothers is paid Rs. 4,200 in full settlement of his account from the personal bank account of Mr. Sujit.

2. Enter the following transactions in the books of Manmohan and post them to ledger and balance the ledger.
   a) Started business with cash Rs. 50,000 and deposited Rs. 20,000 out of it in the bank
   b) Purchased goods from AB Ltd. Rs. 19,000
   c) Sold goods to Ramesh on credit Rs. 18,000
   d) Paid to AB Ltd. on account Rs. 10,000
   e) Received a cheque from Ramesh Rs. 14,000
   f) Sold to Dinesh Rs. 5,000
   g) Received a cheque from Dinesh Rs. 3,000
   h) Paid to AB Ltd. Rs. 8,500 in full settlement of his account
   i) Ramesh cleared his account by paying Rs. 3,800
   j) Dinesh’s cheque returned unpaid
   k) Paid wages Rs. 4,000

l) Interest allowed by bank Rs. 700 and bank charges debited by bank Rs. 100

3. Prepare a double column cash book from the following transactions of Praful and Bros. 2020.

April		Rs.
1	Cash in hand	5,000
3	Received from Arun	2,700
	And allowed him discount	50
5	Cash sales	3,500
7	Bought furniture for cash	1,000
9	Paid to Ramesh	1,470
	in full settlement of claim of Rs. 1,500	
12	Paid for trade expenses	80
15	Paid to Tarun against purchase of stationary	1,000
20	Received from Shankar	560
	in full settlement of his debt Rs. 600	
25	Paid premium for goods insured	140
28	Withdraw from bank for office expenses	2,000
30	Paid to Sahu & Co. and availed 2% discount	1,000
31	Encashed a bearer cheque received from Ram	2,000
31	Paid wages	1,200

(*Discount allowed Rs.90 ; Discount received Rs. 50 ; Cash balance Rs. 9,890)*

4. The following balances have been extracted from the books of accounts of Harihar Das as on 31st march 2020. Prepare a trial balance.

Account Name	Balance (Rs.)
Opening stock	82,000
Purchases	2,20,000
Drawings	36,000
Sales	3,60,000
Sales returns	12,000
Wages	10,800
Salaries	18,000
Travelling expenses	1,900
Rent rates and taxes	4,800
Purchase returns	3,000
Interest paid	3,600
Discount allowed	1,600
Commission received	2,000

Bad debt	1,200
Sundry debtors	28,000
Fixed assets	70,000
Sundry Creditors	1,25,000
Cash	16,400
General expenses	2,400
Advertisement Expenses	1,800
Capital	17,500
Investment	7,000
Bank overdraft	10,000

On 31st March 2020, the closing stock was valued at Rs. 32,000.
(*Total of Trial Balance Rs. 5,17,500)*

5. Pass journal entries to rectify the following errors:
    a) Bills received from Ram Rs.12,000 is recorded as Rs. 1,200 in bills receivable book.
    b) Goods returned by Mohan for Rs. 587 is wrongly taken to return inward book as Rs. 857.
    c) Goods worth Rs. 15,000 returned by Saroj has been recorded in purchase book.
    d) Rs. 5000 received from Malti Madhav is wrongly posted to Malti Yadav account.
    e) Salaries paid to Sodhi Rs. 20,000 has been wrongly taken to his personal account.
    f) Rs. 8,000 paid for installation of machinery is debited to installation expense account.
    g) Sales to Anil Rs. 5,000 has been omitted to be recorded in the books.
    h) Rs. 1,000 paid for repairs of plant and machinery was posted to plant and machinery account.

NOTE: The questions and exercises will help you to understand the unit better. Try to write answers for the questions given and try to solve the exercises. These are for your own practice only.

*****

B. COM

SEMESTER I

COURSE: FINANCIAL ACCOUNTING

UNIT – V: FINAL ACCOUNTS (NON-CORPORATE BUSINESS ENTITIES)

STRUCTURE

5.0 OBJECTIVES

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

- understand the importance of preparing final accounts;
- explain the capital and revenue expenditures, and receipts;
- understand trading and profit and loss account;
- understand manufacturing account;
- understand balance sheet;
- present final accounts in vertical form;
- explain the need of adjustments in the final accounts;
- understand and pass the necessary adjustment entries;
- prepare final accounts with adjustments.

5.1 INTRODUCTION

The main objective of running a business organization is to earn profit. The investors and other stakeholders of the organization are interested to know the performance of the business. Final accounts are prepared for determining the financial performance and financial position of the business organization. Final accounts are the summary statements of the transactions which have taken place during a particular period. They mainly consist of 'Profit and Loss Account' and 'Balance Sheet'. The Profit and Loss Account shows the profit earned or loss incurred during the accounting year. The Balance Sheet shows the financial position as on the last date of the accounting year.

5.2 TRIAL BALANCE AND FINAL ACCOUNTS

'Trial Balance' shows the balances of all the ledger accounts at the end of the accounting period. From the trial balance, final accounts are prepared by identifying the expenses, income, assets and liabilities. The nature of each ledger balance must be determined before preparing the trial balance. For example: the ledgers of assets and expenses will show debit balances whereas the ledgers of liabilities and incomes will show credit balances. Drawings will show debit balance. Tallying of the trial balance ensures arithmetical accuracy but not accounting accuracy.

After the preparation of trial balance, summary statements are prepared to determine the net result of the business operations at the end of the accounting period. These summary statements are called the **Final Accounts** or **Financial Statements**. Two basic financial statements are 'Balance Sheet' and 'Trading and Profit and Loss account'. All the nominal accounts of the trial balance are shown in 'Trading and Profit & Loss Account' whereas all the real and personal accounts are considered in 'Balance Sheet'.

5.3 CAPITAL AND REVENUE EXPENDITURE AND RECEIPTS

CAPITAL AND REVENUE EXPENDITURE:

Any expenditure which benefits the organisation for more than one accounting period and is incurred to increase the earning capacity and reduce the working expenses of the business can be termed as **'capital expenditure'**. These expenditures are mostly non-recurring in nature. Some of the examples of capital expenditure are purchase of fixed assets like land, building, machinery, patents and increasing the seating capacity of a cinema hall. Wages paid for installation of plant and machinery and transportation charges and legal expenses on the purchase of any fixed asset are also capital expenditures and become part of the concerned fixed assets. These are shown in the Balance Sheet.

Any expenditure incurred in the day-to-day business activities that are meant for the maintenance of earning capacity of the organisation and the benefit is consumed in one accounting period can be termed as **'revenue expenditure'**. Some of the examples of revenue expenditure are payment of rent of the office building, payment of wages or salaries to the employees, annual repairs, purchase of material and stores. These expenditures are recorded in debit side of the Trading and Profit and Loss account. As the benefits from these expenditures are received during the accounting year, they are not shown in Balance Sheet.

Certain expenditures incurred during a particular accounting period which are revenue in nature but their benefits are likely to be available in more than one accounting year. These expenditures are called '**deferred revenue expenditures'**. Some of the examples of deferred revenue expenditures are preliminary expenses incurred for formation of business entity, expenses incurred for advertisement of a new product, etc. Only a portion of such expenditure is charged to Profit and Loss Account, the balance is shown in Balance Sheet which will be written off during the subsequent accounting period.

CAPITAL AND REVENUE RECEIPTS

'CAPITAL RECEIPTS' refer to any amount received from sale of fixed assets, bank loans, introduction of any additional capital, etc. These are of non-recurring in nature and are received mostly from extra-ordinary transactions. These receipts are taken to Balance Sheet.

'REVENUE RECEIPTS' refer to any amount received from sale of the goods and services, rent, interest, commission, etc., that are earned in regular course of business. A business survives on the revenue receipts during the accounting period. Revenue receipts forms a part of Profit and Loss Account.

5.4 TRADING AND PROFIT AND LOSS ACCOUNT

Trading account determines the trading performance of an organisation. It ascertains the gross profit or gross loss for an accounting period. Net sales or revenues are compared with the cost of goods sold to get the gross profit or loss.

Net Sales = Cash sales + Credit sales – Sales return

Cost of goods sold = Opening stock + Purchase + Direct expenses – Closing stock

Direct expenses are the expenditures incurred to bring the goods from the place of purchase to the place of sale. For example- wages, carriage, freight, etc. Closing stock is the value of the unsold goods at the end of the accounting period. Closing stock of the current year becomes the opening stock of the next year.

Profit and Loss Account is a financial statement prepared at the end of the accounting period to ascertain the net profit or net loss.

Net Profit = Gross Profit + Indirect Incomes – Indirect Expenses and Losses

Trading and profit and Loss Account of XYZ for the year ending -----

Particulars	**Amount** Rs.	**Particulars**	**Amount** Rs.
To Opening Stock	xxx	By Sales	
To Purchase xxx		xxx	xxx
Less: Return Outward xxx	xxx	*Less:* Return Inward xxx	xxx
To Direct Expenses	xxx	By Closing Stock	xxx
To Gross Profit	xxx		
(Transferred to P&L)		By Gross Loss	
	xxx	(Transferred to P&L)	Xxx

To Gross Loss b/d			
To Salaries			
To Rent, rates and taxes		By Gross Profit b/d	
To Printing and stationery		By Commission received	
To Telephone charges		By Discount received	
To Travelling expenses		By Rent received	
To Advertising expenses		By Interest on drawings	
To Packaging charges		By Bad debts recovered	
To Bank charges		By Income from investment	
To Legal charges		By Interest income	
To Discount allowed			
To Office expenses			
To Interest on loan			
To Promotional expenses			
To Depreciation			
To Bad debt			
To Repair and renewal			
To Audit fees			
To Charity and donations			
To Loss of goods by fire			
To Loss on sale of fixed assets			

To Managers commission	xxx		xxx
To Net Profit (transferred to	xxx		xxx
Capital Account)	xxx		xxx
	xxx	Net Loss (transferred to Capital	xxx
	xxx	Account)	xxx
	xxx		xxx
	xxx		xxx
	xxx		xxx
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5.5 BALANCE SHEET

'Balance Sheet' is a summary statement which shows the financial position of the business organisation on a particular date. It shows the assets, liabilities and the capital of the business organisation. In short, it reveals the financial health of the business. Balance Sheet is prepared after the preparation of Trading and Profit & Loss Account. The real and personal accounts ledger balances of the trial balance are taken in Balance Sheet.

Balance Sheet of XYZ as on ---------------

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Capital	xxx		**Fixed Assets**	
Add: Profit	xxx		Land and Building	xxx
Less: Drawings	xxx	xxx	Plant and Machinery	xxx
			Furniture	xxx
Long-term Liabilities			Vehicles	xxx
Loan		xxx	Goodwill	xxx
Current Liabilities			Investments	xxx
Bank Overdraft		xxx		
Bill Payable		xxx	**Current Assets**	
Sundry Creditors		xxx	Cash in Hand	xxx
Outstanding Expenses		xxx	Bills Receivable	xxx
			Cash at Bank	xxx
			Prepaid Expenses	xxx
		xxx		xxx

'Assets' are the properties, possessions and rights of the business organisation that have economic value and are expected to provide future benefits. Assets are classified as fixed assets and current assets. Assets that have a long-term use in the business and are not meant for resale can be termed as **fixed assets**. They are the long-term resources of the organisation. Fixed assets can further be classified as tangible fixed assets and intangible fixed assets. The fixed assets that have a shape, size and can be seen and touched are called **tangible fixed assets**. Example- Plant and machinery, furniture, building, land, etc. Those fixed assets that cannot be seen and touched are referred to as **intangible fixed assets**. Example- goodwill, patent, copyright, trademark, etc. **Current assets** are the assets that are expected to be sold or used as a result of standard business operations. These are expected to be converted into cash within an accounting period. They are the short-term resources of the business. Some examples of current asset are cash in hand, cash at bank, sundry debtors, inventories, short term loans and advances, prepaid expenses, etc. Current assets that can be readily converted to cash without loss of value are known as **liquid assets.**

'Liabilities' refer to all claims against the assets of the business organization. It may be the claims of the outsiders (creditors and lenders) or of the owners of the business. The claims of the outsiders may be sub-divided into current liabilities and non-current or long-term liabilities. The obligations which are to be met within one accounting year are known as current liabilities. The non-current liabilities refer to the long-term sources of funds like loans which are not paid during one accounting period.

'Capital' shows the owner's claim. The net profit/loss and drawings during the accounting year are adjusted in the capital.

5.6 PRESENTATION OF FINAL ACCOUNTS IN VERTICAL FORM

These days many firms present the final accounts in 'vertical presentation'.

Trading and Profit and Loss Account of XYZ for the year ending ---------

Particulars	**Amount (Rs.)**	**Amount (Rs.)**
Sales		xxx
***Less:* Cost of goods sold:**		
Opening stock	xxx	
Add: purchase	xxx	
Add: direct expenses	xxx	
Less: Closing stock	xxx	
Gross Profit		xxx
***Add:* Other incomes**		xxx
		xxx
***Less:* Indirect expenses**		
Salaries	xxx	
Rent	xxx	
Electricity bills	xxx	
Insurance	xxx	
Printing and stationary	xxx	
Travelling expenses	xxx	
Audit fees	xxx	xxx
Net Profit/Loss		
		xxx

Balance sheet of XYZ as on-------------------

Particulars	**Amount (Rs.)**	**Amount (Rs.)**

Fixed Assets:		
Land and Building	xxx	
Plant and Machinery	xxx	
Vehicles	xxx	
Furnitures	xxx	
Goodwill	xxx	
Patents	xxx	
		xxx
Current Assets:		
Stock in hand	xxx	
Sundry debtors	xxx	
Cash at bank	xxx	
Cash in hand	xxx	
		xxx
Less: Current liabilities:		
Sundry creditors	xxx	
Bills payable	xxx	
Outstanding expenses	xxx	xxx
Working Capital		xxx
Capital		
Opening balance	xxx	
Add: Net profit	xxx	
Less: Drawings	xxx	xxx
Loans		xxx
		xxx

CHECK YOUR PROGRESS A

1. Why is it essential to prepare final accounts?
2. Why the firms have to differentiate between capital and revenue items?
3. How will you calculate cost of goods sold?
4. Fill in the blanks:
   i. Wages and salaries are charged to -------------account.
   ii. All indirect expenses are debited to -------------------- account.
   iii. Carriage inward is an example of --------------------expense.
   iv. The liabilities which become due within 1 year are classified as ------------- liabilities.
   v. Prepaid expenses are shown on the -----------side of the Balance Sheet.

5. State whether the following statements are true or false.

i. The gross profit is the difference of total sales and total cost.
ii. Income tax paid in case of a proprietary concern is charged to profit and loss account.
iii. Direct expenses are charged to trading account.
iv. Trade expenses are charged to profit and loss account.
v. Profit and Loss Account is a real account.

5.7 MANUFACTURING ACCOUNT

A manufacturing concern has to prepare manufacturing account first to determine the cost of goods produced. The cost of goods produced is then transferred to the trading account to ascertain the cost of goods sold and the gross profit.

Manufacturing Account of XYZ for the period ending------------

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To opening WIP	xxx	By Sale of scrap	xxx
To Raw materials consumed:		By closing WIP	xxx
Op. stock of Raw Material xxx		By cost of goods produced	xxx
Add: Purchase xxx	xxx	(transferred to trading account)	
Less: Closing Stock <u>xxx</u>	xxx		
	xxx		
To carriage inward	xxx		
To Freight, import duties, etc.	xxx		
To Manufacturing wages	xxx		
To coal, gas, water	xxx		
To Factory lighting	xxx		
To Factory insurance	xxx		
To Oil			
To Repairs to plant and machine	xxx		
To Depreciation on	xxx		
-Plant and machinery			
-Factory building	xxx		xxx

Scrap refers to the waste materials coming out of the manufacturing process.

WIP = Work-in-Progress refers to the goods that are still in the processes of manufacturing.

5.8 NEED FOR ADJUSTMENTS

Adjustments refer to the transactions which have not been considered in the trial balance even though they belong to the current accounting period. The transactions that are recorded in the books but pertain to the next accounting period are also to be adjusted. These adjustments are required for determination of true profit and true financial position. Some adjustments relating to non-cash items like depreciation, provision for bad debt must be done to know the true picture of the final accounts.

5.9 TREATMENT OF ADJUSTMENTS

TREATMENT OF ITEMS OF ADJUSTMENT APPEARING OUTSIDE THE TRIAL BALANCE

CLOSING STOCK: The goods that remain unsold at the end of the accounting period is called closing stock. It does not appear in the trial balance usually.

Adjustment Entry: Closing Stock A/c Dr.
To Trading Account A/c

Treatment in Trading and P&L A/c	Shown in credit side of trading account
Treatment in Balance Sheet	Shown in the asset side of the balance sheet under current asset

Outstanding expenses: The expenses that are due for payment in the current year but not paid are called the outstanding expenses. As these expenses pertain to the current period, it must be accounted with the concerned expense of the year.

Adjustment Entry: Concerned Expenses A/c Dr.
To Outstanding Expenses A/c

Treatment in Trading and P&L A/c	Shown in debit side of trading account (if the concerned expense is direct expense) or profit & loss account (if the concerned expense is indirect expense).
Treatment in Balance Sheet	Shown in the liability side as a current liability.

PREPAID EXPENSES: The expenses that are paid in advance but pertain to the next accounting period are called prepaid expenses.

Adjustment Entry: Prepaid Expenses A/c Dr.
To Concerned Expenses A/c

Treatment in Trading and P&L A/c	Subtracted from the concerned expense on the

	debit side
Treatment in Balance Sheet	Shown on the asset side as current asset

Interest on capital: Interest is given on the capital contribution of the owner.

Adjustment Entry: Interest on capital A/c Dr.
To Capital A/c

Treatment in P&L A/c	Shown as a separate item on the debit side
Treatment in Balance Sheet	Shown on the liability side by adding it with the capital

INTEREST ON DRAWINGS: When the owner withdraws money from the business for personal use, it is treated as a temporary loan and interest is charged for the amount. Interest on drawing is an income for the business organisation.

Adjustment Entry: Capital A/c or Drawing A/c Dr.
To Interest on drawing A/c

Treatment in P&L A/c	Shown as a separate item on the credit side
Treatment in Balance Sheet	Shown on the liability side by way of deduction from the capital

INTEREST ON LOAN: A business may obtain loans from private parties, banks and financial institutions. Interest on loan is an expense for the business.

Adjustment Entry: Interest on Loan A/c Dr.
To Outstanding Interest A/c

Treatment in P&L A/c	Shown as a separate item on the debit side
Treatment in Balance Sheet	Outstanding interest is added with the loan on the liability side

ACCRUED INCOME: Accrued incomes are earned during the current period but not received. These incomes are a part of the total income of the current year.

Adjustment Entry: Accrued Income A/c Dr.
To Concerned Income A/c

Treatment in P&L A/c	Added to the concerned income on the credit side
Treatment in Balance Sheet	Shown on the asset side as a current asset

DEPRECIATION: Depreciation is a reduction in the value of the fixed assets. Depreciation is deducted from the fixed asset to find out their real value. The depreciation accumulated over the period can be used for purchase of a new asset. Written down value method and straight-line methods are two most important method for the calculation of depreciation. Depreciation has been explained in detail in Unit – VI.

Adjustment Entry: Depreciation A/c Dr.
To Concerned Asset A/c

Treatment in P&L A/c	Shown as a separate item on the debit side
Treatment in Balance Sheet	Shown as a deduction from the concerned asset

BAD DEBT: Bad debts are the amount that is irrecoverable from the debtors. It is a loss for the business.

Adjustment Entry: Bad Debt A/c Dr.
To Sundry Debtors A/c

Treatment in P&L A/c	Shown as a separate item on the debit side
Treatment in Balance Sheet	Shown as a deduction from the sundry debtors

PROVISION FOR BAD DEBTS: As per conservatism principle, it is necessary to account for the **provision** of bad debts or doubtful debts (debts which are considered doubtful of recovery) by setting aside a part of the profit to meet the bad debts which may arise in future.

Calculation of Provision for Bad Debt:
When there is no further bad debt under adjustment: Required provision = Sundry Debtor X $\frac{Rate}{100}$
When there is additional bad debt given in adjustments: Required provision = (Sundry Debtor – Additional bad debts) X $\frac{Rate}{100}$

Adjustment Entry: Profit and Loss A/c Dr.
To Provision for doubtful debt A/c

Treatment in P&L A/c	Shown as a separate item on the debit side
Treatment in Balance Sheet	Shown as a deduction from the sundry debtors

If the old or the existing provision is more than the sum of total bad debt and required provision, the difference amount will be shown on the credit side of the profit and loss account.

PROVISION FOR DISCOUNT ON DEBTORS: This is a discount given to the good debtors as an incentive for prompt payment. This provision is calculated on the net sundry debtors. Net sundry debtors = Sundry debtors - bad debt - provision for doubtful debt

Adjustment Entry: Profit and Loss A/c   Dr.
                                        To Provision for discount on debtors A/c

Treatment in P&L A/c	Shown as a separate item on the debit side
Treatment in Balance Sheet	Shown as a deduction from the sundry debtors

Provision for discount on creditors: It refers to the reserve created for discount that are likely to be earned from the creditors on their payments.

Adjustment Entry: Provision for discount on creditors A/c   Dr.
                                        To Profit and Loss A/c

Treatment in P&L A/c	Shown as a separate item on the credit side
Treatment in Balance Sheet	Shown as a deduction from the sundry creditors

ABNORMAL LOSS OF GOODS BY FIRE: Sometime the business suffers from abnormal loss due to fire, flood, accident, etc. Such loss reduces the value of the closing stock at the end of the year. Generally, these abnormal losses of goods are covered under insurance. When the loss is admitted by the insurance company, the amount of claim is credited to the abnormal loss account and the balance if any in the abnormal loss is transferred to trading and profit & loss account.

When the goods are fully insured:

Adjustment Entry: Loss by fire A/c   Dr.
                                        To Trading A/c

                          Insurance claim A/c   Dr.
                                        To Loss by fire A/c

Treatment in Trading A/c	Loss by fire: Shown in the credit side as a separate item
Treatment in Balance Sheet	Insurance claim: Shown on the asset side as a current asset

When the goods are partially insured:

Adjustment Entry: Loss by fire A/c   Dr.
                                        To Trading A/c

Insurance claim A/c Dr.
Profit and Loss A/c Dr.
To Loss by fire A/c

Treatment in Trading A/c	Loss by fire: Shown in the credit side as a separate item
Treatment in P&L A/c	Loss shown on the debit side as a separate item (for the loss not covered by insurance)
Treatment in Balance Sheet	Insurance claim: Shown on the asset side as a current asset

When the goods are not insured:

Adjustment Entry: Loss by fire A/c Dr.
To Trading A/c

Profit & Loss A/c Dr.
To Loss by fire

Treatment in Trading A/c	Loss by fire: Shown in the credit side as a separate item
Treatment in P & L A/c	Loss shown on the debit side as separate item

DEFERRED REVENUE EXPENDITURE: It refers to the revenue expenditure which gives benefit for more than one accounting period. This expenditure is spread over the years in which benefit will be availed. A proportionate amount is charged every year to profit and loss account and the balance is carried forward to subsequent years as deferred revenue expenditure.

Adjustment Entry: Deferred Revenue Expenditure A/c Dr.
To Advertisement A/c
Profit & Loss A/c Dr.
To Deferred Revenue Expenditure A/c

Treatment in P & L A/c	A portion is shown on the debit side
Treatment in Balance Sheet	Balance is shown on the asset side

GOODS DISTRIBUTED AS FREE SAMPLE: Usually goods are purchased to resale. But at times they are also used for charitable or advertisement purpose.

Adjustment Entry: Charity/Advertisement A/c Dr.
To Purchase A/c

Treatment in Trading A/c	Shown by way of deduction from purchase on the debit side
Treatment in P & L A/c	Shown on the debit side as separate item

DRAWING OF GOODS BY PROPRIETOR: These refer to the goods that are taken by the proprietor for his personal use.

Adjustment Entry: Drawing A/c Dr.
To Purchase A/c

Treatment in Trading A/c	Shown by way of deduction from purchase on the debit side
Treatment in Balance Sheet	Shown by way of deduction from capital on the liability side

MANAGER'S COMMISSION: Managers are sometimes given incentives by way of percentage of profit. A fixed percentage on the net profit can either be calculated before charging commission or after charging commission.

Manager's Commission on net profit before charging commission = Profit before charging commission X $\frac{Rate}{100}$

Manager's Commission on net profit after charging commission = Profit before charging commission X $\frac{Rate}{100+Rate}$

Adjustment Entry: Manager's Commission A/c Dr.
To Outstanding Commission A/c

Treatment in P & L A/c	Shown on the debit side as separate item
Treatment in Balance Sheet	Shown on the liability side under current liability

5.10 ADJUSTMENTS GIVEN IN TRIAL BALANCE

When adjustment is given outside trial balance then their treatment is done in two places in the final accounts. But some adjustment items also appear in trial balance. This happens when journal entry in respect of adjustment has already been given and the same has been posted in the ledger accounts. When prepaid expense is given in the trial balance, it means the amount of prepaid expense has already been deducted from the particular expense account. So, it will not be shown in the trading and profit & Loss A/c, but it must be shown on the asset side of the balance sheet.

Items given in Trial Balance	Treatment in P&L A/c	Treatment in Balance Sheet
Closing Stock		Shown on the asset side as a current asset

Prepaid expenses		Shown on the asset side as a current asset
Outstanding expense		Shown on the liability side as a current liability
Accrued income		Shown on the asset side as a current asset
Income received in advance		Shown on the liability side as a current liability
Depreciation	Shown on the debit side	
Bad debt	Shown on the debit side	
Provision for discount on debtors	Shown on the debit side	
Provision for discount on creditors	Shown on the credit side	
Manager's commission		Shown in liability side
Abnormal loss	Shown on the debit side	
Drawings		Shown as deduction from capital
Interest on capital	Shown on the debit side	
Interest on drawing	Shown on the credit side	
Interest on loan	Shown on the debit side	

CHECK YOUR PROGRESS B

1. Why is it essential to create a provision for bad debts?
2. How will you find out the cost of goods manufactured?
3. How will you treat the goods distributed as free samples and given in adjustment?

4. Choose the correct answer from the four alternative answers given below the questions.

   i) The excess of net sales over the cost of goods sold is called:
   a) Net Profit　　b) Gross Profit
   c) Gross Loss　　d) Operating Profit

   ii) The profit and loss account takes into account:
   a) Only direct expenses　　b) Only indirect expenses
   c) Both indirect expenses and incomes　　d) Only indirect income

   iii) The balance of profit and loss account is transferred to:
   a) Capital account　　b) Drawings account
   c) Asset account　　d) Net profit account

iv) Which of the following liability is not shown in the balance sheet?

a) Fixed liability b) Contingent liability

c) Current liability d) Long term liability

v) Which of the following is shown on the liability side of the balance sheet?

a) Accrued income b) Prepaid expense

c) Outstanding expense d) Book debts

vi) A permanent decrease in the value of fixed assets is called:

a) Amortisation b) Depletion

c) Depreciation d) Obsolescence

5.11 PREPARATION OF FINAL ACCOUNTS

For preparation of final accounts, the following points should be taken into consideration:

- Read the items of the trial balance carefully and mark the item to be taken to trading account, P&L account and Balance Sheet.
- Read the adjustments carefully and treat them in the final accounts directly.
- The following illustrations will help you in understanding the preparation of final accounts.

ILLUSTRATION 1

From the following trial balance of Mr. Sahu & Sons, prepare Trading and Profit and Loss Account for the year ended December 31, 2020 and a Balance Sheet as on that date.

Trial balance

Name of the accounts	**Debit balances (Rs.)**	**Credit balances (Rs.)**
Capital		2,00,000
Sundry Creditors		67,000
Bank overdraft		80,000
Net sales		4,80,000
Interest received		12,000
Discount on purchase		9,000
Furniture	65,000	
Sundry Debtors	1,08,000	
Stock on 1.1.20	1,22,000	
Cash in hand	86,000	
Net Purchases	2,56,000	
Wages	85,000	
Trade expenses	16,000	
Rent	28,000	
Administrative expenses	42,000	
Discount on sales	18,000	
Commission on purchases	14,000	
Bank charges	8,000	
Total	**8,48,000**	**8,48,000**

Additional information:

- Wages outstanding Rs. 6,500
- Provide for depreciation on Furniture at 5% p.a.
- Rent paid in advance Rs. 3,000
- Provide for interest on capital at 10% p.a.
- Stock on 31.12.2020 amounted to Rs. 1,04,000

SOLUTION:

Trading & Profit and Loss Account
For the year ended December 31, 2020.

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Opening Stock	1,22,000	By Net sales	4,80,000
To Net Purchase	2,56,000	By Closing Stock	1,04,000
To Wages 85,000			
Add: Outstanding 6,500	91,500		
To Commission on Purchase	14,000		
To Gross Profit c/d	1,00,500		
	5,84,000		**5,84,000**
To Rent 28,000		By Gross Profit b/d	1,00,500
Less: Prepaid 3,000	25,000	By Discount on purchase	9,000
To Trading expenses	16,000	By Interest received	12,000
To Administrative expenses	42,000	By Net loss c/d	10,750
To Discount on sales	18,000		
To Bank Charges	8,000		
To Interest on Capital	20,000		
To Depreciation Furniture	3,250		
	1,32,250		**1,32,250**

Balance Sheet of Sahu & Sons
As on 31 December, 2020

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
Capital		**Fixed Assets**	
Balance 2,00,000		Furniture	
Add: Interest 20,000		65,000	61,750
Less: Net Loss 10,750	2,09,250	*Less:* Depreciation	
		3,250	
Current Liabilities			86,000
Sundry Creditors	67,000	**Current Assets**	1,08,000
Bank overdraft	80,000	Cash in hand	1,04,000
Wages outstanding	6,500	Sundry debtors	3,000
		Closing Stock	

		Prepaid Rent	
	3,62,750		**3,62,750**

ILLUSTRATION 2

From the following trial balance of Sharma & Sons, prepare Trading and Profit and Loss Account for the year ended December 31, 2020 and a Balance Sheet as on that date.

Trial balance

Name of the accounts	**Debit balances (Rs.)**	**Credit balances (Rs.)**
Capital		7,00,000
10% Loan from Bank		1,50,000
Sundry Creditors		3,00,000
Provision for bad debt		6,000
Bank overdraft		1,00,000
Net Sales		54,00,000
Discount		14,000
Land	8,00,000	
Plant and Machinery	1,00,000	
Furniture	80,000	
Goodwill	2,00,000	
Sundry Debtors	80,000	
Closing Stock	2,40,000	
Cash in hand	34,000	
Drawings	18,000	
Adjusted Purchases	50,00,000	
Carriage inward	6,000	
Carriage outward	4,500	
Electricity charges	8,500	
Salaries	68,000	
Trade expenses	12,000	
Insurance premium	16,000	
Bad debt	3,000	
Total	**66,70,000**	**66,70,000**

Additional information:

- Salaries outstanding Rs. 6,000
- Loan from bank was taken on 1.10.2020
- Plant and machinery is to be depreciated at 2.5% and Furniture at 5%
- The manager is entitled to a commission of 2% of net profit before charging such commission
- Provision for doubtful debt is necessary at 5% on sundry debtors

SOLUTION:

Trading & Profit and Loss Account
For the year ended December 31, 2020.

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Adjusted Purchase	50,00,000	By Net sales	54,00,000
To Carriage inward	6,000		
To Gross Profit c/d	3,94,000		
	54,00,000		**54,00,000**
To Salaries 68,000		By Gross Profit b/d	3,94,000
Add: Outstanding 6,000	74,000	By Discount	14,000
To Electricity	8,500		
To Trading expenses	12,000		
To Insurance premium	16,000		
To Carriage outward	4,500		
To Bad debt			
3,000			
Add: Provision(5%80,000)	1,000		
4,000			
Less: Old Provision	3,750		
6,000			
To Interest on Loan			
(10% X 1,50,000 for 3 months)	6.500		
To Depreciation	5,635		
Plant and Machinery 2,500	2,76,115		
Furniture			
4,000			
To Manager's Commission			
(note)			
To Net Profit c/d			
	4,08,000		**4,08,000**

Note:

Manager’s Commission = (Total Credit – Total Debit) X rate/100

= (4,08,000 – 1,26,250) X 2/100

= Rs. 5,635

Balance Sheet of Sharma & Sons
As at 31 December, 2020

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
Capital		**Fixed Assets**	
Balance 7,00,000		Land	8,00,000
Less: drawings 18,000		Goodwill	2,00,000
Add: Net profit <u>2,76,115</u>	9,58,115	Plant & Machinery	
		1,00,000	97,500
Long term Liabilities		*Less:* Depreciation	
Loan from Bank 1,50,000		<u>2,500</u>	76,000
Add: Interest <u>3,750</u>	1,53,750	Furniture	
		80,000	
Current Liabilities		*Less:* Depreciation	34,000
Sundry Creditors	3,00,000	<u>4,000</u>	
Bank overdraft	1,00,000		76,000
Salaries outstanding	6,000	**Current Assets**	2,40,000
Manager’s Commission	5,635	Cash in hand	
		Sundry debtors 80,000	
		Less: Provision	
		<u>4,000</u>	
		Closing Stock	
	15,23,500		**15,23,500**

ILLUSTRATION 3

From the following trial balance of Gupta & Sons, prepare trading and Profit and Loss Account for the year ended March 31, 2020 and a Balance Sheet as on that date.

Trial balance

Name of the accounts	**Debit balances (Rs.)**	**Credit balances (Rs.)**
Capital		12,04,000
Sundry Creditors		2,50,000
Bills Payable		1,50,000
Provision for bad debt		20,000
Provision for discount on debtors		6,000
Net sales		34,08,000
Plant and Machinery	8,00,000	
Land and Building	5,00,000	
Closing stock	2,50,000	
Carriage inward	84,000	
Carriage outward	46,000	
Purchases	22,06,000	
Salaries and wages	1,80,000	
Rates and taxes	24,000	
Printing and stationery	12,000	
Office expenses	36,000	
Furniture	80,000	
Sundry debtors	3,00,000	
Bills receivable	1,60,000	
Cash in hand	15,000	
Cash at bank	54,000	
Insurance	12,000	
Drawings	1,80,000	
Income taxpaid	16,000	
Provision for discount on creditors	8,000	
Loose tools	75,000	
Total	**50,38,000**	**50,38,000**

Additional information:

- Salaries and wages payable Rs. 25,000
- Value of loose tools at the end Rs. 45,000
- Provision for bad debt is to be kept at 5% on debtors
- Provision for discount on debtors is to be maintained at 2%
- Provision for discount on creditors to be kept at 2%
- Write off depreciation at 10% on plant and machinery, 5% on land and building, and 15% on furniture
- Machinery worth Rs. 3,00,000 was purchased and installed on 1.10.2019 and wages thereon Rs. 10,000 were included in salaries and wages account
- On 10th March, stock worth Rs. 1,00,000 was destroyed by fire and the insurance company agreed to pay Rs. 80,000 as compensation.

SOLUTION:

Trading & Profit and Loss Account
For the year ended March 31, 2020.

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Purchase	22,06,000	By sales	34,08,000
To Carriage inward	84,000	By stock destroyed by fire	1,00,000
To Gross Profit C/d	12,18,000		
	35,08,000		**35,08,000**

To Carriage outward To Salaries & wages 1,80,000 *Add:* outstanding 25,000 *Less:* Machinery installation Expenses included <u>10,000</u> To Rates and taxes To Printing & stationery To office expenses To Insurance To Loose tools consumed To Depreciation Plant & Machinery 65,500 Land & Building 25,000 Furniture <u>12,000</u> To Provision for discount on creditors (8,000-5,000) To Loss of stock by fire (1,00,000-80,000) To Net Profit	46,000 1,95,000 24,000 12,000 36,000 12,000 30,000 1,02,500 3,000 20,000 7,42,800	By Gross Profit b/d By Provision for bad debt (20,000-15,000) By Provision for discount on debtors (6,000-5,700)	12,18,000 5,000 300
	12,23,300		**12,23,300**

Balance Sheet of Gupta & Sons
as at 31 March, 2020

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
Capital Balance 12,04,000 *Less:* Drawings (1,80,000+16,000) 1,96,000 *Add:* Net profit <u>7,42,800</u> **Current Liabilities** Sundry Creditors	 17,50,800	**Fixed Assets** Plant & Machinery 8,10,000 *Less:* Depreciation <u>65,500</u> Land & building 5,00,000 *Less:* Depreciation	 7,44,500 4,75,000 68,000

2,50,000 *Less:* Provision for discount <u>5,000</u> Bills Payable Outstanding Expenses: Salaries and Wages	2,45,000 1,50,000 25,000	<u>25,000</u> Furniture 80,000 *Less:* Depreciation <u>12,000</u> **Current Assets** Cash in hand Cash at bank Sundry debtors 3,00,000 *Less:* Provision for bad debt 15,000 *Less:* Provision for Discount <u>5,700</u> Bills Receivable Insurance claim receivable Loose tools Closing stock	 15,000 54,000 2,79,300 1,60,000 80,000 45,000 2,50,000
	21,70,800		**21,70,800**

WORKING NOTES:

i) Depreciation on Plant and Machinery:

		Rs.
Plant and Machinery (Given in trial balance)		8,00,000
Less: Purchased on 1.10.2019		<u>3,00,000</u>
Balance of plant and machinery on 1.4.2019		<u>5,00,000</u>
Depreciation on Rs. 5,00,000 @ 10% p.a		50,000
Plant and Machinery purchased on 1.10.2019	3,00,000	
Add: Installation expenses	<u>10,000</u>	
Total	3,10,000	
Depreciation on Rs. 3,10,000 for 6 months @ 10%		<u>15,500</u>
Total Depreciation on Plant and Machinery		65,500

ii) The total cost of Plant and Machinery to be taken to Balance sheet = 8,00,000 + 10,000 (Installation expenses) = Rs. 8,10,000

iii) Loose tools consumed:

Value of loose tools in the trial balance	75,000

Loose tools valued at the end of the period	45,000
Loose tools consumed	30,000

iv) Drawings to be deducted from capital:

Drawings as per trial balance	1,80,000
Income tax paid	16,000
	1,96,000

ILLUSTRATION 4

The following particulars were extracted from the books of accounts of AK and Brothers. You are required to prepare the Manufacturing Account and Trading Account for the year ending on 31st March,2020.

	Rs.
Sales	39,56, 000
Purchases of raw materials	12,45,000
Carriage Inwards	3,900
Carriage Outward	12,000
Stock on 01.04.2019:	
Raw Materials	15,000
Work-in-Progress	6,000
Finished Goods	31,000
Factory Wages	9,87,000
Fuel and Power	3,53,000
Factory Rent	1,85,000
Repair and Maintenance of Plant	52,000
Sale of Scraps	8,100
Stock on 31.03.2020	
Raw Material	14,000
Work-in-Progress	3,500
Finished Goods	33,000
Plant	65,00,000

Depreciation is to be charged on plant @ 10%.

SOLUTION:

Manufacturing Account of AK and Brothers for the year ending March 31,2020

Particulars	Amount(Rs.)		Amount(Rs.)
To Raw Materials Consumed:		By Sale of Scraps	8,100
Opening Stock		By Closing Work-in-Progress	3,500
15,000		By Cost of Goods Produced	34,99,300
Add: Purchased	12,46,000	(Transferred to Trading Account)	
12,45,000	3,900		
Less: Closing Stock	6,000		
<u>14,000</u>	9,87,000		
To Carriage Inward	3,53,000		
To Opening Work-in-Progress	1,85,000		
To Factory Wages	52,000		
To Fuel & Power	6,50,000		
To Factory Rent			
To Repair & Maintenance			
To Depreciation on Plant			
	35,10,900		**35,10,900**

Trading Account of AK and Brothers for the year ending on March 31, 2020

Particulars	Amount (Rs.)		Amount (Rs.)
To Opening Sock of Finished		By Sales	39,56,000
Goods	31,000	By Closing Stock of Finished	
To Cost of Goods Produced	34,99,300	Goods	33,000
To Gross Profit c/d	4,58,700		
	39,89,000		**39,89,000**

Note: Carriage outward is an indirect expense which is to be taken in Profit and Loss Account.

5.12 LET US SUM UP

The accounting year of a business organization usually ends on 31st March or 31st December. At the end of the accounting year, the business organisation prepares final accounts with the help of a trial balance. In order to prepare the final accounts properly, it is essential to make a distinction between capital and revenue items. The incomes earned and the expenditures incurred during an accounting year may be capital or revenue in nature. As per accounting principle, items of revenue nature are shown in profit and loss account and items of capital nature in the balance sheet for finding out true profit and true financial position.

The profit and loss account and balance sheet are the most important components of the final account. The profit and loss account is prepared for determining the net profit or the net loss of the business organization during the accounting year. The balance sheet is prepared for determining the financial position of the business organization at the end of the accounting year. It shows all assets and liabilities of the business.

The trading account can be prepared to ascertain the gross profit or gross loss of the business organization. The gross profit is determined by deducting cost of goods sold from the sales revenue. In trading account, we take the direct expenses whereas in profit and loss account we take all indirect expenses and losses. In practice, the business organization usually prepares a combined trading and profit and loss account.

Some firms are engaged in manufacturing of goods. They prepare a manufacturing account for determining the cost of goods produced which is transferred to the trading account for determining the cost of goods sold and gross profit. A manufacturing organization can also prepare the trading account directly without preparing a manufacturing account showing all expenses incurred in the factory in the trading account.

At the time of preparing the final accounts, we have to make adjustments in a number of items for finding out the total expenses and total incomes of the current year so that the final accounts will show a true and fair view. Such adjustments are usually given below the trial balance and are reflected at two places in the final accounts so as to complete the double entry. Sometimes the adjustments may be undertaken before preparation of the trial balance. Such item of adjustment appearing in the trial balance is shown at one place only in the final accounts.

5.13 KEY WORDS

FIXED ASSETS: Assets that have a long-term use in the business and are not meant for resale can be termed as fixed assets.

TANGIBLE FIXED ASSETS: The fixed assets that have a shape, size and can be seen and touched are called tangible fixed assets.

INTANGIBLE FIXED ASSETS: Those fixed assets that cannot be seen and touched are referred to as intangible fixed assets.

CURRENT ASSETS: Assets that are expected to be sold or used as a result of standard business operations are called current assets.

SCRAP: It is the waste material that arise in the course of manufacture.

DEPRECIATION: Depreciation is a reduction in the value of the fixed assets.

CLOSING STOCK: Goods that remain unsold at the end of the accounting period.

OPENING STOCK: Stock of goods at the beginning of the accounting period.

WORK-IN-PROGRESS (WIP): The goods that are still in the processes of manufacturing.

GROSS PROFIT: Excess of revenue over cost of goods sold.

NET PROFIT: Excess of gross profit and other incomes over the indirect expenses and losses.

CAPITAL EXPENDITURE: Any expenditure which benefits the organisation for more than one accounting period and are incurred to increase the earning capacity or reduce the working expenses of the business can be termed as capital expenditure.

REVENUE EXPENDITURE: Any expenditure incurred in the day-to-day business activities that are meant for the maintenance of earning capacity of the organisation and the benefit is consumed in one accounting period can be termed as revenue expenditure.

5.14 SOME USEFUL BOOKS

1. Maheswari S.N. and S.K. Maheswari, 2020. Introduction to Accounting, Vikas Publishing House: new Delhi.
2. Gupta R.L. and M. Radhaswamy, 2020. Advanced Accountancy, Volume 1, Sultan Chand & Sons: New Delhi.
3. Sukla, M.C. and T.S. Grewal, 2020. Advanced Accounts, S.Chand & Co: New Delhi.
4. Anthony, R.N., D. Hawkins and K.A. Merchant, 2013. Accounting: texts and Cases, 13th Ed., McGraw-Hill Education.
5. Horngren, C.T. and D. Philbrick. Introduction to Financial Accounting, Pearson Education

5.15 ANSWERS TO CHECK YOUR PROGRESS

A: 4. I) Trading account, ii) Profit and loss, iii) Direct, iv) Current, v) Asset

A: 5. I) False, ii) False, iii) True, iv) True, v) False

B: 4. I) – b, ii) – c, iii) – a, iv) – b, v) – c, vi) – c

5.16 TERMINAL QUESTIONS/EXERCISES

QUESTIONS

1. What are the objectives of preparing final accounts?
2. How can you prepare the final accounts of a business?
3. Why balance sheet is called a position statement? What are the important items of the balance sheet?
4. What are adjustment entries? Why is it necessary to pass adjustment entries at the time of preparation of final accounts?
5. What will be the effect on net profit and balance sheet if prepaid expenses are not adjusted in final accounts? Explain with one example.
6. How would you classify the assets and liabilities of a business into different categories?
7. What are the direct and indirect expenses of a business? What are their effects on the final accounts?

EXERCISES

1. From the following trial balance of Bikram & Sons, prepare trading and Profit and Loss Account for the year ended March 31, 2020 and a Balance Sheet as on that date.

Trial balance

Name of the accounts	Debit balances (Rs.)	Credit balances (Rs.)
Capital		8,00,000
Sundry Creditors		2,65,000
Sales		10,00,000
12% Loan		2,00,000
Commission		35,000
Building	2,00,000	
Drawing	85,000	
Furniture	1,00,000	
Motor Van	2,80,000	
Interest on 12% loan	8,000	
Purchases	8,00,000	
Stock on 1.4.19	1,80,000	
Establishment Expenses	1,20,000	
Wages	45,000	
Rent	10,000	

Sundry Debtors	2,42,000	
Bank Balance	1,60,000	
Goodwill	70,000	
Total	**23,00,000**	**23,00,000**

Additional information:

- Closing Stock on 31.03.2020 amounted to Rs. 1,50,000
- Wages in arrears is Rs. 8000
- Unexpired rent is Rs. 4000
- Provide for depreciation on building 2.5%, on Furniture at 5% p.a. and on motor van 7.5%
- Charge interest on drawing Rs. 3000
  (Gross Profit: Rs. 1,17,000; Net Loss: Rs. 26,000; Balance sheet total Rs. 11,75,000)

2. From the following trial balance of Soham Das, prepare trading and Profit and Loss Account for the year ended December 31, 2020 and a Balance Sheet as on that date.

Trial balance

Name of the accounts	**Debit balances (Rs.)**	**Credit balances (Rs.)**
Capital		14,00,000
Building	8,00,000	
Net Sales		12,00,000
Net purchases	8,50,000	
Opening Stock	2,50,000	
Discount	8,500	
Bank charges	4,250	
Salaries	1,25,000	
Sundry debtors	3,80,000	
Sundry creditors		2,50,000
Manufacturing wages	1,48,000	
Carriage inwards	6,250	
Carriage outwards	5,000	
Advertisement	13,000	
Bad debt provision		7,500
Rent		2,500
Cash in hand	90,000	

Cash at bank	1,80,000	
Total	**28,60,000**	**28,60,000**

Additional information:

- Closing stock Rs. 4,20,000
- Depreciation of building at 7%
- Bad debt provision required Rs. 6000
- Interest on capital to be allowed at 5% p.a.
- Wages prepaid Rs 8,000

(Gross Profit: Rs.3,73,750; Net Profit: Rs.96,000; Balance sheet total: Rs.18,16,000)

3. From the following trial balance of Ram Chandra Mishra, prepare trading and Profit and Loss Account for the year ended December 31, 2020 and a Balance Sheet as on that date.

Trial balance

Name of the accounts	**Debit (Rs.)**	**Credit (Rs.)**
Purchases	16,25,050	
Sales		25,24,000
Provision for doubtful debts		52,000
Sundry debtors	5,02,000	
Sundry creditors		3,05,260
Bills payable		39,500
Opening stock	2,67,250	
Wages	2,31,370	
Salaries	55,750	
Furniture	72,500	
Postage	42,260	
Power and Fuel	13,500	
Trade expenses	58,310	
Bad debts	5,250	
Loan to Shyam @ 10% on Sept 1, 2020	30,000	
Cash in hand and bank	1,00,000	
Trade expenses accrued not paid		7,000
Drawing	44,520	
Capital		1,00,000
Outstanding wages		20,000

Total	**30,47,760**	**30,47,760**

Additional information:

- Depreciation on furniture is to be charged @ 10%
- Sundry debtors include an item of Rs. 5000 due from a customer who has become insolvent
- Provision for doubtful debts is to be maintained @ 5% on sundry debtors
- Goods of the value of Rs. 15,000 have been destroyed by fire and insurance company admitted a claim for Rs. 10,000
- Stock on 31.12.2020 was Rs. 1,25,000

(Gross Profit: Rs.5,26,830; Net Profit: Rs.3,76,160; Balance sheet: Rs.8,03,400)

4. From the following trial balance of Harish Mehra, prepare trading and Profit and Loss Account for the year ended December 31, 2020 and a Balance Sheet as on that date.

Trial balance

Name of the accounts	**Debit balances (Rs.)**	**Credit balances (Rs.)**
Capital		8,00,000
Sundry creditors		1,00,000
Bad debt reserve		31,000
Bills payable		1,10,000
Bank Loan		80,000
Sales		17,50,000
Drawings of Harish	60,000	
Sundry debtors	1,90,000	
Bad debts	10,000	
Bills receivable	1,20,000	
Furniture	50,000	
Plant and Machinery	4,60,000	
Land and Building	4,00,000	
Cash in hand	19,600	
Closing stock	1,20,000	
Cost of sales	12,00,000	
Carriage outward	12,000	
Salaries	1,38,000	
Rates and Taxes	13,000	
Printing and Stationery	18,000	
Insurance	16,000	

Bank Interest	2,400	
Travelling expenses	30,000	
Commission	12,000	
Total	**28,71,000**	**28,71,000**

Additional Information:

- Salaries payable Rs. 12,000.
- Bad debts Rs. 10,000 is to be written off.
- Bills receivable dishonoured amounted to Rs. 20,000.
- Provide 2% provision for discounts on debtors and creditors after providing 5% for bad and doubtful debts.
- Remuneration to be given to manager at 2% on gross profit.
- Write off depreciation at 10% on Plant and Machinery and 5% on land and buildings.

(Gross Profit: Rs.5,50,000; Net Profit: Rs.2,16,400; Balance sheet: Rs.12,69,800)

5. From the following trial balance of Satya Narayan, prepare trading and Profit and Loss Account for the year ended December 31, 2020 and a Balance Sheet as on that date.

Trial balance

Name of the accounts	**Debit (Rs.)**	**Credit (Rs.)**
Building	4,00,000	
Drawings	1,00,000	
Furniture	52,000	
Discount	32,000	
Bad debts	16,000	
Carriage on purchase	36,000	
Commission	44,000	
Salaries	1,80,000	
General expenses	80,000	
Return inward	40,000	
Purchases	22,00,000	
Debtors	3,60,000	
Stock on 1.1.2020	4,40,000	
Taxes and insurance	40,000	
Sales		30,00,000
Rents		20,000
Creditors		2,78,000
Bank overdraft		82,000

Capital Discount		6,00,000 40,000
Total	**40,20,000**	**40,20,000**

Adjustments:

- Stock as on 31.12.2020 is Rs. 4,01,200
- There has been a loss of goods by fire on 30th December 2020 to the extent of Rs. 1,00,000 is not covered by insurance
- Provide for depreciation Rs. 20,000 on building and Rs. 5,000 on furniture
- Maintain provision for doubtful debt @ 5% on debtors
- Unexpired insurance amounted to Rs. 4,000
- Provide for interest on capital @ 5% p.a

(Gross Profit: Rs.7,85,200; Net Profit: Rs.2,84,200; Balance sheet: Rs.11,74,200)

6. From the following particulars of Puja and Sons, prepare a Manufacturing Account and Trading Account for the year ending on 31st March,2020.

	Rs.
Sales	14,00,000
Purchases of raw materials	6,80,000
Stock on 01.04.2019:	
Raw Materials	7,000
Work-in-Progress	4,000
Finished Goods	8,000
Factory Wages	3,68,000
Factory Rent	1,20,000
Fuel and Power	12,000
Repair and Maintenance of Plant	25,000
Sale of Scraps	3,000
Stock on 31.03.2020	
Raw Material	8,000
Work-in-Progress	5,000
Finished Goods	9,000
Depreciation on Plant	15,600

(Cost of Goods Produced: Rs. 12,15,600; Gross Profit: Rs. 1,85,400)

NOTE: The questions and exercises will help you to understand the unit better. Try to write answers for the questions given and try to solve the exercises. These are for your own practice only.

B.COM

SEMESTER I

COURSE: FINANCIAL ACCOUNTING

UNIT – VI: DEPRECIATION

STRUCTURE

6.0 OBJECTIVES

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

- Understand the meaning of depreciation;
- Differentiate depreciation from other related concepts
- Explain the causes of depreciation;

- State the objectives of providing depreciation;
- Explain the factors influencing the amount of depreciation;
- Describe the methods of computing depreciation, i.e., straight line method and diminishing balance method; and
- Explain the disposal of depreciation and change of method.

6.1 INTRODUCTION

In this unit, we shall have a detailed discussion on depreciation, study the causes and factors influencing the amount of depreciation, and various methods of computing depreciation. Depreciation is the decrease in the value of a fixed asset. It is an operating expense which must be taken into consideration to determine the true results or the correct amount of profit/loss of a business organisation for the accounting period. We are required to charge depreciation on various fixed assets at some given rate.

6.2 MEANING AND NATURE OF DEPRECIATION

You know that the purchase of fixed assets is a capital expenditure as their benefits are available to a business organisation for more than one accounting year. Therefore, the cost of a fixed asset is allocated over the period of its useful life, which is called depreciation. Depreciation is a permanent and continuous reduction in the value of a fixed asset due to wear and tear, expiry of time or obsolescence. It represents the expired portion of the cost of a long-term asset which has a limited useful life. This allocated cost is an expense which is matched against the revenue earned to find out net profit.

The Institute of Chartered Accountants of India defines depreciation as follows:

"Depreciation is a measure of the wearing out, consumption and other loss of value of depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion if the depreciable amount in each accounting period during the expected useful life of the asset."

The International Accounting Standard Board defines depreciation as, "Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life. Depreciation for the accounting period is charged to income either directly or indirectly."

Depreciation is the allocation of the cost of a tangible fixed asset or long-term asset over its useful life. It is charged as an expense to profit and loss account. It is applicable in case of property, plant, machinery, building, equipment, furniture, fixtures, vehicles, tools, etc. The depreciable amount of these assets shall be allocated on a systematic basis over their useful life. It is not a process of valuation. ***As land has an indefinite or unlimited useful life, no depreciation is charged on land.*** If the land has a limited useful life due to some reason and its value reduces every year, then only depreciation is charged on land.

6.3 OTHER RELATED CONCEPTS OF DEPRECIATION

The allocated costs/expenses or periodic write-offs relating to long-term assets are known by different names for different categories of assets. Depreciation is a wider term and refers to a reduction in the value of all kinds of fixed assets.

DEPLETION: In case of natural resources, i.e., quarries, mines, oil, timber, coal, ore, the term 'Depletion' is used in place of depreciation. Thus, depletion is the name of allocated cost/expense or write-off of natural resources. These are also called wasting assets. This category of assets are exhausted or used up through extraction, which reduces its value and the available quantity of material.

AMORTISATION: The term 'amortisation' refers to allocation of cost or writing off of the proportionate value of the intangible assets, i.e., patents, copyrights, goodwill, trademarks, etc. It is a periodic write-off to expenses of the intangible asset's cost over its useful life.

OBSOLESCENCE: The term 'obsolescence' refers to the decrease in usefulness of fixed assets due to external factors like change in technology, change in style, new inventions, etc.

FLUCTUATION: Fluctuation is a temporary decrease or increase in the value of an asset, usually due to external causes such as rise or fall in market price of an asset.

6.4 CAUSES OF DEPRECIATION

Some of the important causes of depreciation are as follows:

1. **WEAR AND TEAR:** Wear and tear refers to the constant use of a fixed asset leading to physical deterioration during its useful life. It causes decline in the service potential or economic utility of the asset. It reduces the value of the asset.
2. **LAPSE OF TIME:** The lapse of time causes some reduction in the value of an fixed asset as it becomes old. Some assets have a fixed number of years of legal life like lease and patents. Their value decreases due to passage of time.
3. **OBSOLESCENCE:** Obsolescence refers to an asset becoming out-of-date due to fast-changing technology or change of fashion. These assets become obsolete before they wear out. Business organisations replace computers as they become obsolete.
4. **DEPLETION:** Some categories of assets like mines, quarries and oil wells, are of wasting character. Their values decline as these natural resources are exhausted due to extraction. Thus, their value depletes through mining, pumping, cutting, etc.

6.5 OBJECTIVE OF PROVIDING DEPRECIATION

1. **ASCERTAINING THE TRUE COST OF PRODUCTION:** The plants and machineries are required for production of goods. Depreciation of these fixed assets used in the factory is an

important component of the cost of production. Thus, the depreciation of all the fixed assets used in the factory should be taken into consideration for determining the true cost of production.

2. **ASCERTAINING THE TRUE PROFIT:** The actual profit of a business organization can be determined by charging depreciation as it is an operating expense. Various fixed assets are used in a business organization and their depreciation expense should be deducted from revenue to find out true profit.

3. **PRESENTATION OF TRUE FINANCIAL POSITION:** True financial position of a business organization can be known by showing the fixed assets at their real value. Depreciation is deducted from the cost of the fixed assets to find out their real value and to show the asset at its proper value in the balance sheet.

4. **FUNDS FOR REPLACEMENT OF ASSETS:** Charging depreciation reduces the profit and this fund is retained in the firm. This fund, retained over the years is available for the firm to replace its fixed asset when its useful life is over.

CHECK YOUR PROGRESS A

1. What is the nature of depreciation?
2. Why is it essential to charge depreciation? Explain with examples.
3. What is amortization? How is it different from depreciation?
4. State whether the following statements are true or false.
   i) Depreciation is an operating expense.
   ii) Depreciation is charged to find out the market value of the asset.
   iii) Depreciation is also charged also on current assets.
   iv) Profit is not affected if depreciation is not charged.
   v) Expenses will be overstated if depreciation is charged.
   vi) Depreciation need not be charged if proper repair and maintenance expenditure is incurred.

6.6 FACTORS IN THE MEASUREMENT OF DEPRECIATION

The computation of depreciation of a fixed asset for an accounting period depends on the following factors:

1. **DEPRECIABLE ASSET:** A depreciable asset is a fixed asset which:
   i) is expected to be used during more than one accounting period,
   ii) has a limited useful life, and
   iii) is held by an enterprise for use in the production or supply of goods and services
2. **USEFUL LIFE:** The useful or economic life of the fixed asset is the time period over which the depreciable asset is expected to be used by the business organisation. It can

also be in terms of quantity, i.e., number of units of output or any other operating measure such as kilometres in case of vehicles.

3. **DEPRECIABLE AMOUNT:** Depreciable amount of a depreciable asset is the cost of the asset less the estimated residual value. The cost of the asset includes purchase price and all other costs incurred to bring the asset to usable condition such as transportation costs, installation charges, etc. But the financial charges, such as interest on loan taken for the purchase of the fixed asset should not be included in the cost of the asset.
4. **RESIDUAL VALUE:** Residual value is the estimated scrap value, also known as salvage value. It is expected to be realized when the asset will be sold at the end of its useful life. It is often insignificant amount and can be ignored in the calculation of depreciable amount.

6.7 METHODS OF RECORDING DEPRECIATION

There are two methods of recording depreciation in the books of accounts:

1. **PROVISION FOR DEPRECIATION ACCOUNT IS MAINTAINED:** In this method, the amount of depreciation is credited to the 'Provision for Depreciation Account' every year and the concerned fixed asset account continues to appear at its original cost. In the balance Sheet, the accumulated amount of the Provision for Depreciation Account is deducted from cost of the concerned asset and shown.

   i) JOURNAL ENTRY FOR CHARGING DEPRECIATION:

   Depreciation Account Dr.
   To Provision for Depreciation Account
   (Being depreciation provided)

   ii) ENTRY FOR TRANSFERRING DEPRECIATION TO PROFIT AND LOSS ACCOUNT

   Profit and Loss Account Dr.
   To Depreciation Account
   (Being transfer of depreciation)

2. **PROVISION FOR DEPRECIATION ACCOUNT IS NOT MAINTAINED:** In this method, the Provision for Depreciation Account is not opened. Here, the amount of depreciation is directly credited to the concerned asset account every year. Due to this the asset account would appear at the depreciated value or written down value.

   i) Journal entry for charging depreciation

   Depreciation Account Dr.
   To Asset Account
   (Being depreciation provided)

   ii) Entry for transferring depreciation to Profit and Loss Account

   Profit and Loss Account Dr.
   To Depreciation Account
   (Being transfer of depreciation)

A business organization can follow any of the above two methods of recording depreciation.

6.8 METHODS OF COMPUTING DEPRECIATION

Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. There are different methods for calculating the amount of depreciation expense to be charged to profit and loss account. Two basic methods of depreciation, which are commonly used are:

1. **STRAIGHT LINE METHOD:** This method is based on the assumption that each accounting year receives same benefits from using the asset. Therefore, this method allocates an equal amount of depreciation in each accounting year of the useful life of the asset. This method is also called 'Fixed Instalment Method' as a fixed and equal amount is charged as depreciation every year during the life time of an asset. It is called 'Straight Line Method' as the amount of depreciation presented on a graph paper would show a straight line parallel to the X-axis.

   The formulae for calculating the amount of depreciation for each accounting period is:

   Annual Depreciation $= \frac{Acquisition\ Cost - Estimated\ scrap\ value}{Expected\ useful\ life\ in\ years}$

   ADVANTAGES

   i) It is easy and simple to apply.

   ii) There is no change either in the rate or the amount of depreciation during the useful life of the asset.

   iii) It is suitable for those assets which get depreciated due to lapse of time, like patents, lease-holds, etc.

   DISADVANTAGES

   i) When the effective utilization of the asset varies from year to year, this method does not reflect the correct amount of depreciation.

   ii) It does not take into consideration the reality that the maintenance of asset is generally more in the later years. Thus, the combined charge of depreciation and maintenance would be greater in later years which would unjustifiably burden the Profit and Loss Account with more charges.

   iii) It does not take into consideration the loss of interest on the money invested in the asset.

   The following illustration 1 shows an example to explain the above method.

   ILLUSTRATION 1

   A machinery was purchased for Rs. 8,00,000 to produce match sticks. The life period of the machine is estimated as 8 years. The residual value is estimated as Rs. 40,000. Find out the amount of depreciation on the basis of Straight Line Method.

   SOLUTION

Annual Depreciation = $\frac{Cost - estimated\ scrap\ value}{Expected\ useful\ life\ in\ years}$

= Rs. (8,00,000 – 40,000)/8 = Rs. 95,000

2. **DIMINISHING BALANCE METHOD:** Under this method, though the rate of depreciation is fixed, it is calculated on the reducing balance or the written down value (Cost - Depreciation) of the asset. Thus, the amount of depreciation keeps on decreasing from year to year.

The formulae for calculating the rate of depreciation for each accounting period is:

Rate of Depreciation = $[1- \sqrt[n]{\frac{Residual\ value}{Cost\ of\ asset}}] \times 100$

ADVANTAGES

i) It is simple to understand.

ii) The higher depreciation is charged in the earlier years when the asset is more efficient compared to the later years.

iii) Depreciation and maintenance of the asset taken together ensures a fair charge to Profit and Loss Account every year because the amount of depreciation decreases year after year whereas the maintenance expenses increases year after year.

DISADVANTAGES

i) It is slightly difficult to calculate the rate of depreciation.

ii) It does not take into consideration the loss of interest on the money invested in the asset.

iii) Under this method, the value of an asset cannot be brought down to zero. Hence, even after the useful life of the asset is over, it may have certain book value.

The following illustration 2 shows an example to explain the above method.

ILLUSTRATION 2

AB Brothers purchased a costly computer for Rs. 10,00,000. Its residual value is estimated to be Rs. 64,000. Its useful life is only 3 years. Find out the rate of depreciation on the basis of Diminishing Balance method.

SOLUTION

Rate of Depreciation = $[1- \sqrt[n]{\frac{Residual\ value}{Cost\ of\ asset}}] \times 100 = 60\%$

Difference between Straight Line Method and Diminishing Balance Method

The difference between the above two methods are as follows:

Straight Line Method	**Diminishing Balance Method**
Depreciation is calculated on the original cost of the asset.	Depreciation is calculated on the diminishing balance value of the asset.
Depreciation amount is same every year.	Depreciation amount goes on diminishing every year.

The balance in the asset account is reduced to zero at the end of the useful life of an asset.	The balance in the asset account is not reduced to zero at the end of the useful life of an asset.
The combined expense of depreciation and maintenance is low during the initial years and high during later years. Calculation of the rate of depreciation is very easy.	The combined expense of depreciation and maintenance is more or less equal during the useful life of an asset. Calculation of the rate of depreciation is difficult.
This method is suitable for assets which get depreciated more on the basis of passage of time.	This method is suitable for assets which require repair and maintenance more in the later years of their working life.

ILLUSTRATION 3

ABC Firm purchased a machinery for Rs. 4,00,000 on January 1, 2020 and spent Rs. 20,000 on installation. Its useful life was estimated to be 10 years. Its residual value at the end of the life period is Rs. 50,000. The books are closed on 31st December every year and the firm follows Straight Line Method. Make journal entries and prepare Machinery Account for two years. Also show how the balance of Machinery Account would appear in the Balance Sheet as on December 31, 2020.

SOLUTION

Annual Depreciation = (Cost – Estimated Scrap Value)/Expected Useful Life in Years
= Rs. (4,00,000 + 20,000 – 50,000)/10 = Rs. 37,000

Journal Entries

Date	**Particulars**	**L. F.**	**Debit**	**Credit**
1.1.2020	Machinery A/c Dr. To Bank A/c (Being the machinery purchased)		4,00,000	4,00,000
1.1.2020	Machinery A/c Dr. To Bank A/c (Being installation charges paid)		20,000	20,000

31.12.20	Depreciation A/c Dr. To Machinery A/c (Being the depreciation provided)		37,000	37,000
31.12.20	Profit and Loss A/c Dr. To Depreciation A/c (Being the transfer of Depreciation A/c)		37,000	37,000
31.12.2021	Depreciation A/c Dr. To Machinery A/c (Being the depreciation provided)		37,000	37,000
31.12.2021	Profit and Loss A/c Dr. To Depreciation A/c (Being the transfer of Depreciation A/c)		37,000	37,000

Machinery A/c

Dr. **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
2020	To Bank A/c	4,00,000	2020	By Depreciation A/c	37,000
Jan. 1	To Bank A/c (Installation expenses)	20,000	Dec. 31	By Balance c/d	3,83,000
		4,20,000			**4,20,000**
2021	To Balance b/d	3,83,000	2021	By Depreciation A/c	37,000
Jan. 1			Dec. 31	By Balance c/d	3,46,000
		3,83,000			**3,83,000**

Balance Sheet as on December 31, 2020

	Fixed Asset: Machinery 4,00,000 *Add:* Installation charges 20,000 4,20,000	Rs.

	Less: Depreciation 37,000	3,83,000

ILLUSTRATION 4

AB Brothers purchased a machine for Rs. 6,00,000 on April 1, 2018. The depreciation is to be charged at 20% p.a. on Diminishing Balance Method. Prepare the Machinery A/c for first three years.

SOLUTION

Machinery A/c

2018			2019		
Apr. 1	To Bank A/c	6,00,000	Mar. 31	By Depreciation A/c	1,20,000
			Mar. 31	By Balance c/d	4,80,000
		6,00,000			**6,00,000**
2019			2020		
Apr. 1	To Balance b/d	4,80,000	Mar. 31	By Depreciation A/c	96,000
			Mar. 31	By Balance c/d	3,84,000
		4,80,000			**4,80,000**
2020			2021		
Apr. 1	To Balance b/d	3,84,000	Mar. 31	By Depreciation A/c	76,800
			Mar. 31	By Balance c/d	3,07,200
		3,84,000			**3,84,000**

ILLUSTRATION 5

A firm purchased a machinery on April 1, 2017 for Rs. 12,00,000. The installation expenses were Rs. 3,00,000. It was decided to depreciate the machine by Straight Line Method. The useful life was estimated to be 5 years and the scrap value at the end of the life period was estimated to be Rs. 1,00,000. The firm followed financial year for closing its books of accounts. At the end of the third year, the machinery was destroyed due to cyclone and was sold for Rs. 2,00,000. The insurance company agreed to pay Rs. 3,00,000 in full settlement. Prepare Plant Account for three years.

SOLUTION

Machinery A/c

2017			2018		
Apr. 1	To Bank A/c	12,00,000	Mar. 31	By Depreciation A/c	2,80,000
	To Bank A/c	3,00,000	Mar. 31	By Balance c/d	12,20,000
	(Installation charges)				
		15,00,000			**15,00,000**
2018			2019		
Apr. 1	To Balance b/d	12,20,000	Mar. 31	By Depreciation A/c	2,80,000
			Mar. 31	By Balance c/d	9,40,000
		12,20,000			**12,20,000**
2019			2020		
Apr. 1	To Balance b/d	9,40,000	Mar. 31	By Depreciation A/c	2,80,000
			Mar. 31	By Insurance Company	3,00,000
				By Bank A/c (Sale)	2,00,000
				By Profit & Loss A/c (Loss)	1,60,000
		9,40,000			**9,40,000**

CHECK YOUR PROGRESS B

1. Outline the factors taken into consideration for calculating the amount of depreciation.

2. Explain the difference between Straight Line Method and Diminishing Balance Method.

3. How will you record depreciation in the books of accounts when provision for depreciation is not maintained?

4. State whether the following statements are true or false.
   i) Depreciable amount of an asset is the cost of the asset less the estimated residual value.
   ii) Depreciable asset can have unlimited useful life.
   iii) When Provision for Depreciation Account is maintained, the depreciation is directly charged to asset account every year.
   iv) Under Diminishing Balance Method, the combined effect of depreciation and maintenance is uniform over the years.
   v) Under Straight Line Method, the value of an asset cannot be brought down to zero even after the useful life of the asset is over.

6.9 DISPOSAL OF DEPRECIATION

A fixed asset can be disposed or sold either at the end of its useful life or during its useful life. Disposal of depreciable asset may be made during its useful life due to obsolescence or other factors.

When the asset is sold: The sale proceeds should be credited to the asset account.

1. *When Provision for Depreciation Account is maintained:*

i) Bank Account Dr.
   To Asset Account
   (Being sale proceeds)

ii) Provision for Depreciation Account Dr.
   To Asset Account
   (Being transfer of provision on the asset sold)

iii) Asset Account Dr.
   To Profit and Loss Account
   (Being transfer of profit on sale)
   Or

   Profit and Loss Account Dr.
   To Asset Account
   (Being transfer of loss on sale)

2. *When Provision for Depreciation Account is not maintained*

i) Bank Account Dr.
To Asset Account
(Being sale proceeds)

ii) Asset Account Dr.
To Profit and Loss Account
(Being transfer of profit on sale)

Or

Profit and Loss Account Dr.
To Asset Account
(Being transfer of loss on sale)

6.10 CHANGE OF METHOD

The depreciation method selected should be followed consistently from year to year. Sometimes the business organization may decide to change the method of depreciation which it followed. Change of method is undertaken if the change would result in a more appropriate preparation or presentation of the financial statements. The change can also be made for compliance with an accounting standard.

The following procedure to be followed for change in the method of depreciation:

i) Depreciation should be computed applying the new and changed method from the date of the acquisition of the asset till the date of change of method.
ii) The difference between the total depreciation under the new method and the old method till the date of change may be surplus or deficiency.
iii) The surplus is credited to Profit and Loss Account under the head 'Depreciation Written Back'. The deficiency is charged to Profit and Loss Account.
iv) The written down cost of the asset should be written off over the remaining useful life on the basis of the new method commencing with the period in which the change is made.
v) Such change of depreciation method should be treated as change in accounting policy and its effect should be disclosed.

If the firm decides to implement the change of method with prospective effect, no adjustment is necessary in respect of depreciation charged in earlier years. It is only required to charge depreciation from the year of change onwards according to the new method.

When there is a change in estimated useful life of an asset, the outstanding depreciable amount on the date of change should be allocated over the revised remaining useful life of the asset.

6.11 LET US SUM UP

Depreciation is a permanent and gradual decrease in the value of a fixed asset due to wear and tear, passage of time and obsolescence.

Depreciation is an operating expense and charged to the Profit and Loss Account as it represents the expired portion of the cost of a fixed asset. In Balance Sheet, depreciation is deducted from the concerned fixed asset to find its real value. If depreciation is not taken into consideration, the business organization will not be able to find out the true profit and true financial position.

For calculating the amount of depreciation, we need the following information:

(i) The total cost of the asset to be depreciated; (ii) The estimated useful life of the asset; (iii) The estimated scrap/salvage value.

Two methods are usually followed for recording the depreciation in the books of accounts. They are: (i) By maintaining a Provision for Depreciation account in which depreciation is credited from year to year; (ii) Without maintaining a Provision for Depreciation Account, where depreciation is directly credited to the concerned asset account.

Two most common methods of charging depreciation are: (i) Straight Line Method, and (ii) Diminishing Balance Method. Under 'Straight Line Method', an equal amount of depreciation is charged every year during the useful life of an asset. Under 'Diminishing Balance Method', the amount of depreciation goes on diminishing year after year during the life period of an asset. The Diminishing Balance Method is considered better because the combined expense of depreciation and maintenance is uniformly distributed over the useful life of an asset.

A fixed asset can be disposed or sold either at the end of its useful life or during its useful life. Disposal of depreciable asset may be made during its useful life due to obsolescence or other factors.

If a firm decides to change the method of depreciation, it is usually with retrospective effect. Depreciation is calculated in the changed method from the date of acquisition of the asset till the date of change and the difference is adjusted in the Profit and Loss Account. The written down cost of the asset is written off over the remaining useful life on the basis of the new method from the date of change.

6.12 KEY WORDS

AMORTISATION: Writing off the expired portion of the cost of an intangible asset like patent or trademark.

DEPLETION: Decrease in value of a wasting asset or natural resources.

DEPRECIATION: Permanent and gradual decrease in the value of a long-term asset.

FLUCTUATION: Fluctuation is a temporary decrease or increase in the value of an asset.

OBSOLESCENCE: Decrease in value of a fixed asset by becoming out of date due change in technology or fashion.

RESIDUAL VALUE: Expected realizable value from an asset after its useful life.

6.13 SOME USEFUL BOOKS

Maheswari S.N. and S.K. Maheswari, 2020. Introduction to Accounting, Vikas Publishing House: new Delhi.

Gupta R.L. and M. Radhaswamy, 2020. Advanced Accountancy, Volume 1, Sultan Chand & Sons: New Delhi.

Sukla, M.C. and T.S. Grewal, 2020. Advanced Accounts, S.Chand & Co: New Delhi.

Anthony, R.N., D. Hawkins and K.A. Merchant, 2013. Accounting: texts and Cases, 13th Ed., McGraw-Hill Education.

Horngren, C.T. and D. Philbrick. Introduction to Financial Accounting, Pearson Education

6.14 ANSWERS TO CHECK YOUR PROGRESS

A **4.** i) True, ii) False, iii) False, iv) False, v) False, vi) False.

B **4.** i) True, ii) False, iii) False, iv) True, v) False.

6.15 TERMINAL QUESTIONS/EXERCISES

QUESTIONS

1. State the meaning of depreciation. Why is it charged?
2. Explain these terms with example: Depletion, Amortisation and Obsolescence.
3. Outline the need and importance of depreciation. What are the factors influencing the calculation of the amount of depreciation?
4. Discuss the two methods of calculating depreciation with their advantages and disadvantages.
5. Explain the two methods of recording depreciation in the books of accounts with journal entries.
6. Distinguish the Straight Line Method from the Diminishing Balance Method. How can you change a method?

EXERCISES

1. A machinery was purchased on July 1, 2020 for Rs. 12,00,000. Its installation expenses are Rs. 20,000. Its working life is estimated to be 8 years. The realizable value at the end of the life period is estimated to be Rs. 1,00,000. The accounting year ends on December 31. Calculate annual depreciation on Straight Line Method and show its accounting treatment in final accounts with journal entry.
   (Answer: Annual Depreciation Rs. 70,000)
2. A plant is purchased on April 1, 2020 for Rs. 2,50,000. The installation expenses of the plant are Rs. 50,000. Its estimated useful life is three years. The residual value at the end of the life period is estimated to be Rs. 30,000. Calculate depreciation rate on the basis of Diminishing Balance Method. Prepare the Plant Account for two years.
   (Rate of Depreciation: 53.6%)
3. AB and Sons purchased a plant for Rs. 7,70,000. Rs. 30,000 were spent on installation expenses. The depreciation is to be charged at 20% p.a. on Diminishing Balance Method. Prepare Plant Account for first three years.
   (Depreciation for 3 years: Rs. 1,60,000; Rs. 1,56,800; and Rs. 1,25,440)
4. XY and Brothers purchased two trucks at Rs. 10,00,00 each on 1 January, 2018. The firm writes off depreciation @ 20% p.a. on original cost and its accounting year is same as calendar year. On April 1, 2020, one of the trucks met with an accident and is completely destroyed. Insurance company paid Rs. 4,00,000 in full settlement of the claim. Prepare Truck Account for three years ending on December 31,2020.
   (Depreciation for 3 years: Rs. 4,00,000, Rs. 4,00,000, Rs. 2,50,000; Loss to be transferred to P&L Account: Rs. 1,50,000)
5. AK Sahu formed a sole proprietorship firm on April 1, 2017 and purchased a machinery for Rs. 4,00,000 including a boiler worth Rs. 40,000. The depreciation is charged on the basis of Diminishing Balance Method at the rate of 20%. The firm follows financial year. At the end of the third year, the boiler became useless due to some damage and it was sold for Rs. 4,000. Prepare the Machinery Account for the first three years.
   (Depreciation for 3 years: Rs. 80,000, Rs. 64,000, Rs. 51,200; Loss on sale of boiler: Rs. 16,480)

NOTE: The questions and exercises will help you to understand the unit better. Try to write answers for the questions given and try to solve the exercises. These are for your own practice only.

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B. COM

SEMESTER I

COURSE: FINANCIAL ACCOUNTING

UNIT 7 ACCOUNTING FOR HIRE PURCHASE AND INSTALLMENT SYSTEMS

STRUCTURE

7.10 **Suggested Readings**

7.0 OBJECTIVES

After studying this chapter the learner should be able:

1. To define the hire purchase and installment system and also differentiate between other systems of acquiring or purchasing an asset.
2. To demonstrate use of hire purchase accounting.
3. To illustrate the steps involved in hire purchase accounting.

7.1 INTRODUCTION

When a person wants to buy or purchase goods, there are many ways by which he can do so:

1. Cash purchases: Ownership of goods is transferred immediately upon payment of the price of the Asset.
2. Credit purchases: It involves deferring the payment, but as far as ownership is concerned, it is transferred immediately.
3. Using borrowing: Buyer, in order to purchase goods can borrow money from either the bank or the private money lender or he can opt for hire purchase for installment system.

In this chapter we will be learning about the hire purchase and installment system.

7.2 MEANING AND DEFINITION OF HIRE PURCHASE

Hire Purchase is a system under which a buyer buys goods on installment which include principal and interest and he gets the ownership when the last installment is paid.

ACCORDING TO HIRE PURCHASE ACT 1972:

"Hire purchase agreement means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of agreement and includes an agreement under which:

1. Possession of goods is delivered by the owner thereof to a person on condition that such person face the agreed amount in periodical installment, and
2. the property in goods is to pass to such person on the payment of the last installment, and
3. such a person has a right to terminate the agreement at any time before the property so passes."

So in the hire purchase system a person only gets the possession of the goods, ownership is retained by the owner till the last installment is paid.

7.2.1 FEATURES OF HIRE PURCHASE AGREEMENT

Based on the above discussion and definition of hire purchase agreement, following are the key features of hire purchase agreement:

1. The seller **(known as vendor)** immediately transfers only the possession of goods to the hirer **(known as hire purchaser)**.
2. Goods are to be delivered by the vendor to the Hirer on the condition that the hire purchaser should pay the agreed amount in regular installments over a specified period of time.
3. Ownership of the goods remains with the hire vendor till the last installment is paid.
4. Installment includes both principal and interest.
5. The vendor charges interest usually at flat rate.
6. The vendor gets back the position of goods in the event of default of payment made by the hirer.
7. Amount received by the vendor by way of installment is treated as hire charge for that period.
8. The hirer has the right to terminate the agreement anytime before the property passes. Amount already paid as a higher charge cannot be recovered from the hire vendor.

7.2.2 TERMS USED IN THE HIRE PURCHASE AGREEMENT

1. **Hire Purchaser or Hirer:** The buyer in a hire purchase agreement.
2. **Hire Vendor:** The seller in a hire purchase agreement.
3. **Down payment/Initial Payment:** Payment made at the time the hire purchase agreement is entered into.
4. **Cash Price:** The amount to be paid on an outright purchase made in cash.
5. **Hire Charges:** Interest charged on installments.
6. **Hire Purchase Price:** The total price to be to be paid when goods are purchased under the hire purchase system. it includes cash price plus interest on future installments.

Hire Purchase Price (HPP)=Down Payment+Future Installments (including interest)

SAQ Self Assessment Questions

State True or False:

1. Under the hire purchase system the buyer takes possession of goods immediately and agrees to pay the total hire purchase price in installments.
2. Interest is calculated on purchase price.
3. In case of default the hire vendor is allowed to repossess the goods immediately.

Fill in the blanks:

1. Instalments are treated as___________________________________.
2. A hire purchase agreement is defined in the______________________________________.
3. Hirer has the right to____________________the agreement before the property passes.
4. Ownership of goods is transferred____.

7.3 DIFFERENCE BETWEEN HIRE PURCHASE AND INSTALLMENT SYSTEM

S. No.	Basis	Hire Purchase	Installment System
1	Nature of Contract	It is an agreement of Hiring	It is an agreement of Sale
2	Act	It is governed by Hire Purchase Act, 1972	It is governed by Sale of Goods Act, 1930
3	Ownership	Ownership remains with the vendor till the last installment is paid.	Ownership is transferred to the buyer immediately as in case of usual sale
4	Charges	Monthly payment is called Hire Charges	Monthly Payment is called Installments
5	Risk	Risk is to be borne by the Vendor	Risk is to be borne by the buyer
6	Repossession	Vendor can repossess the goods when default of payment is made by the Hire Purchaser	Seller cannot repossess the goods but can file a suit for recovery of price
7	Return of goods	The buyer can exercise the option to return the goods	The buyer cannot excerise the option to return the goods

8	Right of Disposal of goods	The buyer cannot dispose the goods until the last installment is paid	The buyer has the right to dispose the goods even if the installments are pending

7.4 ACCOUNTING TREATMENT OF LARGE HIRE PURCHASE TRANSACTIONS

In case of hire purchase agreements accounts are prepared both by the higher purchaser at the vendor. Accounting treatment of hire purchase transactions in the books of hire purchase and vendor are discussed as follows:

7.4.1 IN THE BOOKS OF HIRE PURCHASER

Case I: When assets are recorded at full cash price:

The following journal entries are passed in the books of hire purchaser:

1. When asset is purchased on hire purchase

Asset A/C................................Dr

To Hire Vendor A/C

(Being Asset purchased under hire purchase system)

2. For Down Payment

Hire Vendor A/C......................... Dr

To Cash A/C

(Being down payment made)

3. For Interest Accrued

Interest A/C.......................... Dr

To Hire Vendor A/C

4. When Ist Installment is paid

Hire Vendor A/C...................... Dr

To Bank A/c

5. For Depreciation Charges

Depreciation A/C .... Dr

To Asset A/C

6. **For Transfer of interest and depreciation to profit and loss account**

Profit and loss A/C........................ Dr

To Interest A/c

To Depreciation A/C

Note: Entries 3 and 4 will be repeated for all subsequent installment till last installment is paid.

CASE II: WHEN ASSETS ARE RECORDED AT CASH PRICE ACTUALLY PAID:

In this method entries are passed when the installment becomes due and the amount is paid towards the price of the goods.

JOURNAL ENTRIES

1. **No Entry will be passed at the time asset is purchased.**
2. **When down payment is made:**

Asset A/C .... Dr

To Cash A/C

3. **When installment becomes due**

Asset A/C (Cash Price) ....Dr

Interest A/C (on Installment). ....Dr

To Hire Vendor A/C

4. **When the first installment is paid**

Hire vendor A/C................ Dr

To Bank A/C

5. **For depreciation charges**

Depreciation A/C ....Dr

To Asset A/C

(Note: Depreciation is charged on full cash price)

7.4.2 IN THE BOOKS OF HIRE VENDOR

1. **When goods are sold on hire purchase**

Hire Purchaser's A/C .... Dr

To Sales A/C

(with total cash price)

2. **When down payment is received**

Bank A/C ....Dr

To Hire Purchaser's A/C

(amount of down payment)

3. **When interest becomes due**

Hire Purchaser's A/C .... Dr

To Interest A/C

(amount of interest on outstanding cash price)

4. When installment is received

Bank A/C ....Dr

To Hire Purchase's A/C

(With the amount of installment)

5. For transfer of interest to profit and loss account

Interest A/C .... Dr

To Profit and Loss A/C

6. For transfer of sales to trading account

Sales A/C ....Dr

To Trading A/C

7.5 CALCULATION OF INTEREST

- Whenever goods are sold on an installment basis or hire purchase basis the price quoted by the vendor is always higher than the price quoted for sale on a cash basis.
- the excess of hire purchase price over the cash price is:
    - partly for the interest on the credit granted by the seller.
    - partly for covering the inherent risks attached to the business
- In the accounting system the excess of hire purchase over the total cash price is taken as payment towards interest.

i.e.

Hire purchase price (HPP) - Cash Price (CP) = Interest

Since interest is a financial gain, it is treated separately.

7.5.1 METHODS OF SEPARATING INTEREST FROM INSTALLMENTS

- Cash price, Installment and Rate of Interest
- Cash Price and Installment
- Installment and Rate of Interest
- Installment, Rate of Interest and Present Value of Annuity
- Cash price, Amount pf Cash price inInstallmen and Rate of Interest

THESE METHODS ARE DISCUSSED AS FOLLOWS:

METHOD 1: WHEN CASH PRICE, INSTALLMENT AMOUNT AND RATE OF INTEREST ARE GIVEN

Steps to be followed:

Step 1: Determine the unpaid amount that is outstanding balance of cash price of the Asset acquired at the beginning of each installment as follows:

(i) Unpaid balance of cash price at the beginning of first installment *= Cash price - down payment*

(ii) Unpaid balance of cash price at the beginning of second installment *=*
unpaid balance of cash price at the beginning of first installment - first installment cash price

(iii) Unpaid balance of cash price at the beginning of the third installment *=*
unpaid balance of cash price at the beginning of second installment - Second installment cash price

Note: These calculations will be followed till the last installment

Step 2: Calculate the amount of installment interest using rate of interest given and unpaid balance cash price at the beginning of each installment computed above.

Installment interest =
Unpaid balance of cash price at the beginning of each installment X Rate of interest

Step 3: last installment interest will be calculated as

Last Installment interest =
Last installment amount - unpaid balance of cash prize at the beginning of last installment

ILLUSTRATION 1: ABC Transport Company purchased a Tempo Traveller from Delhi motor company on hire purchase agreement on 1st January 2019, paying cash ₹10000 And agreed to pay for the three installments of ₹10000 each on 31st December of each year. The cash price of the car is ₹37250 Delhi motor company charges interest at the rate of 5% per annum. you are required to calculate interest paid by the buyer to the seller each year.

SOLUTION:

Down Payment: ₹10000
Amount of Installment ₹10000
No. of Installments 3

Hire Purchase Price (HPP) = Down Payment + Total Installment Price
= 10000 + (10000 X 3)
= 40000

Cash Price = ₹37250

So,

Total Interest = HPP - Cash Price
= 40000 - 37250 = ₹2750

Calculation of interest amount and cash price in each installment

No.of Installments	Cash price outstanding before installment	Amount of Installment	Interest@ 5%	Cash Price in Installments
1st (31-12-19)	37250-10000= 27250	10000	27250*5%=1363	10000-1363= 8637
2nd (31-12-20)	27250-8637= 18613	10000	18613*5%=931	10000-931 = 9069
3rd (31-12-21)	18613-9069 = 9544	10000	10000-9544=456	10000-456 = 9544

Method 2: WHEN CASH PRICE, INSTALLMENT CASH PRICE AND RATE OF INTEREST ARE GIVEN

- In this case determine the installment interest for each of the installments
- It is calculated using: (i) unpaid cash price at the beginning of each installment, (ii) rate of interest, (iii) duration of each installment.
- Out of these 3, rate of interest and installment duration are given in the question.
- Unpaid cash price balance at the beginning of each installment (including last installment) needs to be calculated using the following formula:

(a) Unpaid cash price balance at the beginning of first installment =

Cash Price - Down Payment

(b) Unpaid cash price balance at the beginning of second installment =

Unpaid cash price balance at the beginning of first installment - first installment cash price

(c) Unpaid cash price balance at the beginning of third installment =

Unpaid cash price balance at the beginning of second installment - second installment cash price

Alternatively this can be calculated by preparing a statement as under:

Unpaid Cash Price Balance and Installment Interest

Particulars	Unpaid Cash Price Balance (a)	Rate of Interest (%) (b)	Installment Interest
Cash price of the asset acquired on Hire Purchase Less: Down Payment	------ -----		

Unpaid Cash Price Balance at the Beginning of Ist Installment	-----…(a*)	--….(b*)	a*x b*= ------
Less: First Installment Cash price	-----		
Unpaid Cash price Balance at the beginning of 2nd Installment	----- ..(a**)	-- ...(b**)	a** x b** = ---

This process is followed till the last installment

METHOD 3: WHEN CASH PRICE AND INSTALLMENT AMOUNT ARE GIVEN : Following steps are followed:

STEP 1 Ascertain the total hire purchase price by computing the sum of down payments and installment amounts

STEP 2 Total Interest = Hire Purchase Price - Cash Price

STEP 3 Divide total interest amount among different installment in the ratio of unpaid hire purchase price at the beginning of each installment

ILLUSTRATION 2

Cash Price of an asset = ₹ 56000
hire purchase price of asset = ₹ 60000
Down payment = ₹ 15000
Number of installments = 3
Installment amount = ₹ 15000

Calculate installment interest and split the installment amount into installment cash price and installment interest

SOLUTION:

Calculation of total interest = HPP - CP
= 60000-56000
= ₹4000

Calculation of unpaid hire purchase price balance at the beginning of:

Ist installment = HPP - Down Payment
= 60000-15000
= ₹ 45000

2nd installment =
Unpaid hire purchase price balance at the beginning of Ist Installment - Ist Installment
= 45000 - 15000
= ₹ 30000

3rd installment =

hire purchase price balance at the beginning of 2nd installment - 2nd installment

= 30000 - 15000

= ₹15000

Since and hire purchase price balance at the beginning of Ist, 2nd and 3rd installment is ₹45000, ₹30,000 and ₹15000 respectively.

Hence,

Total interest of ₹ 4000 will be apportioned in the ratio of:

45000:30000:15000

i.e. 3:2:1

Statement Showing Installment Amount and Installment Cash price

Installment No.	**Installment Amount (₹)**	**Interest (₹4000)**	**Installment Cash Price(₹)**
Down Payment	15000	0	15000-0=15000
Ist Installment	15000	4000x3/6=2000	15000-2000=13000
2nd Installment	15000	4000x2/6=1333	15000-1333=13667
3rd Installment	15000	4000x1/6=667	15000-667=14333
Total	60000	4000	56000
	(Hire Purchase Price)	(Total Interest)	(Cash Price)

METHOD IV: WHEN RATE OF INTEREST AND INSTALLMENTS ARE GIVEN BUT TOTAL CASH PRICE IS NOT GIVEN

This can be explained with the help of following illustration:

ILLUSTRATION 3:

- Machinery is purchased on hire purchase
- ₹ 6000 was payable on delivery
- Three annual installments of ₹6000, ₹ 9100 and ₹ 9000 were payable later
- Rate of interest is 10%

Calculate total cash price

SOLUTION:

Installment	Amount due at the end	Installment	Interest in Installment	Cash Price	Amount Due in the

					Beginning
III	9000	9000	9000*10/110 =818	9000-818= 8182	8182
II	9100+8182= 17282	9100	17282*10/110 =1571	9100-1571=7529	8182+7529 =15711
I	6000+15711 =21711	6000	21711*10/110 =1973	6000-1973=4027	15711+4027 =19738

Total Cash Price =
Amount due at the beginning of Ist Installment + Down Payment
= 19738 + 6000
= ₹ 25738

METHOD V: WHEN AMOUNT OF EACH INSTALLMENT, RATE OF INTEREST AND PRESENT VALUE OF ANNUITY ARE GIVEN BUT THE CASH PRICE IS NOT GIVEN

ILLUSTRATION 4:

- Hire purchase price: ₹ 48000
- Down payment: ₹ 12000
- Number of installments: 3
- Annual installments: ₹ 12000
- tabPresent value of annuity of 1 rupees for 3 years @ 5% is 2.7325

Calculate the cash price

SOLUTION:

Cash Price for ₹36000 (12000 x 3) = 36000 x 2.7325/3 =	₹32679
Add: Down Payment	₹12000
Total Cash Price	₹44679

Calculation of Cash Price in Each Installment

Installments	Total Cash Price	Installment Paid	Interest Paid	Cash Price Paid
Down Payment	44679 -12000	-	-	12000
	32679		12000+10844+11429= 34313*5/105	12000 -

Ist Installment	-10366	12000	= 1634	1634 =10366
2nd Installment	22313 -10844	12000	12000+11429=23429*5/105=1116	12000-1116 =10884
3rd Installment	11429 -11429	12000	12000*5/105 =571	12000-571 =11429
Total	0	36000	3321	44679
Add: Down Payment	12000			
Hire Purchase price	48000			

Note: Start Calculations from 3rd Installment and proceed backward till Ist installment.

7.6 DEFAULT AND REPOSSESSION OF GOODS OR FORFEITURE OF GOODS BY THE VENDOR

- In a hire purchase agreement (as discussed in the earlier section of this chapter) the ownership of goods is passed to the hire purchaser after the payment of the last installment.
- If the hire purchaser fails to pay any of the installment, the hire vendor has the right to terminate the hire purchase agreement.

7.6.1 RIGHTS OF THE HIRE VENDOR

On the termination of the Hire Purchase agreement, the hire vendor has the following rights:-

1. Seize the goods in the possession of the hire purchaser.
2. Retain the hire charges already paid and to recover the arrears of hire charges due.
3. Claim damages for non-delivery of the goods.

The above rights are subject to the following restrictions:

1. When the hire vendor seizes the goods under the hire purchase agreement, the hirer may recover from the vendor the amount, if any, by which the hire purchase price falls short of the sum of two amounts:
   a. Amount paid as hire purchase price upto the date if seizure and
   b. Value of the goods on the date of seizure

7.7 FORMS OF REPOSSESSION

As far as the repossession of goods are concerned the hire vendor can take back the whole of the goods or part thereof. on this basis repossession can be:

7.7.1 Complete repossession

7.7.2 Partial Repossession

7.7.1 COMPLETE REPOSSESSION: When the hire vendor takes back the whole of the goods it is called complete repossession.

On complete repossession of the goods:

- Hire purchaser's account is closed in the books of hire vendor by transferring the balance of Hire Purchaser account to Goods Repossessed account.
- Hire purchaser closes the hire vendors account in his books by transferring the balance of hire purchase asset account to the Hire Vendors account.

7.7.1.a BOOKS OF HIRE PURCHASER

- Main accounts are maintained:
  - Asset Account
  - Hire Vendor's Account

At the time of repossession both the accounts are closed.

- Normally, an asset is repossessed at a price less than the book value. Therefore it is a loss to the hire purchaser.

JOURNAL ENTRIES

1. All entries up to the date of default in payment of installment are passed, except entry for payment of installment for which default is made by the hire purchaser.
2. Entries for depreciation are also passed as usual.
3. When asset is taken back and the account of hire vendor is closed

   Hire Vendor's A/C .... Dr

   To Asset A/c
4. When asset account is closed

   In case of Profit

   Profit and Loss A/C ....Dr

   To Asset A/C

   (with excess of value of asset over amount due to hire vendor)

   In case of loss

   Asset A/ C .... Dr

   To Profit and Loss A/C

7.7.1.b BOOKS OF HIRE VENDOR

1. All entries except the entry of receipt are passed in the usual manner up to the date of default.
2. When goods are repossessed and Hire Purchaser account is closed

   Goods Repossessed A/C ....Dr

   To Hire Purchaser A/c

(with the market value of asset on date of repossession)

3. When repossessed goods are reconditioned

   Goods Repossessed A/C ....Dr

   To Cash A/C

4. When Repossessed goods are sold

   Cash or Bank A/c ....Dr

   To Goods Repossessed A/C

   (With actual amount realised)

After passing the above journal entries in the goods repossessed account, it may show a Debit balance, which means loss for credit balance which means profit. Such balance is transferred to profit and loss account and following journal entry is passed:-

(a) If Profit

   Goods Repossessed A/C ....Dr

   To Profit and Loss A/C

(b) If Loss

   Profit and Loss A/C ....Dr

   To Goods Repossessed A/C

7.7.2 PARTIAL REPOSSESSION

1. Only a part of the Asset taken back by the hire vendor.
2. Other part is left with the hire purchaser.
3. All journal entries are passed in the date of default in the books of both the parties.
4. Portion of acid still remains with the hire purchaser, therefore none of the parties closes the accounts of each other in their books.
5. Asset is repossessed at a mutually agreed value
6. In the books of hire vendor following journal entry is passed.

   Goods Repossessed A/C ....Dr

   To Hire Purchaser A/C

   (with the agreed value)

   In the books of hire purchaser, following entry is passed

   Hire Vendor's A/C ....Dr

   To Asset A/C

   (with the agreed value)

7. If,

   Repossessed Value < Book Value of Asset

   Difference is loss on repossession and charged to profit and loss account

8. Normal rate of depreciation is applied on the remaining asset and hire purchaser shows the Asset at its written down value.

SOLVED ILLUSTRATIONS

On 1st January, 2017, five Lorries were purchased from Delhi Transport Company on hire purchase system. The price of each lorry is ₹55000. The payment was to be made as follows:

10% of the cash price as down payment. 25% of the cash price at the end of each of the subsequent half year. The payment due on 31st December 2017 could not be made. You are required to prepare the necessary ledger accounts in the books of both parties under each of the following situations:-

1. The Vendor Repossesses all the lorries, spends ₹ 15000 on the repairs and sell two of them for ₹95000.
2. The vendor allows Delhi Transport Company to keep 3 Lorries on the condition that the value of other two Lorries would be adjusted against the amount due. The lorry is being valued at cost less 25% depreciation. the vendor spends ₹ 6000 thoroughly overhauling the lorries and sell them for ₹ 95000.
3. Delhi transport company charges depreciation @ 15% per annum on original cost and closes his books on 30th June each year

SOLUTION

Cash Price of lorries ₹55000 x 6 =	₹275000
Down Payment (10% of 275000)	₹27500
Installments (25% of 275000)	₹68750
Hire Purchase Price = 68750 x 4 + 27500 =	₹302500

(no. of Installments = 4)

Interest = HPP - Cash Price

= 302500 - 275000

= 27500

This comes to 10% of Cash price.

Since the rate of interest has not been given, the amount of interest included in each installment will be ascertained by dividing the total interest in the ratio of higher purchase price outstanding in the beginning of each period.

Calculation of hire purchase price outstanding in the beginning of:

Ist Installment = HPP - DP

= 302500 - 27500

= 275000

2nd Installment =

Unpaid Hire Purchase price balance at the beginning of Ist Installment - First Installment

= 275000 - 68750

= 206250

3rd Installment =

Unpaid Hire Purchase price balance at the beginning of 2nd Installment - 2nd Installment

= 206250 - 68750

= 137500

4th Installment =

Unpaid Hire Purchase price balance at the beginning of 3rd Installment - 3rd Installment

= 137500 – 68750 = 68750

Since unpaid hire purchase price balance at the beginning of first, second, third and fourth installment is 275000, 206250,137500 and 68750,

Hence,

Total Interest of 27500 will be apportioned in the ratio of:

275000: 206250: 137500: 68750

4: 3: 2: 1

Statement Showing Installment Amount, Interest amount and Installment Cash Price

Installment No.	**Installment**	**Interest (27500)**	**Installment Cash Price**
Down Payment	27500		27500
Ist Installment	68750	27500 x 4/10 = 11000	68750-11000=57750
2nd Installment	68750	27500 x 3/10 = 8250	68750-8250=60500
3rd Installment	68750	27500 x 2/10 = 5500	68750-5500=63250
4th Installment	68750	27500 x 1/10 = 2750	68750-2750=66000
Total	302500	27500	275000
	(Hire Purchase Price)	(Total Interest)	(Cash Price)

(i) WHEN ALL LORRIES ARE SEIZED

Books of a Hire Purchaser

Lorries A/c

Dr. **Cr.**

Date	**Particulars**	**Amount (₹)**	**Date**	**Particulars**	**Amount (₹)**
2017 Jan 1	To Vendor	275000	2017 June 30	By Depreciation (275000 x 15% x ½) By Balance c/d	20625 254375
		275000			275000

2017 July 1	To Balance b/d	254375 254375	2017 Dec 31	By Depreciation A/c By Hire Vendor	20625 233750 254375

Hire Vendor A/C

Dr **Cr**

Date	**Particulars**	**Amount (₹)**	**Date**	**Particulars**	**Amount (₹)**
2017, Jan 1	To Cash A/c	27500	2017,Jan 1	By Lorries A/C	275000
Jun-30	To Cash A/c	68750	Jun-30	By Interest	11000
Jun-30	To Balance b/d	189750			
		286000			286000
Dec-31	To Lorries	233750	Jul-01	by Balance b/d	189750
			Dec-31	By Interest	8250
				By P and L A/C(Bal. Fig)	35750
		233750			233750

Books of Hire Vendor
Delhi Transport Company's Account

Dr					Cr
Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2017	To Sales A/C	275000	Jan-01	By Cash	27500

Jan 1					
Jun-30	To Interest A/C	11000	Jun-30	By Cash	68750
			Jun-30	By Balance c/d	189750
		286000			286000

2017 july 1	To Bal b/d	189750	Dec-31	By Goods Repossessed A/C	198000
	To Interest A/C	8250			
		198000			198000

Goods Repossessed A/c

Dr **Cr**

Date	Particulars	Amount	Date	Particulars	Amount
2017			2017		
Dec 31	To Delhi Transport Company's A/C	198000	Dec 31	By Cash (Sale of 2 Lorries)	95000
Dec 31	To Cash (Expenses on Repair)	15000	Dec 31	By Balance c/d	127800
Dec 31	To Profit and Loss A/C	9800			
		222800			222800

BOOKS OF A HIRE PURCHASER

(ii) WHEN ONLY TWO LORRIES ARE SEIZED

Dr. **Lorries A/C** **Cr**

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
2017			2017		
Jan 1	To Hire Vendor	275000	June 30	By Depreciation A/C	20625
				By Balance c/d	254375
		275000			275000
2017			2017		
Jul 1	To Balance b/d	254375	Dec 31	By Depreciation A/C	20625
				By Hire Vendor	82500
				By Profit & Loss A/c (loss on Seizure of lorries)	11000
				By Balance c/d	140250
		254375			254375

Hire Vendor's A/C

Dr **Cr**

Date	Particulars	Amount	Date	Particulars	Amount
2017 Jan 1 Jun 30 Jun 30	To Bank (Down Payment) To Bank To Balance c/d	27500 68750 189750 286000	2017 Jan 1 Jun 30	By Lorries A/c By Interest	275000 11000 286000
2017 Dec 31 Dec 31	To Lorries A/C To Balance c/d	82500 115500 198000	2017 Jul 1 Dec 1	By Bal b/d By Interest a/c	189750 8250 198000

Loss on Lorries Seized	₹
Book Value of the trucks as per Delhi Transport Company's books (₹110000 less Depreciation@15%on original cost = ₹16500)	93500
Value at which Lorries have been taken by the Vendor (₹110000 less Depreciation@25%on original cost = ₹27500)	82500
Loss	11000
Alternatively Book Value of 5 Lorries on Dec 31, 2017 after depreciation	233750
Less: Book Value of 3 Lorries on Dec 31, 2017 (3/5th with the purchaser)	140250
Book Value of 2 Lorries Seized	93500
Less: Value at which seized	82500
Loss	11000

Books of Hire Vendor

Dr **Hire Purchases A/c** **Cr**

Date	Particulars	Amount	Date	Particulars	Amount
2017 Jan 1 Jun 30	To Sales A/C To Interest	275000 11000	2017 Jan 1 Jun 30	By Cash By Cash By Balance c/d	27500 68750 189750

		189750			
		286000			286000
2017 Jul 1 Dec 31	 To Bal b/d To Interest A/c	 189750 8250	2017 Dec 31 Dec 31	 By Goods repossessed A/c By Bal c/d	 82500 115500
		198000			198000

Dr **Goods Repossessed A/C** **Cr**

Date	Particulars	Amount	Date	Particulars	Amount
2017			2017		
Dec 31	To Delhi Transport Company's A/C	82500	Dec 31	By Sales A/c	95000
Dec 31	To Cash (Expenses on Repair)	6000			
Dec 31	To Profit and Loss A/C	6500			
		95000			95000

7.8 TEST YOUR KNOWLEDGE

7.8.1 SHORT ANSWER QUESTIONS

1. What is meant by the hire purchase system?
2. What is meant by installment purchase system?
3. What is the difference between hire purchase and installment purchase?
4. What is complete repossession and partial repossession?

7.8.2 LONG ANSWER QUESTIONS

1. Discuss the accounting treatment of the repossessed goods on default made by the purchaser.
2. What are the journal entries which are passed in the books of hire purchase and vendor in case goods are sold on hire purchase system
3. What is the hire purchase system? What are the main features of hire purchase system?

7.8.3 TEST YOUR UNDERSTANDING

1. A machinery is taken under the Hire-Purchase System for ₹ 2,500 to be paid as follows: On delivery ₹ 400; at the end of first year ₹ 600; at the end of second year ₹400; at the end of third year ₹ 1,100. Interest included in ₹ 2,500 being charged on the cash value at 10% per annum. Pass Journal entries in the books of hire-purchaser writing off depreciation @ 5% per annum on Diminishing Balance Method. Also give necessary accounts in the ledger of hire-purchaser.

2. Dinesh Limited on April 1 2013 purchased a machine from Rajesh Limited on hire purchase basis. The cash price of the machine was ₹ 25000.The payment was to be made ₹5000 on the date of the contract and the balance in four equal installments of ₹5000 each plus interest at the rate of 5% per annum payable on 31st December each year and the first such installment week paint table on 31. 12.2013. Depreciation is to be charged at the rate of 10% on original cost, show the necessary journal entries and ledger accounts in the books of both the parties.
3. X purchase from Y three cars costing ₹ 100000 each on hire purchase system. Payment was to be made ₹ 60000 down and balance in three equal installments together with interest at the rate of 15% per annum. X provides depreciation at 20% per annum on a diminishing balance method. X paid the first installment at the end of first year but it could not pay the second installment. why Dukh projection of all the three ca₹ He spent ₹18000 on repairs and sold them for ₹ 150000. Show the necessary ledger accounts in the books of both the parties.
4. ABC Limited purchased two machines of ₹10500 each on hire purchase system paying ₹6000 as down payment and remainder in three equal installments of ₹ 5000 each together with interest at 5% per annum. The company writes off depreciation at 10% per annum according to the diminishing balance method. The company could not pay the second installment. The vendor left one machine with the company adjusting the value of the other against the amount due taking the machine at 20% depreciation at diminishing balance method. Prepare ledger accounts in the books of ABC Limited and vendor.
5. Transport Limited purchased 3 buses from Arvind Motors costing ₹75000 each on hire purchase system. Payment was to be made for each bus ₹ 45000 down and the remainder in three equal installments together with interest at 12%. Transport Limited wrote off depreciation at 20% on diminishing balance. It paid the first installment at the end of the first year but could not pay the next. Arvind Motors agreed to leave one bus with the purchaser adjusting the value of other two buses against the amount due. The buses were valued on the basis of 30% depreciation and only on a straight line method. Show the necessary entries in the books of Transport Limited.

6. Janki Distributors sold three light commercial vans to Jain Enterprises on January 1, 2020 on hire purchase system. The price of each van was ₹ 90,000 payment of which was to be made as follows: ₹ 30,000 as down payment for each van, remaining amount in 3 annual equal instalments along with interest @15%. Jain Enterprises were charging depreciation **@** 20% each year on written down value method. After payment of 1st instalment as on December 31,

2020, they could not pay further instalments. It was agreed between the parties for repossession of two vans adjusting their value against the amount due. For the purposes of repossession, depreciation @ 30% p.a. was charged. Repossessed goods were repaired at a cost of ₹ 2,000 and were then sold for Rs, 92,000, Calculate the value of repossessed stock and show the necessary accounts in the books of both the parties.

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7.10 SUGGESTED READINGS

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B. COM

SEMESTER I

COURSE: FINANCIAL ACCOUNTING

UNIT 8: CONSIGNMENT ACCOUNTING

STRUCTURE

8.0 LEARNING OUTCOMES:

After reading the chapter the learner should be able to:

1. **Describe what consignment accounts are.**
2. **Demonstrate how consignment accounts are prepared.**
3. **Illustrate the use of consignment accounts.**
4. **Differentiate between sale and consignment.**

8.1 INTRODUCTION

When a producer/manufacturer/retailer sells goods directly to the customer it is ordinarily known as sales. Here he could sell to the customer in the domestic market for overseas markets. But when a producer/ manufacturer/ retailer/ trader wants to expand business beyond the local or national boundaries, it would be very expensive for him to sell directly. So he can do this by appointing an agent at places where they want to expand. The knowledge and experience of the agents will help the producer/manufacturer/retailer or trader to understand the market and expand its sales. Selling goods in the domestic market and foreign market through these agents is known as Consignment.

8.2 MEANING AND DEFINITION OF CONSIGNMENT

Consignment is a special kind of agreement in which the manufacturer or wholesaler or trader sells goods through the agents in farof domestic markets or foreign markets. Simply stating it is a specialised kind of transaction between a person (called consignor) and another person (called consignee), where consignor sends goods to the consignee, to be sold by him on behalf of the consignor for a mutually agreed commission. Consignment is a means of facilitating sale but it is not actually a sale. The relationship between the consignor and consignee is that of “principal” and “an agent.”

8.2.1 PARTIES TO CONSIGNMENT:

There are two parties in Consignment agreement

1. **Consignor:** He is the owner of the goods (also called Principal)
2. **Consignee:** He is a person who works for consignor and sells goods on behalf of the consignor. In return, the consignee gets the commission.

8.2.2 FEATURES OF CONSIGNMENT

The main features of consignment are:

1. Consignment involves only transfers of possession of goods from consignor to consignee for the purpose of sale.
2. The property in goods does not pass on to the consignee.
3. The consignee sells the goods on behalf of the consignor.
4. The risk is also borne by the consignor. But the consignee is expected to take reasonable care of goods consigned to him.
5. All the expenses incurred by the consignee on goods so consigned are to be reimbursed by the consignor.
6. Is not liable to make the payment of the goods until these are sold.
7. The consignee is entitled to get a fixed Commission on sales made by him as consignee.
8. Any loss or bad debts arising on goods, which the consignee is authorised to sell, is to be borne by the consignor.
9. The consignee will send periodic statements showing details of goods sold, expenses incurred and commission charged on sales to the consignor.

8.2.3 DIFFERENCE BETWEEN CONSIGNMENT AND SALES

S. No.	**Basis**	**Consignment**	**Sales**
1	Ownership	Remains with the Consignor	Transferred to the buyer
2	Possession	Possession of Goods is transferred to the consignee	Possession of Goods is transferred to the buyer
3	Relation	Principal (consignor) and Agent (Consignee)	Debtor and Creditor (until account is settled
4	Risk	Consignor bears the risk and loss due to damage	After sale, any loss or damage is borne by the buyer
5	Return of Goods	Unsold goods are returned to the consignor	Goods are returnable if wrongly delivered or they are defective
6	Expenses	Expenses incurred by consignor are ultimately borne by the	Expenses incurred after sale will be borne by the buyer

		consignor	
7	Proforma Invoice vs Sales Invoice	Consignor prepares proforma invoice	Seller prepares Sales Invoice
8	Account Sales	Consignee submits account sales to the consignor	No account sale is required

SAQ 1 **State whether following statements are True or False**
i) All the legitimate expenses incurred by the consignee relating to consignment are borne by the consignor. ii) For the consignor the consignment is an outward consignment and the same becomes an inward consignment for the consignee. ii) The consignee does not become the debtor of the consignor on receipt of goods.
Fill in the Blanks
i) The legal ownership of the goods is not transferred till the goods are sold in case of ____________________. ii) The party responsible for the risk attached to the goods in consignment is ____________________. ii) The relationship between consignor and consignee is that of___________________.

8.2.4 TERMS USED IN CONSIGNMENT ACCOUNTS

8.2.4.1 ACCOUNT SALES: Account sale is a statement prepared by the consignee and sent to the consignor regularly. This statement shows information related to

- Quantity of goods,
- Type and quality of goods,
- Goods sold,
- Expenses incurred,
- Commission charged,
- Any advances already sent to consignor and
- Balance amount due to consignor

On receipt of account sale, the consignor journal entries in his books of accounts and completes the consignment account and consignee's account.

Specimen of Account Sales

Name of Consignee	
CST No…………………. **Phone No………………..**	**6, CP, New Delhi**

Email Id:.......................... **Website ………………….** **Ref. No…………………..** **Account Sales of…….. (Product) on behalf of……(Name of Consignor)**			
Particulars	**Rate (₹)**	**Details (₹)**	**Amount (₹)**
No. of Items (product) **Less: Expenses** **Loading and Unloading** **Octroi** **Rent of Showroom** **Commission@ R%** **Net Proceeds** **Less: Advance** **Balance Paid Vide….** **Bank Draft No.** **Dated…………** **Bank** **Name……..**			
E & O.E			**For (Consignee)**

8.2.4.2 PROFORMA INVOICE: When goods are consigned by consignor to the consignee, a document called invoice is sent to the consigning. Invoice that is sent is a kind of forwarding letter which contains information relating to: the name of the item, number i.e quantity weight & measurement and the price. Since consignment is not an actual sale and the consignee is not a buyer, this letter is meant only for his information. Because this letter is drawn up in the form of an invoice, therefore it is termed as **"Proforma Invoice."**

Specimen of Proforma Invoice

Name of Consignor				
CST No…………………. **Phone No………………..** **Email Id:..........................** **Website ………………….** **Ref. No…………………..** **Consigned to:.. (Name of Consignee)**			**6, CP, New Delhi**	
Quantity	**Particulars**	**Rate**	**Details**	**Amount**

1	**Item details** **Less: Expenses** **Total**			
E & O.E.			**(Consignor)**	

Difference Between Proforma Invoice and Account Sales

Basis	Proforma Invoice	Account Sale
1. Sent by	Consignor to Consignee	Consignee to Consignor
2. Information Included	About quality, type, price, etc of goods sent to consignee.	About goods sold by the consignee, expenses incurred by the consignee, commission due to him, advance money and the balance amount.
3. What is it	Intimation of goods sent by the consignor to the consignee	Basic record to be used for accounting purposes.
4. When sent	When goods are sent by consignor to the consignee	Sent by consignee to the consignor periodically.

8.2.4.3 EXPENSES: Expenses of consignment are divided into two categories:

(i) Non-Recurring Expenses

(ii) Recurring Expenses

(i) NON-RECURRING EXPENSES:- The expenses that are incurred once are Non-recurring expenses or Direct Expenses. The expenses which are incurred for bringing goods to the Godown of the consignee are non recurring expenses. Proportionate part of such expenses must be added while valuing consignment stock. These expenses include:

a. All expenses incurred by Consignor, for example, Freight, carriage, insurance in transit, dock charges.

b. All expenses incurred by consignee, for example, clearing charges, custom duty, octroi, carriage to godown, custom duty.

(ii) RECURRING EXPENSES:- The expenses incurred after the goods reach the godown of the consignee. These are also called Indirect Expenses. These expenses do not increase the value of the goods therefore not included in the valuation of consignment stock. Examples of Recurring expenses are: warehousing expenses, Insurance premium, office expenses, advertisement, godown rent, etc

8.2.4.4 COMMISSION: The Consignee gets Commission for selling goods on behalf of the consignor. Consignor pays commission as a fixed percentage on sales made by the consignee.

This commission can be of following types depending on extra burden or activities undertaken by the consignee:

(i) Simple or Ordinary Commission

(ii) Special or Overriding Commision

(iii) Del-Credere Commission

(i) SIMPLE OR ORDINARY COMMISSION: This type of commission is given to the consignee for selling goods on behalf of the consignor, providing ordinary consignment services like: safe custody of goods. This type of commission is generally a fixed percentage on total sales as per the terms of the consignment agreement.

(ii) SPECIAL OR OVERRIDING COMMISSION: Commission is paid in addition to the simple or ordinary commission. This is also paid as per the terms of consignment agreement. This type of commission is given to the consignee as extra incentive for effecting sales at higher selling price. It is given at a higher percentage on the additional sales value realized.

(iii) DEL-CREDERE COMMISSION: When goods are sent to the consignee for sale, the risk of bad debts remains with the consignor as he is the owner of the goods. Sometimes the consignee agrees to take the risk of bad debts and in return he gets additional commission at a higher rate. This commission is called Del-credere Commission. It is calculated as a fixed percentage on total sales, unless otherwise agreed.

SAQ 2

1. **Differentiate between Ordinary Commission and Del-Credere Commission**
2. **Del-Credere Commission and Overriding Commission**

ILLUSTRATION 1

Avon Cycles, Ludhiana sent 2000 cycles costing ₹500 each for sale on consignment to Roopam of patiala subject to the following terms:

(i) Normal Selling price per cycle ₹600.

(ii) Consignee's commission will be calculated as under:

a. 5% on normal Selling Price

b. 1% additional commission if selling price is more than normal price

c. 1% del-credere commission on total sales for guaranteeing collection of credit sales

Roopam reported sales as follows:

Cash Sales:	
500 cycles @ ₹600 each=	300000
200 cycles @ ₹750 each=	150000
Credit Sales	
400 cycles @ ₹750 each=	300000
400 cycles @ ₹800 each=	320000
Total Sales	1070000

Calculate commission due to the consignee.

SOLUTION

Calculation of Commission due to the Consignee

Details	Amount (₹)
a. Normal Commission No. of Cycles sold at Normal Selling Price (1500 x 60= 900000 5% of 900000 (b) Overriding Commission 1% on sales (affected) at more than normal Selling price: 770000 x 1% Total Sales Affected 1070000 Less: sales at normal rate (500 x 600) 300000 Sales higher than normal rate 770000 (c) Del-Credere Commission 1% on Total Sales (1070000 x 1%)	 45000 7700 10700
Total Commission	**63400**

SAQ 3

Surat cycles Limited of Surat 2002 there agent at Chandigarh costing ₹3500 each on the following terms:

(i) Normal selling price of the bicycle ₹4500

(ii) Consignee's Commission to be calculated as follows:

(a) 5% on normal selling price

(b) 20% on any surplus sales over and above normal selling price

(c) 1% Del-credere Commission on total sales

Agent reported that he was sold:

3000 bicycles on cash @ ₹ 5000 per bicycle

1500 bicycles on credit @ ₹ 5500 Per bicycle

Agent also reported that he has failed to recover the sale proceeds of 5 bicycles sold on credit by him. Calculate Commission due to the agent.

8.2.4.5 ADVANCE ON CONSIGNMENT:

On delivery of goods to the consignee, consignors insist on some advance payment from the consignee. This advance can be given for two reasons:

1. Against consignment
2. Against security of goods

1. Advance against Consignment: In this advance is adjusted against the amount due even if the goods remain unsold.

2. Advance against security of goods: In this whole amount will no0t be adjusted against the amount due from the consignee. The proportionate amount representing unsold goods is carried forward and remains unadjusted till goods are sold by the consignee

(Note: If nothing is given about the type of advance in the question, it is treated as Advance against Consignment)

If the advance is given as security, advance to be retained is calculated as:

Advance to be retained is = (Amount of Advance) x Unsold Stock/Stock Consigned

8.2.4.6 DISCOUNTING OF BILLS RECEIVED ON CONSIGNMENT:

Discounting of Bills received on consignment are done in the same way as normal bills receivable. It is debited to general profit and loss a/c because it is purely a financial matter and does not affect the profitability of consignment.

SAQ 4

Fill in the Blanks:

i) Discounting of Bills is purely a____________________matter and does not affect ____________________.

ii) Consignor allows____________________-Commission to the consignee to bear the bad debts.

iii) ____________________expenses are those expenses which are incurred after the goods reach the consignee's godown.

iv) Unloading charges paid by the consignee are________________expenses.

8.3 ACCOUNTING TREATMENT IN CONSIGNMENT

8.3.1 BOOKS OF CONSIGNOR:

In the books of consignor following accounts are prepared:

1. **CONSIGNMENT ACCOUNT:** It is a kind of trading and Profit and Loss A/c. All expenses related to consignment are debited to Consignment A/C, whether incurred by the consignor or consignee. Sales both cash and credit are recorded on the credit side of consignment A/c. The balancing figure will be either profit on consignment or loss on consignment. Separate account is prepared for each Consignment.

Dr. **Specimen of Consignment A/C** **Cr**

Particulars	Amount	Particulars	Amount
To Opening Stock To Goods Sent on Consignment To Cash A/c (Expenses of Consignor) To Consignee A/C (expenses of consignee) To Consignee A/C (commission) To Consignee A/C (Bad debt)		By Consignee A/C Cash Sales Credit Sales Own Purchases By Closing Stock By P/L A/C (if Loss)	

To P/L A/C (if Profit)			

3. **GOODS SENT ON CONSIGNMENT ACCOUNT:** This is a kind of real account. It records the goods sent on consignment. At the end of the year, this account is closed by transferring to purchases a/c or to trading a/c.

Dr **Specimen of Goods sent on Consignment A/C** **Cr**

Particulars	**Amount**	**Particulars**	**Amount**
To Trading A/C		**By Consignment A/C**	

3. CONSIGNEE'S ACCOUNT: This is a personal account. Since, the consignee is not the buyer; therefore his personal account is not debited when goods are sent to him. This account is prepared to show the balance due to or from the consignee at a particular date.

Dr **Specimen of Consignee's A/c** **Cr**

Particulars	**Amount**	**Particulars**	**Amount**
To Consignment A/C **Cash Sales** **Credit Sale** **Own Purchases** **To Balance c/f**		**By Consignment A/C** **(Expenses of Consignee)** **By Bills Receivable A/C** **(full amount of Bills)** **By Bank/Cash A/c** **(advance paid to consignor)** **By Consignment A/c** **(Consignee's Commission)** **By Consignment A/c** **(bad debt)** **By Bank/Cash A/c** **(for final payment)**	

8.3.2 BOOKS OF CONSIGNEE

Consignee maintains separate books of accounts. The accounts maintained in consignee's books are:

1. **CONSIGNOR'S A/C:** This account is a kind of personal account.

Dr **Specimen of Consignor's A/ C** **Cr**

Particulars	**Amount**	**Particulars**	**Amount**
To Bills Payable A/C		**By Cash A/C (Sales)**	

To Cash A/C (Expenses) **To Commission A/C** **To Bank A/C (Bal. Fig.)** **(Balance remittance)**			

2. COMMISSION A/C: It is a nominal account. This account is credited with the amount of commission due from consignor on sale and debited with bad debts, if del-credere commission is given to consignee and balance is transferred to profit and loss A/c

Dr **Specimen of Commission A/C** **Cr**

Particulars	**Amount**	**Particulars**	**Amount**
To Profit and Loss A/c		**By consignor AC**	

8.4 METHODS OF ACCOUNTING

There are three methods of accounting in consignment accounts:

8.4.1 Cost Price Method

8.4.2 Invoice Price Method

8.4.3 Memorandum Column Method

8.4.1 COST PRICE METHOD

Under this method, the consignor sends the goods to consignee at cost price. The journal entries passes in the books of consignor and consignee are as follows:

Books of Consignor	**Books of Consignee**
1. Goods sent on Consignment	
Consignment A/C ....Dr. To Goods sent on consignment A/c (At Cost Price)	No Entry (only record is kept by consignee in Consignment Inward register)
2. Expenses incurred by consignor	
Consignment A/C ....Dr To Cash A/C	No entry
3. Advance sent by consignee to consignor	
Cash/Bank/Bill Receivable	Consignor A/C............................ Dr

A/C............ Dr To Consignee A/C	To Cash/Bank/ Bills Receivable A/C
4. Discounting of Bill Sent by the consignee as advance	
Bank A/c…………Dr.(with net proceeds) Discount A/c… ......Dr.(Disc. Amount) To Bills Receivable A/C	No entry
5. Goods returned by consignee	
Goods Sent on Consignment A/C…….Dr To Consignment A/C	No entry
6. Goods sold by Consignee	
Consignee A/C.................................... Dr To Consignment A/c (With Total Sales)	Cash A/c…….Dr (with cash sales) S. Debtors A/C..Dr (credit sales) To Consignor's A/C
7. Cash received from debtors	
No Entry	Cash A/C................Dr To S. Debtors A/C
8. Cash Disc and Allowances allowed to debtors	
Consignment A/C ....Dr To Consignee's A/C	Consignor's A/C................. Dr To S. Debtors
9. Bad Debts **(i) No Del-Credere Commission**	
Consignment A/C ....Dr To Consignee's A/C	Consignor's A/C...................... Dr To S. Debtors A/C
9. Bad Debts **(ii) Del-Credere commission is paid**	
No Entry	Bad Debts A/C................. Dr To S. Debtors A/c Commission/Del-Credere Com A/c.Dr

	To Bad Debts A/c

10. Expenses Incurred by Consignee	
Consignment A/C……+…….Dr To Consignee's A/C	Consignor's A/C .... Dr To Cash A/C
11. Commission due to consignee (All types)	
Consignment A/C ....Dr To Consignee's A/C	Consignor A/C .... Dr. To Commission A/C (ordinary, Special and/or Del-Credere Commission)
12. Unsold Goods Taken over by Consignee	
Consignee A/C .... Dr To Consignment A/C (At an agreed Value)	Purchases A/C.................Dr To Consignor A/C
13. Amount remitted by consignee relating to sale proceeds	
Cash/Bank/Bills Receivable A/C…….Dr To Consignee's A/C	Consignor's A/C .... Dr To Commission A/C
14. Closing Stock (Unsold Stock)	
Stock on Consignment A/C ....Dr To Consignment A/C	No Entry
15. Profit or Loss on Consignment	
Consignment A/C ....Dr To Profit and Loss A/c (in case of profit) Profit and Loss A/C ....Dr To Consignment A/c (in case of loss)	No Entry
16. Closing Entry for Goods Sent on Consignment	
Goods Sent on Consignment A/C……Dr To Purchases/Trading A/C	No Entry

8.4.1.1 TREATMENT OF GOODS-IN-TRANSIT

Sometimes goods do not reach consignee and remain in transit. Such goods are also included in closing stock and will include the basic cost of goods to the consignor and proportionate expenses of the consignor. Expenses of consignor are not included. No entry for this is passed in the books of consignee. In the books of consignor following journal entry is passed.

Stock on Consignment A/C ....Dr
To Consignment A/C
(goods in transit plus closing stock)

8.4.1.2 VALUATION OF UNSOLD STOCK

If some part of the goods sent on consignment remains unsold, it is brought in the books by passing following journal entry:

Stock on Consignment A/C… ....Dr
To Consignment A/C

(a) Stock on consignment is shown on the asset side of the balance sheet. In the next year, it will be transferred to the debit side of consignment A/c.

(b) Here also, valuation of closing stock at cost or market price, whichever is less is applied. Cost price means original cost of unsold stock +proportionate amount of non-recurring expenses.

(c) If no information is given about the details of expenditure, consignor's expenses are considered as direct expenses and consignee's expenses are treated as Indirect expenses.

Calculation of Value of Unsold stock of Consignment

Step 1: CALCULATION OF VALUE OF UNSOLD STOCK

Cost of Unsold Stock		xxx
Add: Proportionate Non-Recurring Expenses of Consignor		
Non-Recurring Expenses of Consignor/Total Quantity x Units of Unsold Stock	xxx	
Add: Proportionate Non-Recurring Expenses of Consignee:		
Non-Recurring Expenses of Consignee/Total Quantity x Units of Unsold Stock	xxx	
Value of Unsold Stock		

Step II: CALCULATION OF NET REALISABLE VALUE

Total Realisable Value of Unsold Units = (Units Sold x Per unit Realisable Value)	xxx
Less: Realisation Expenses	xxx
Net Realisable Value	xxx

Value of Unsold Stock of Consignment = Value of unsold stock at step 1 or Net Realisable Value at Step II, whichever is less

8.4.2 INVOICE PRICE METHOD

In case the consignor has sent the goods to the consignee at Invoice price, the idea behind this is to not disclose the actual cost of goods. In this case, the adjustment is needed to be made, so that correct profit or loss on consignment can be calculated. Three adjustments are required to be made:

(i) Goods Sent on Consignment

(ii) Goods returned by consignee to consignor.

(iii) Stock on consignment

The accounting entries to make such adjustments will be passed in the books of consignor. Journal entries in the books of consignee remain the same.

JOURNAL ENTRIES IN THE BOOKS OF CONSIGNOR:

When goods are invoiced at Cost	When goods are invoiced at invoice price
1. For Goods sent on Consignment	
Consignment A/C ....Dr To Goods sent on Consignment A/C (At cost)	Consignment A/C................................. Dr To goods Sent on Consignment (At Invoice Price) Goods Sent on Consignment A/C ....Dr To Consignment A/C (with loading)
2. For Goods returned by the Consignee	
Goods Sent on Consignment A/C.......... Dr To Consignment A/C (at cost)	Goods Sent on Consignment A/C ....Dr To Consignment A/C (At Invoice Price) Consignment A/C................................. Dr To goods Sent on Consignment (with loading)
3. For Opening Stock	
Consignment A/C ....Dr To Consignment Stock (At Cost price of opening stock)	Consignment A/C............................. Dr To Consignment Stock (At Invoice price of opening stock) Consignment Reserve A/C................ Dr To Consignment A/C (With loading)
4. For Closing Stock	
Consignment Stock A/C ....Dr. To Consignment A/C (Cost price of closing Stock)	Consignment Stock A/C..................Dr. To Consignment A/C (Invoice price of closing Stock)

	Consignment A/C.................. Dr To Consignment Reserve A/C (with loading)

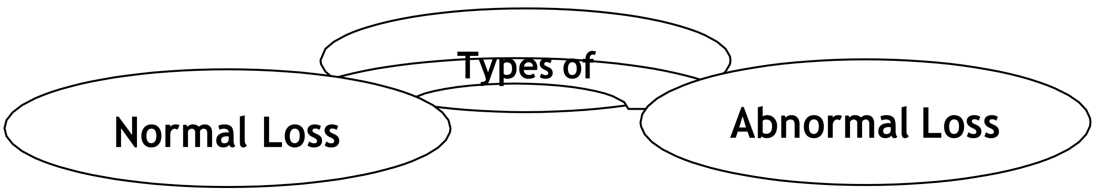
Note: (a) Loading means: (Invoice price - Cost Price)

(b) Closing stock at 4th entry will appear on the Asset side of the balance sheet after subtracting Stock Reserve).

(c) Closing stock Account and the consignment stock reserve Account will be taken to the next year and then it will be transferred to the consignment account.

8.4.2.1 Loss of Stock

Usually some goods may be lost or damaged in transit and its adjustment is required to be made in the books of the consignor. The treatment will depend upon the type of loss.



(a) **NORMAL LOSS:** When the loss arises due to the nature of goods consigned, it is called normal loss. These losses can be determined in advance and are unavoidable. These losses could arise due to evaporation, drying, sublimation, etc. Such loss should be allowed while calculating the cost of unsold stock with the consignee. No treatment is given to the normal loss, but the unsold stock is calculated as under:

$$Value\ of\ Unsold\ Stock = \frac{Non\ Recurring\ Expenses\ of\ Consignor\ and\ Consignee + Total\ cost\ of\ goods\ sent}{Total\ Quantity\ sent - Quantity\ of\ Normal\ Loss}\ x\ Unsold\ Quanti$$

So,

No Journal Entry is passed for Normal Loss. But this loss is adjusted while calculating value of unsold stock with the consignee

ILLUSTRATION 2: Abhinav 6000 tonnes of coal @ ₹100 per tonne to Bihu of Kolkata. He paid ₹ 30000 as freight. Due to normal wastage only 5800 tonnes were received by Bihu. He also paid ₹7500 as unloading and Cartage Charges. The goods that remain unsold are 1900 units. Calculate value of closing stock.

SOLUTION:

Cost of goods sent on Consignment: 6000 x ₹100 per tonne	₹600,000
Freight Paid by Abhinav	₹30000
Unloading and Cartage paid by Bihu	₹7500
	₹637500

$$Value\ of\ Unsold\ Stock = \frac{Non\ Recurring\ Expenses\ of\ Consignor\ and\ Consignee + Total\ cost\ of\ goods\ sent}{Total\ Quantity\ sent - Quantity\ of\ Normal\ Loss}\ x\ Unsold\ Quantity$$

Value of Unsold stock = 637500/5800 x 1900
= ₹208836

(b) ABNORMAL LOSS: Unlike Normal loss, this loss is not natural and can be completely avoided. This loss may arise due to pilferage, theft, negligence, breakage, fire, etc. Here value of unsold stock is not inflated. Abnormal loss is calculated by taking into consideration proportionate expenses incurred on it.

JOURNAL ENTRIES:

1. Goods Destroyed (Not Insured)

(i) Abnormal loss A/C.........................Dr
To Consignment A/C
(with total cost of goods destroyed)

(ii) Profit & Loss A/c… ....Dr
To Abnormal Loss A/C
(With total cost of goods destroyed)

2. Goods Destroyed (Insured)

(i) Abnormal Loss A/C ....Dr
To Consignment A/C
(With total cost of goods destroyed)

(ii) Insurance Claim A/C…………..Dr (with claim accepted)
Profit & Loss A/C……………..Dr (with claim not accepted)
To Abnormal Loss A/c (total cost of goods destroyed)

CALCULATION OF ABNORMAL LOSS

Abnormal loss may occur when goods are in transit or when goods are received by the consignor. Amount of abnormal loss is calculated accordingly

Calculation of Abnormal loss during transit

Particulars	**Amount**
Cost Price of goods lost in Transit	Xxx
Add: Consignor's Proportionate Expenses	
$\frac{Consignor's\ Total\ Expenses}{Total\ units\ Sent}\ x\ Units\ sold$	Xxx
Cost of abnormal loss in transit	Xxx

Calculation of Abnormal loss when goods are with Consignee's

Particulars	**Amount**
Cost Price of goods lost in consignee's Godown	Xxx

Add: Consignor's Proportionate Expenses

$$\frac{Consignor's\ Total\ Expenses}{Total\ units\ Sent}\ x\ Units\ sold \qquad\qquad Xxx$$

Add: Consignee's Proportionate Expenses

$$\frac{Consignee's\ total\ Non-Reccuring\ Expenses}{Total\ units\ received\ by\ the\ Consignee}\ x\ Units\ sold$$

Cost of abnormal loss when goods are with consignee Xxx

Valuation of Stock in case of loss

Value of the stock will include:

(i) Proportion of the cost of goods.
(ii) Expenses incurred on goods before the loss
(iii) Expenses incurred after loss.

ILLUSTRATION 3

D of Delhi consigned 1000 goods to M of Mumbai @ ₹ 70 each. The consignor (D) paid freight ₹750, cartage ₹50 and Insurance ₹250. M received only 900 goods and incurred following expenses: Octroi ₹10000, Cartage ₹500 and sales Expenses ₹600

M sold 600 goods. Calculate the value of closing stock.

SOLUTION:

Calculation of stock on consignment:

No. of Goods = 1000-100-600 =	300
Cost of 300 goods @ ₹70 each =	₹21000
Add: Proportionate non recurring expenses incurred	
By consignor (750+60+250=1050)	
(1050/1000) x 300 =	₹315
Add: Proportionate non recurring expenses incurred	
By consignee (10000 + 500)	
(10500/900) x 300	₹3500
Value of Closing Stock on Consignment	24815

Continuing with same example but now M received 1000 goods and 1000 goods destroyed in godown.

Solution

COST OF ABNORMAL LOSS

No. of goods Destroyed:	100	
Cost of each	₹70	
Total cost of goods destroyed	(100 x70)	₹7000

Proportionate non recurring expenses incurred
By consignor (750+60+250=1050)
(1050/1000) x 100 = ₹105
Add: Proportionate non recurring expenses incurred
By consignee (10000 + 500)
(10500/1000) x 100 ₹1050
Value of Closing Stock on Consignment ₹8155

Value of stock on consignment

Cost of goods unsold (1000-600-100 = 300) 300 x70= ₹21000
Add: Proportionate non recurring expenses incurred
By consignor (750+60+250=1050)
(1050/1000) x 300 = ₹315
Add: Proportionate non recurring expenses incurred
By consignee (10000 + 500)
(10500/1000) x 300 ₹3150
Value of Closing Stock on Consignment 24465

8.4.3 MEMORANDUM COLUMN METHOD

This method is a mixture of cost price method and Invoice price method. In this method two columns are made to record the cost price and invoice price of goods consigned and cost column shows the profit or loss.

ILLUSTRATION 4:

D of Delhi appointed A of Agra as its selling agent on the following terms:

(a) Goods to be sold at invoice price or over.

(b) A to be entitled to a commission of 7.5% on the invoice price and 20% of any surplus price realised.

(c) The principals to draw on the agent a 30 days bill for 80% of the invoice price.

On 1 st February, 2006, one thousand cycles were consigned to A, each cycle costing ₹ 640 including freight and invoiced at ₹ 800.

Before 31st March, 2006 (when the principal's books are closed) A met his acceptance on the due date; sold off 820 cycles at an average price of ₹ 930 per cycle, the sale expenses being ₹ 12,500; and remitted the amount due by means of Bank Draft. Twenty of the unsold cycles were shop-soiled and were to be valued at a depreciation of 50%.

Show by means of ledger accounts how these transactions would be recorded in the books of A, and find out the value of closing stock with A at which value D will account for the balance stock.

SOLUTION:

Dr Consignment A/C Cr

Particulars	Cost ₹	Invoice Price ₹	Particulars	Cost ₹	Invoice Price ₹
To Goods Sent on Consignment A/C	6,40,000	8,00,000	By Consignee a/c	7,62,600	7,62,600
To Consignee a/c (expenses)	12,500	12,500	By Closing stock	1,08,800	1,36,000
To Consignee (commission)	70,520	70,520			
To P&L a/c	1,48,380				
To Profit on I. P. basis		15,580			
	8,71,400	8,98,600		8,71,400	8,98,600

Note: In above solution loss due to damage is treated as normal loss.

Dr **A's A/C (Consignee)** **Cr.**

Particular	Amount	Particulars	Amount
To Consignment a/c	7,62,600	By B/R a/c	6,40,000
		By Consignment a/c (selling exp.)	12,500
		By Consignment a/c (commission)	70,520
		By Bank (balance recovered)	39,580
	7,62,600		7,62,600

Commission Calculation :		Amount
Sale value (820 × 930)		7,62,600
(-) Invoice value (820 × 800)		6,56,000
		1,06,600
Commission	7.5% of 656000	49,200
	20% of 106600	21,320
	Total	70,520

Valuation of stock	**Good units**	**Damaged units**	
Unit	160	20	Total
Invoice value	800 × 160=1,28,000	400 × 20 = 8,000	1,36,000
Cost price	640 × 160 = 1,02,400	320 × 20 = 6,400	1,08,800

Loading	25,600	1,600	27,200

ILLUSTRATION 5:

X of Calcutta sent on 15th January, 2006, a consignment of 500 toys bicycles costing ₹ 100 each. Expenses of ₹ 700 met by the consignor. Y of Bombay spent ₹ 1,500 for clearance and the selling expenses were ₹ 10 per bicycle.Y sold, on 4th April 2006, 300 pieces @ ₹ 160 per piece and again on 20th June 1999, 150 pieces @ ₹ 172. Y was entitled to a commission of ₹ 25 per piece sold plus one fourth of the amount by which the gross proceeds less total commission thereon exceeded a sum calculated at the rate of ₹ 125 per piece sold. Y sent the amount due to X on 30th June 2006.

You are required to show the Consignment Account and Y's Account in the books of X.

SOLUTION:

Dr **Consignment Account** **Cr**

Particulars	₹	Particulars	₹
To goods sent on consignment a/c 500 @ ₹ 100	50,000	By Y-sale of 300 pieces @ ₹ 160	48,000
To Bank A/c - Exp.	700	By Y-sale of 150	25,800
To Y-Clearing Exp	1,500	Pieces @ 172	
To Y-selling Exp	3,000	By consignment	5,220
To Y- selling Exp	1,500	stock A/c	
To Commission A/c	12,510		
To Profit & Loss A/c	9,810		
Profit on Consignment			
	79,020		79,020

Dr. **Y's Account** **Cr**

Particulars	₹	Particulars	₹
To Consignment A/c	48,000	By consignment A/c	1,500
To Consignment A/c	25,800	(clearing exp.)	
		By consignment A/c	3,000
		(selling exp.)	
		By consignment A/c	1500
		(selling exp.)	
		By consignment A/c	12,510

		commission (2) By Bank A/c	55290
	73,800		73,800

WORKING NOTE

(i) VALUATION OF CLOSING STOCK

50 pieces @ ₹ 100 each		₹ 5,000
Add : Proportionate Expenses		
Expenses incurred by X on 500 piece	₹ 700	
Clearing expenses incurred by Y	₹ 1500	
Total Expenses	₹ 2,200	
Therefore, expenses on 50 pieces 2200x50/500		= ₹ 220
Value of Closing Stock		₹ 5,220

(ii) Calculation of Commission

Let Total Commission of Y be a

c = No. of pieces sold x ₹ 25 + ¼ [Gross sale proceeds - (₹ 125 x No. of pieces sold] – c

c = 450 x ₹ 25 + ¼ [R. 73,800 - (₹ 125 x 450] - c)

c = ₹ 45,000 + ₹ 17,500 –c

5c = ₹ 62,550

c= 62,550/5 = ₹ 12,510

ILLUSTRATION 6: D of Delhi Centre consignment agent A of Agra. The invoice price of goods was ₹20000 which was 25% above cost. on receiving the goods, A accepted a 3 months draft for ₹10000 which was discounted by the @ 6%. A also spent the following:

Freight and cartage	₹ 500
Godown insurance and rent	₹ 300

Four fifth of the goods were sold for ₹ 17400. A is entitled to a commission of 10% on the invoice price plus one fourth of any profit finally remaining that D might make.

Prepare accounts in the books of B with memorandum columns.

SOLUTION:

Books of D (Consignor)

Dr. **Consignment A/C** **Cr**

Particulars	Invoice Price (₹)	Cost Price (₹)	Particulars	Invoice Price (₹)	Cost Price (₹)
To Goods sent on			By A’s Account		

Consignment A/C (Cost = 20000 x 100/125=16000)	20000	16000	(sales – 80% Sold)	17400	17400
To A's A/C (Ordinary Commission) (W. Note 2)	1600	1600	By Stock on Consignment A/c (W. Note 1)	4100	3300
To A's A/C (Expenses)	800	800	By Loss	1360	
To A's A/C (over-riding Commission) (W. Note 2)	460	460			
To Profit and Loss A/C		1840			
	22860	20700		22860	20700

Dr. A's A/C (Consignee) Cr

Particulars	Amount ₹	Particulars	Amount ₹
To Consignment A/C	17400	By B/R	10000
		By Consignment A/C (Expenses)	800
		By Consignment A/C(Ordinary Commission)	1600
		By Consignment A/C (Over-ridding Commission)	460
		By Bal c/d (W. Note 3)	4540
	17400		17400

Dr Goods Sent on Consignment A/C Cr

Particulars	Invoice Price (₹)	Cost Price (₹)	Particulars	Invoice Price (₹)	Cost Price (₹)
To Trading A/C (Transfer)	20000	16000	By Consignment A/C	20000	16000
	20000	16000		20000	16000

Dr. Stock on Consignment A/C Cr

Particulars	Invoice Price (₹)	Cost Price (₹)	Particulars	Invoice Price (₹)	Cost Price (₹)
To Consignment A/C	4100	3300	By Balance c/d	4100	3300
	4100	3300		4100	3300

WORKING NOTES:

W. NOTE 1 STOCK ON CONSIGNMENT

	Invoice Price (₹)	Cost Price (₹)
Value of 1/5th goods		
(20000 x 1/5 = 4000) & (16000 x 1/5 =3200)	4000	3200
Add: 1/5th of Carriage and Freight (1/5 of 500)	100	100
Value of Unsold Stock with Consignee	4100	3300

W. NOTE 2 CALCULATION OF COMMISSION

2. **Ordinary Commission**
   (10% of Invoice Price of goods sold) 10/100 x 4/5 x 20000 = ₹1600
3. **Overriding Commission**
   1/4th on finally remaining profit or 20% of Net profit after
   Charging such commission (2300) x 20% ₹460
   Profit = (17400+3300) – (16000+800+1600)
   = 20700 – 18400
   = 2300
   Total Commission ₹2060

ILLUSTRATION 7:

Rakhi sent 1000 boxes on consignment to Geeta ₹1000 per box at a proforma invoice price to show 20% profit on invoice price. Rakhi spent ₹5000 on loading, ₹8000 on freight insurance and ₹2000 miscellaneous expenses. 10 boxes were lost in transit. Geeta received 90 boxes and sent ₹ 50000 as an advance against the consignment. Geeta spent as follows: carriage inward ₹8000, ₹ 10,000 duties and Taxes, ₹ 2000 as Godown rent, ₹ 5000 as advertisement. Sales made by Geeta are:

60 boxes @ ₹1800/box
10 boxes @ ₹1900/box
10 boxes @ ₹2000/box

Geeta is entitled to a Commission of 10% on sales. Bad debts reported were ₹2000.
Prepare the necessary accounts in the books of consignor.

SOLUTION:

In the Books of Consignor

Dr. Consignment A/C Cr

Particulars	Amount ₹	Particulars	Amount ₹
To Goods Sent on		By Geeta's A/C(Sales)	
Consignment A/c		60 x 1800 =108000	
(100 x 1000 x 100/80)	125000	10 x 1900 = 19000	
To Bank A/C (expenses)		10 x 2000 = 20000	147000
Loading	5000	By Abnormal Loss A/c (lost	
Freight and Insurance	8000	in transit) (W. Note 1)	11500

Misc. To Geeta's A/C Carriage Inward Duties and Taxes Godown Rent Advertisement Commission @10% on 147000 To Geeta's A/c To Stock Reserve A/C (Loading on Closing Stock) 25000 x 10/100 To Profit & Loss A/c	2000 8000 10000 2000 5000 14700 2500 15300	By Goods sent on consignment(loading on goods sent) 20/100 x 125000) By Consignment Stock (W. Note 2)	 25000 16000
	199500		199500

Dr. Goods Sent on Consignment A/C Cr

Particulars	Amount ₹	Particulars	Amount ₹
To Consignment A/C (loading on goods) To Trading A/C – Transfer	 25000 100000	By Consignment A/C	125000
	125000		125000

Dr. Geeta's A/C (Consignee) Cr.

Particulars	Amount ₹	Particulars	Amount ₹
To Consignment A/C (Sale Proceeds)	147000	By Bank A/c- Advance By Consignment A/C (Expenses) By Consignment A/c By Balance	50000 39700 2000 55300
	147000		147000

WORKING NOTES:

W. NOTE 1

Abnormal Loss

Cost Price of 10 Boxes (10 x 100)	10000
Add: Proportionate Non-Recurring Expenses of Consignor 15000 x 10/100	1500
Total Abnormal Loss	11500

W. NOTE 2

Valuation of Unsold Stock

Invoice Price of Unsold Stock (100-60-10-10)-10 = 10 x 1000 x 100/80=	12500
Add: Prop. Non-Recurring expenses of consignor 15000/100 x 10 =	1500

Add: Prop. Non Recurring Expenses of Consignee (8000 + 10000) x 10/90=2000

16000

8.5 TEST YOUR KNOWLEDGE

8.5.1 SHORT ANSWER QUESTIONS

1. Write short notes on:
   - (i) Del-Credere Commission
   - (ii) Treatment of Abnormal Loss
   - (iii) Consignment Account
   - (iv) Recurring and Non Recurring Expenses
   - (v) Account Sales
   - (vi) Difference between Proforma Invoice and Account Sale
   - (vii) Difference between Consignment and Sale

8.5.2 LONG ANSWER QUESTIONS

1. Define Consignment. What is the difference between Consignment and Sale of Goods?
2. What Journal entries in respect of consignment are passed in the books of Consignor and Consignee?
3. Write a detailed note on Methods of Accounting in Consignment

8.5.3 TEST YOUR UNDERSTANDING

1. Ashok of Delhi sent goods worth ₹10,000 to Vishnu of Bihar and paid ₹1,200 for packing and ₹800 for insurance. Vishnu took the delivery of the goods and paid ₹2,000 for freight, ₹400 for cartage and unloading, ₹600 for godown rent, ₹400 as selling expenses and ₹800 for insurance. Vishnu sold three fourth of the goods for ₹1,800. Calculate the value of closing stock.

2. Deepak Radios, Chandigarh sent on consignment to Lucky Radios, Mohali 100 radio sets, invoiced at ₹100 each on January1, 2020. Deepak Radios. paid ₹1,000 on the same day for dispatching goods to the consignee. Consignee remitted ₹5,000 as an advance by bank draft on January 10. The Consignee is entitled to a commission of 10% on the sale proceeds. On receipt of goods, the consignee paid ₹1,000 for freight and ₹500 for godown charges. On January 20, Lucky Radios. sent an Account Sales showing that the radiosets have realized ₹200 each. He remits the amount due to Bush Radio & Co. Pass Journal entries and prepare ledger accounts in the books of the consignor.

3. Shri Mehta of Bombay consigns 1,000 cases of goods costing ₹100 each to Shri Sundaram of Madras. Shri Mehta pays the following expenses in connection with consignment. Carriage, Freight & Loading Charges ₹5000 Sri Sundaram sells 700 cases at Rs.140 per case and incurs the following expenses, Clearing Charges ₹850, Storage Rs.1,700, Packing & Selling expenses 600. It is found that 50 cases have been lost in transit and 100 cases are still in transit. Sri Sundaram is entitled to a commission of 10% on gross sales. Prepare the Consignment Account and Sundaram’s Account in the books of Sri Mehta.

4. On June 1, 2020, Malhotra & Co., Patiala consigned 1000 cases of goods costing ₹250 each to Sethi & Co., Chandigarh. On the same date, the Consignor paid ₹3,500 for freight and carriage, ₹1,000 as loading charges, and ₹2,200 for insurance. On July 1, 2020 the Consignee paid ₹2,800 for clearing charges, ₹1,750 for warehousing and storage charges, and ₹1000 for packing and selling expenses. He also remitted a bank draft for ₹15,000 as an advance against the consignment. On July 5, 2020 they sold 1275 cases at ₹300 each. Sethi & Co. are entitled to 5% commission on the gross proceeds of sales. It is found that 50 cases have been lost in transit. Sethi & Co submitted an Account Sale on July 10, 2020. Prepare the necessary ledger accounts in the books of Consignor.

5. Dutta of Delhi makes sewing machines at a cost of ₹120. On 1st Jan 2020, he consigned 200 at invoice price of ₹150 to Kumar of Bombay to be sold on behalf of Dutta. Kumar to receive a commission @ 10% on sales, 2% Del-Credere Commission and 10% of any profits that may remain on the basis of invoice price.

   Kumar was to bear all expenses after the machines reach his godown. Dutta incurred ₹500 as forwarding expenses and Insurance. 10 Machines were damaged during the transit for which Dutta received ₹1050 from Investors

   Kumar took delivery of remaining machines. He paid freight ₹1040 and storage and other charges ₹500. Kumar sold 160 machines @ ₹180, 100 on credit sales, out of which payment could not be received for 5 machines. Kumar remitted the amount to Dutta.You are required to prepare necessary accounts in the books of Dutta.

6. 'Vikas' of Delhi purchased 10,000 pieces of Shirts @₹100 per Shirt. Out of these Shirts, 6000 were sent on consignment to 'Yogesh' of Agra at a selling price of ₹200 per Shirt. The consignor paid ₹3000 for packing and freight. Yogesh sold 5000 Shirts at ₹230 per Shirt and incurred ₹1000 for selling expenses and remitted ₹7,00,000 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 ₹225 per Shirt. 3000 Shirts were sold at Delhi at ₹110 per Shirts. Prepare the consignment Account in the books of 'X' and their account in the books of the agent 'Y' of Agra.

7. Harmesh of Bombay consigned goods at the invoice price of ₹1,00,000 which is 25% above cost price, to their agent Kittu, Ahmedabad. The consignor incurred ₹5,000 for carriage and freight and ₹3,500 for insurance. Harmesh received ₹25,000 as advance against the consignment. The Consignee is allowed 3% commission on all sales. Any goods taken by the Consignee himself or lost through Consignee's negligence shall be valued at cost plus 25% and no commission would be allowed on them. The Consignee sold 4/5th of the goods consigned for ₹1,40,000. Goods of the invoice price of ₹10,000 were taken by the Consignee and the remaining goods were lost through his negligence. The Consignee paid ₹2,500 for advertisement and selling expenses. Prepare necessary accounts in the books of Harmesh and Kittu.

8. On 21st September 2020 goods which cost ₹ 33000 to X were consigned by him to his agent Y at a Proforma price which was 20% over cost. X pet insurance and freight charges amount into ₹ 1250. why was allowed ₹ 3500 towards establishment cost 5% Commission on gross sales and 3% Del credere Commission. He was also allowed 5% extra Commission on Profit on such consignment sales after charging such Commission. Y incurred an expense of ₹ 255 as landing charges.

   Three-fourth of goods at cost price sold at 33.33% profit on cost, half of which were on credit; half of the balance code was damaged and a claim on insurance company was made for ₹ 4000 which was settled at a discount of 10%.

   You are required to prepare consignment account and an abnormal loss account in the books of x for the year ended 31st December 2020

8.6 REFERENCES:

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3. S.N. Maheshwari, and. S. K. Maheshwari. *Financial Accounting*. Vikas Publishing House,NewDelhi.
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5. https://www.researchgate.net/publication/267151510_Advanced_Financial_Accounting_-_Volume_01/link/544647970cf2d62c304db09c/download
6. https://www.jandkicai.org/pdf/16773Consignment.pdf

8.7 SUGGESTED READINGS

1. Advanced Accounts by M. C. Shukla, T. S. Grewal and S.C Gupta, S. Chand Publishers, New Delhi
2. Financial Accounting,P.C. Tulsian, Pearson Education
3. Financial Accounting. Deepak Sehgal. Vikas Publishing H House, New Delhi.
4. Financial Accounting, C. Mohan Juneja, Neeraj Goyal, Manav Aggarwal, Kalyani Publisher.

B. COM

SEMESTER I

COURSE: FINANCIAL ACCOUNTING

UNIT 9: JOINT VENTURE

STRUCTURE

9.0 LEARNING OUTCOMES:

After reading the chapter the learner should be able to:

4. Describe what Joint Venture is?

5. Replicate the methods to Maintain Joint Venture Accounts

3. Demonstrate how joint venture transactions are recorded under different methods.

4. Differentiate between Joint Venture, Partnership and consignment.

9.1 INTRODUCTION

When a person, due to lack of time, money and expertise, could not execute a job he is compelled to join hands with another person to execute a particular job for a particular period. This results in Joint Venture.

9.1.1 MEANING OF JOINT VENTURE

A joint venture is a temporary kind of partnership, which does not use the firm's name and is limited to carrying out a particular business plan in which the persons concerned agree to contribute capital and share profits or losses.

Joint Venture may be done for construction of a building or bridge or roads or dams, supply of certain types of material or may be some kind of technical services, Underwriting of Shares, etc.

9.1.2 CO-VENTURER

The parties in a joint venture are called co-venturers. The liabilities of co-venturers are limited to the venture for which they agree to contribute capital and share profits or losses. The Joint Venturers may simultaneously run their own business individually alongside the joint venture business. Here, the accounting concept of going concern is not applicable, since the venture is for a specific purpose only. When the co-venturers accomplish that purpose, the venture or temporary partnership comes to an end.

9.2 FEATURES OF JOINT VENTURE:

The main features of joint venture are:

1. It is an agreement between two or more persons.

2. Agreement is done for a specific purpose and therefore it is for a limited duration and is called particular partnership or temporary partnership.
3. The partners in the joint venture are called co venturers.
4. The joint venture is dissolved once the purpose of the venture is completed.
5. The profit or loss on a joint venture is shared by the co venturers in the agreed ratio.In case the agreement is silent on the profit sharing ratio, then the profits are shared equally.
6. During the tenure of the joint venture, the co-venturers are free to continue with their own business unless agreed otherwise.
7. Profits in the joint venture are calculated for each individual joint venture and not on periodic basis.
8. No specific firm name is used for the joint venture business

9.3 ADVANTAGES OF JOINT VENTURE

9.3.1 SYNERGIES: When two companies or two people enter into a joint venture, they share the core competencies of each other that help them to scale up their businesses.

9.3.2 ECONOMIES OF SCALE: Joint Ventures help the company to increase their production capacity. The competencies of each other can be used to generate economies of scale.

9.3.3 LOW COST OF PRODUCTION: When two people/companies or firms join together and achieve economies of scale and synergies, this further helps them to provide best products at a most competitive price to the customers.

9.3.4 INNOVATION: As joint ventures can be done nationally and internationally. The domestic companies when enter into a joint venture, the international company can bring along new ideas and technology to reduce the costs and provide better quality products.

9.4 DIFFERENCE BETWEEN PARTNERSHIP AND JOINT VENTURE

S. No	Basis	Joint Venture	Partnership
1.	**Name**	No separate name is given to the joint venture.	Partnership is carried in the separate Firm's Name.
2.	**Books of Accounts**	No separate books of accounts are maintained by the co-venturer. Only one co-venture can maintain the accounts.	Separate books of accounts of firm are prepared.
3.	**Persons Involved**	Persons involved are called Co-venturer.	Persons involved are called partners.
4.	**Continuing the same**	Co-venturers can continue the same business.	Restriction on partners to carry on same business.

	business		
5.	**Profits and losses**	Profits and losses are calculated at the end of the joint venture.	Profits and losses are calculated on periodic Basis.

6.	**Act**	Not governed by any specific law, it may be treated as a partnership.	Governed by Partnership Act, 1932.
7.	**Registration**	No need of registration.	Registration not compulsory, but it is always recommended.
8.	**Life of Business**	It comes to end when the purpose of joint venture comes to an end.	Partnership business continues for a long period till the partners want.
9.	**Minor as member**	Minor cannot be a co-venturer.	Minor can be a partner for the profits only.

9.5 DIFFERENCE BETWEEN JOINT VENTURE AND CONSIGNMENT

S. No.	Basis	Joint Venture	Consignment
1.	**No. of Persons**	Normally two, but can be more than two.	Two persons, Consignor and Consignee
2.	**Relationship**	Co-venturers are the owners of the joint venture	Relationship of consignor and consignee is that of Principal and agent
3.	**Profits**	Profits are shared between co-venturer in the agreed ratio.	Consignee is paid commission, sometimes on profit also. But profits are not shared between them.
4.	**Investment of funds**	Investment in business is made jointly by co-venturers in the agreed proportion	Only consignor make investment in the business
5.	**Life of Business**	Ends on the completion of the purpose.	Consignment is a continuous process
6.	**Ownership in goods**	Co-venturers are the co-owner of the goods.	Only Consignor is the owner of the goods.
7.	**Scope**	Joint venture can be undertaken for any kind of legal business, e.g. construction, supply of goods	Consignment is only concerned with moveable goods.

		and services, etc.	
8.	**Risk**	Co-Venturers are jointly responsible for any risks.	Consignor bears the risk

SAQ 1

STATE TRUE OR FALSE

1. Joint Venture is similar to partnership.
2. Partners in Joint venture are called co-parceners
3. Ownership in goods remains with only one co-venturer.
4. Joint venture is an agreement for moveable goods.
5. Joint venture is similar to consignment
6. Joint venture is for a limited period
7. Joint venture is governed by Partnership Act 1932.
8. Co-venturer contributes jointly towards the capital of the business in the agreed proportion.

9.6 ACCOUNTING TREATMENT OF JOINT VENTURE

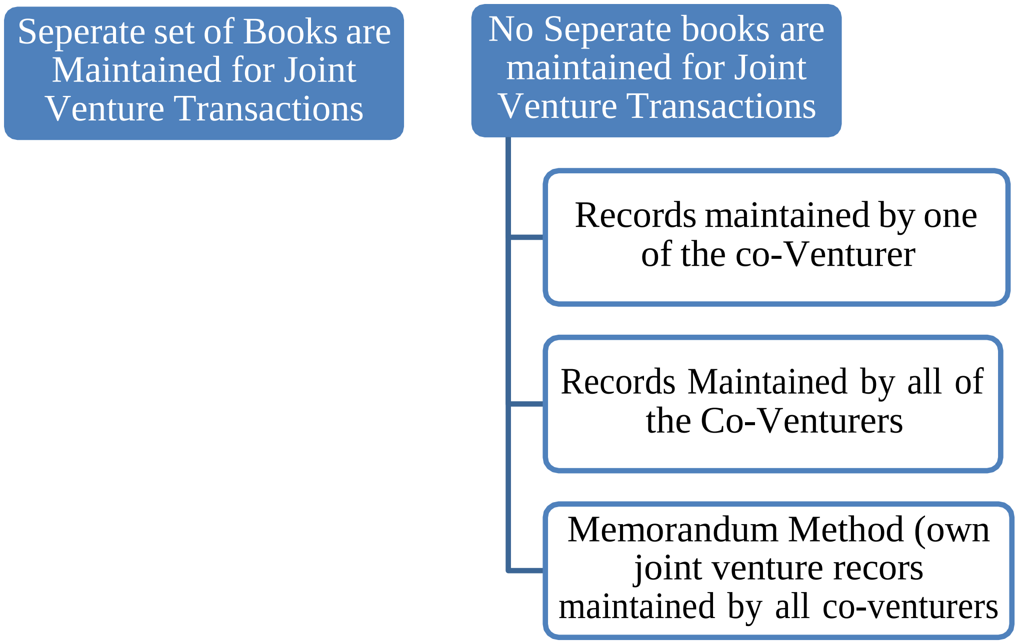
As discussed earlier in the section, no periodic profits are calculated for the joint venture. Profits are calculated for a particular venture and also separately for each venture.

The recording of the Joint Venture transactions can be done in two ways:

(i) In Separate set of books maintained exclusively for joint venture transactions.

(ii) In the set of books in which a co-venturer records his individual business transactions.

Joint Venture Transactions



Detailed discussion of these methods is as follows:

9.6.1 SEPARATE BOOKS OF ACCOUNTS ARE MAINTAINED:

When a co-venturer in a joint venture is assigned with the responsibility of maintain the books of accounts, he in order to keep his personal business separate maintains separate books for the joint venture. Often a separate bank account is opened for the joint venture in the joint names of the co-venturers.

(Note: Sometimes it may not be given in the question, whether separate accounts are maintained or not. If a reference of Joint bank is given in the question, it is a sufficient indication that separate joint venture books are maintained)

Following accounts are maintained for the joint venture:

1. **JOINT BANK ACCOUNT:**
   - Joint Bank Account is a real account like the ordinary Bank Account.
   - All the Co-venturers pay or deposit their contribution in this account.
2. **JOINT VENTURE ACCOUNT:**
   - The Joint Venture Account is a nomial account. It is like a profit and loss account which shows all the expenses and incomes of the joint venture.
   - It is prepared to ascertain profit or loss on joint venture.

3. **PERSONAL ACCOUNT OF EACH CO-VENTURER:**

- The personal accounts of the Co- venturers shows their contributions in the form of goods, cash, expenses and the amounts received by them.

9.6.1.1 ACCOUNTING ENTIRES

S. No JOURNAL ENRTY

1. Contribution of Capital by Co-Venturer

Joint Bank A/C.................................... Dr

To Co-Venturers Personal A/C

2. Contribution in any form other than cash

Joint Venture A/C............................ Dr

To Co-Venturer's Personal Account

3. When Purchases are made for Joint Venture:

(a) For Cash

Joint Venture A/C.................Dr

To Joint Bank A/C

(b) Credit Purchases

Joint Venture A/C................ Dr

To Supplier's A/C

4. When Payment is made to the suppliers

(a) Payment of full amount

Suppliers' A/C................ Dr

To Joint Bank A/C

(b) Discount Received

Suppliers A/C………….Dr (Total Amount)

To Joint Bank A/C (Actual Amount paid)

To Joint Venture A/C (Discount Amount)

5. Supplying goods out of own stock by any of the coventurer

Joint Venture A/C................... Dr

To Co-Venturer A/C

6. Payment of expenses

(a) Out of joint bank A/c

Joint Venture A/c......................Dr.

To Joint Bank A/c

(b) By the co-venturer

Joint Venture A/c......................Dr.

To Co-Venturer A/C

7. Sale of Goods

(a) On cash

Joint Bank A/c....................... Dr

To Joint Venture A/C

(b) On Credit

Customer's A/c..................... Dr

To Joint Venture A/c

(c) By the Co-Venturer

Co-Venturer's Personal A/C ....Dr

To Joint Venture A/C

8. Receipts from Customer

Joint Bank A/C.........................Dr (with the amount received)

Joint Venture A/C.................... /Dr (discount allowed)

To Customer's A/C (with total amount due from customer)

9. Discounting of Bills Receivable

Joint Bank A/C……………Dr (Amount received)

Joint Venture A/C…………Dr (Discounting Charges)

To Bills Receivable A/C (Total amount of Bills receivable)

10. Bad Debts

Joint Venture A/C............... Dr

To Customers A/C

11. Commission, interest, salary, etc. Payable to partners

Joint Venture A/C................. Dr

To Co-Venturer’s Personal A/c

12. Unsold stock taken over by co-venturer in full or in part

Co-Venturer’s Personal A/C ....Dr

To Joint Venture A/C

13. Profit or Loss on Joint Venture

For Profit (distributed in agreed ratio)
Joint Venture A/C........................ Dr
To Co-Venturer’s Personal A/C
For loss (distributed in the agreed ratio)

Co-Venturer’s A/C ....Dr

To Joimt Venture A/C

14. For Final settlement of Accounts

(a) Debit balance in Joint Bank A/C (Due from)
Joint Bank A/C ....Dr
To Co-Venturer’s Personal A/c

(b) Credit balance in Joint Bank A/c
Co-venturer’s Personal A/c… ....Dr
To Joint Bank A/c

Note: (i) Joint Bank A/C gets closed automatically upon settlement of amount due to or from each co-venturer.
(ii) If settlement is made before the completion of the joint venture, the unsold stock is taken into account at cost by passing following journal entry
Stock A/c ....Dr
To Joint Venture A/C

ILLUSTRATION 1:

Abir and Abhay entered into a joint venture to underwrite public issue of Reliance Ltd. They agreed to guarantee the subscription at par on 1,00,000 shares of ₹ 10 each of TATA Steel Ltd. and sharing profits and losses in the ratio of 2:3. The terms with the company are 4.5 % commission payable in cash and 6,000 fully paid shares of the company. They agreed to pay expenses in connection with the issue of shares. The expenses incurred are advertisement ₹ 5,000; Printing and stationery ₹ 2,000 and postage ₹ 600. All expenses are paid by Abir. The public subscribed to 88,000 shares only. The remaining shares under the agreement were duly taken by Abir and Abhay who provided the necessary cash equally. The commission is received in cash and is shared by the co-venturers in the ratio of 4:5. The entire holding of the joint venture is then sold in the market through brokers as follows : 25% at a price of ₹ 9 per share, 50% at a price of ₹ 8.75 per share, 15% at a price of ₹ 8.50 per share and the remaining 10% is taken over by A and B equally at an agreed price of ₹ 8 per share. Prepare the Joint Venture Account, Joint Bank Account, Shares Account and the Accounts of Abir and Abhay showing the final statement.

SOLUTION:

Dr **Joint Venture A/C** **Cr**

Particulars		**₹**	**Particulars**	**₹**
To Advertisement	5000		By Joint A/c (commission)	45,000
Printing	2000		By shares a/c (commission)	
Postage	600	7,600		60,000
To Shares A/c (Loss on sale)		23,400		
To profit transferred to:				
Abir	29,600			
Abhay	44,400	74,000		
		1,05,000		1,05,000

Dr.	**Joint Bank A/C**		**Cr**
Particulars	**₹**	**Particulars**	**₹**
To Abir (contribution)	60,000	By Shares A/c	1,20,000
To Abhay (contribution)	60,000	By Abir (commission)	20,000
To Joint Venture A/C (Commission)	45,000	By Abhay(commission)	25,000
To Shares A/C		By Abir (final settlement)	70,000
	40,500	By Abhay (final settlement)	72,200
25%			
50%	78750		
15%	22950		
	3,07,200		3,07,200

Dr.		Share Account	Cr
Particulars	**₹**	**Particulars**	**₹**
To Joint Bank a/c	1,20,000	By Joint Bank A/c (Sale of Shares)	40,500
To Joint Venture (commission)	60,000	By Joint Bank A/c (sale of shares)	78,750
		By Joint Bank A/c(Sale of shares)	22,950
		By Abir (Shares Taken Over)	7,200
		By Abhay (Shares Taken over)	7,200
		By Joint Venture A/c	23,400
	1,80,000		1,80,000

Dr.		Abir's Account	Cr
Particulars	**₹**	**Particulars**	**₹**
To Joint Bank A/c (Commission)	20,000	By Joint Venture A/c (Expenses)	7,600
To Shares A/c	7,200	By Joint Bank A/c (Commission)	60,000
To Joint bank A/c (Final Settlement)	70,000	By Joint Venture A/c (Profit)	29,600
	97,200		97,200

Dr.		Abhay's Account	Cr
Particulars	**₹**	**Particulars**	**₹**
To Joint Bank A/c (Commission)	25,000	By Joint Bank A/c (Commission)	60,000
To Shares A/c	7,200	By Joint Venture A/c (Profit)	44,400
To Joint Bank A/c (Commission)	72,200		

	1,04,400		1,04,400

WORKING NOTES:

1. Distribution of commission received in cash 4.5 % of ₹ 10,00,000 = ₹ 45,000

   Abir's shares 4/9 x 45,000 = ₹20,000

   Abhay's shares 5/9 x 45,000 = ₹ 25,000

2. Calculation of shares received

Shares received by way of commission	6,000
Shares not subscribed by public	12,000
Total Number of shares received	18,000

a) SOLD FOR CASH

25% of 18,000 i.e. 4,500 shares sold @ ₹ 9 per share ₹40,500

50% of 18,000 i.e. 9,000 shares sold @ ₹ 8.75 per share ₹ 78,750

15% of 18,000 i.e. 2,700 shares sold @ ₹ 8.50 per share ₹ 22,950.

b) DIVIDEND AMONGST ABIR AND ABHAY

10 % of the remaining shares i.e. 1,800 shares are taken over equally by Abir and Abhay at an agreed price of ₹ 8 per share.

Abir: 900 shares @ ₹ 8 per share = ₹ 7200

Abhay : 900 shares @ ₹ 8 per share = ₹ 7200

SAQ 2

A, B and C entered into a joint venture for the construction of a five storey building for a housing company. The contract price was agreed at ₹ 25,00,000 to be paid in cash ₹22,00,000 in four equal installments and the balance amount as 10% Debentures of the company. They agreed to share profits and losses equally. A joint bank account was opened with the cash contribution as follows:

A: ₹300,000, B: ₹375000, C: ₹200000

A arranges for the plan of building and pays ₹32000 to the architect for the same. B brought concrete mixer for ₹80000 and C brought a motor lorry for ₹75000. Following expenses were made out of the bank account:

Material	₹1226800
Wages	₹732200
Sundry Expenses	₹20000
Plant	₹60000

On completion, concrete mixer is sold for ₹70000. C took back Motor lorry for ₹40000. A took over the debentures@ ₹280000. Show the necessary Ledger Accounts for Joint Venture.

9.6.2 NO SEPARATE BOOKS OF ACCOUNTS ARE MAINTAINED:

Method 1: Joint Venture records Maintained by one of the Co-Venturers
Method 2: Joint Venture records Maintained by all Co-Venturers
Method 3: Memorandum Method (only own joint venture records are maintained by each co-venturer.

METHOD 1: JOINT VENTURE RECORDS MAINTAINED BY ONE OF THE CO-VENTURER

- In this method one co-venturer is assigned with the responsibility to record the joint venture transactions.
- He opens the joint venture account and personal account of all other co-venturers in his books.
- The personal accounts of other co- venturers are prepared to find out the amount due to or from them.
- This method of recording is followed when the business is not too big.
- As each co-venturer is also entitled to carry on his own business and these transactions will be in addition to what he records in respect of his own business.
- Generally an additional commission is paid to the co-venturer who maintains the books of joint venture.

The following Journal entries are passed in the books of co-venturer appointed to maintain the books of joint venture:

S. No	Transaction
1.	**When the co-venturers send their contribution** Cash/Bank A/C .... Dr To Co-venturer's Personal A/c
2.	**When the goods are purchased for the joint venture:** Joint Venture A/c .... Dr. To Cash/Bank A/c
3.	**When the goods are supplied from his own stock by the Co-venturer who is recording the transactions:** Joint Venture A/c Dr. To Purchases A/c (Purchases Account is credited because the co-venturer who is maintaining records is supplying the goods from his own stock at cost. But if the goods are supplied by him at a price other than the cost price, the Sales Account shall be credited instead of the Purchases Account.)
4.	**When the goods are supplied by other Co-venturers:** Joint Venture A/C Dr.

	To Co-venturer's Personal A/c
5.	**When some expenditure is incurred on account of the joint venture:** Joint Venture A/c Dr. To Cash/Bank A/c But, if expenses are paid by a Co-venturer other than the one who is recording the transactions, then the entry will be: Joint Venture A/c Dr. To Co-venturer's Personal A/c
6.	**When the Co-venturer recording the transactions sells the goods:** **a) For cash sales:** Cash/Bank A/c Dr. To Joint Venture A/c **b) For credit sales:** Debtor's Personal A/c Dr. To Joint Venture A/c
7.	**When cash is received from debtors:** Cash/Bank A/c Dr. To Debtor's Personal A/c
8.	**When cash discount is allowed to the debtor, or if bad debts are incurred:** Joint Venture A/c Dr. To Debtor's Personal A/c
9.	**When sales are made by other Co-venturers:** Co-venturer's Personal A/c Dr. To Joint Venture A/c
10.	**When some cash or bills receivable are received from other co- venturers on account of sales made by them:** Cash/Bank/Bills Receivable A/c Dr. To Co-venturer's Personal A/c
11.	**When the Co-venturers recording the transactions is entitled to some commission or salary:** Joint Venture A/c Dr. To Commission/Salary A/c

12.	**When the unsold stock of joint venture is taken over by the co- venturer recording the transactions:** Purchases A/c Dr. To Joint Venture A/c **If the unsold stock is taken over by some other Co-venturer, the journal entry will be:** Co-venturer's Personal A/c Dr. To Joint Venture A/c
13.	**For any Profit or Loss on Closing the Joint Venture:** **a) If it shows profit:** Joint Venture A/c Dr. To Profit & Loss A/c (his own share) To Co-venturers' Personal A/c (individually for their shares) **b) If it results in loss:** Profit & Loss A/c Dr. (his own share of loss) Co-venturers' Personal A/c Dr. (individually for their shares) To Joint Venture A/c
14.	**After closing the Joint Venture Account, if any amount is found to be** **(a) Due to other Co-venturers and such amount is sent to them.** Co-venturers' Personal A/c Dr. To Cash/Bank A/c **(b) Due from other Co-Venturers and such amount is received** Bank A/C Dr To Co-Venturers' Personal A/c

ILLUSTRATION 2:

Madhu and Mallika entered into a joint venture in which Madhu would manage the business. They contributed ₹ 10000 each for the joint-venture. Madhu purchased goods worth ₹ 19000 and sold them for ₹ 25000. Expenses on the venture paid by her amounted to ₹ 1000. Madhu would get a commission of 4% on sales. They shared profits and losses equally. Pass journal entries and prepare ledger accounts in the books of Madhu

SOLUTION:

Books of Madhu
Journal Entries

S. No	Particulars	Dr	Cr
1.	Bank A/C.................. Dr	10000	

	To Mallika's A/c (Amount received from Mallika as her share of Investment)		10000
2.	Joint venture A/C Dr To Bank A/C (Bought goods for the Joint Venture)	19000	19000
3.	Joint Venture A/C Dr To Bank A/C (Expenses paid for the venture)	1000	1000
4.	Bank A/C Dr To Joint Venture (Amount of Cash Sales)	25000	25000
5.	Joint Venture A/C Dr To Commission A/C (4% commission on sales)	1000	1000
6.	Joint Venture A/C Dr To Profit & Loss A/C To Mallika's A/C (profit from joint venture shared equally between Madhu and Mallika	4000	2000 2000
7.	Mallika's A/C Dr ToBank A/C (Payment made on Final settlement	12000	12000

Dr **Joint Venture A/C** **Cr**

Particulars	**Amount**	**Particulars**	**Amount**
To Bank A/C (purchases) To Bank A/C (expenses) To Commission (4% on Sales) To Mallika (Share of Profit) To Profit & Loss A/C (half share)	19000 1000 1000 2000 2000	By Bank (Sales)	25000
	25000		25000

Dr **Mallika's A/C** **Cr**

Particulars	**Amount**	**Particulars**	**Amount**

To Bank A/C	**12000**	**By Bank A/c** **By Joint Venture A/C**	**10000** **2000**
	12000		**12000**

SAQ 3

Aarly and Abbas entered into a joint venture agreement to share profits and losses in the ratio of 3:2. On 4th January 2020 Abbas purchased goods worth ₹ 90000 and spent ₹ 3000 as expenses. On the same date he sent to Aarly part of these goods costing ₹ 60000.On 7th February 2020 Aarly sent ₹ 45000 to Abbas. On 10 February 2020 he purchased goods costing ₹ 70,000 and sent half of the goods to Abbas. he paid ₹ 1500 as a carriage. on 24th March 2020 Abbas sold most of the goods in his possession for ₹ 22500 and the remaining goods costing ₹ 45000 were taken over by him at an agreed price of ₹ 6000.On 18th April 2020 Aarly sold all goods in his possession for ₹ 112500 accept some damaged goods costing ₹ 7500 which it was agreed to be written off as unsaleable. his selling expenses amounted to ₹ 3000. on 30th April 2020 the amount required to settle the accounts between Aarly and Abbas was paid by the concerned party. show the joint venture account and Aarly's account in the books of Abbas.

Hint: No Entry will be passed for damaged goods for which nothing has been realised

METHOD II: JOINT VENTURE RECORDS MAINTAINED BY ALL THE CO-VENTURERS

- Separate Joint Venture account and Co-venturers' Personal accounts of others are opened by each C0-venturer
- Following Journal Entries are passed under this method:

S. No **Journal Entry**

1. **Expenditure incurred or goods supplied by co-venturer himself**

Joint Venture A/C Dr

To Cash A/C (for expenses incurred)

To Purchases A/C (for goods supplied)

2. **Expenditure incurred on goods supplied by other Co-Venturer**

Joint Venture A/C Dr

To Personal A/c of Co-venturer

3. **Advance (Bills Receivable) received from other venture**

Bills Receivable A/C Dr

To Personal A/C of co-venturer

4. **Advance paid to other coventurer (Bills Payable)**

Personal Account of the Co-Venturer A/c Dr
To Bills Payable A/C

5. Discounting of Bills Receivable

Bank A/c Dr
Discount A/C Dr
To Bills Receivable A/C

Transfer of Discount account to Joint Venture Account

Joint Venture A/C Dr
To Personal A/c of Co-Venturere A/c

6. Money received on account of joint venture (own)

Bank A/C Dr
To Joint Venture

Money received on account of joint venture by other coventurer

Personal A/c of the Coventure Dr
To Joint Venture A/C

7. Commission Received on Account of Joint Venture (own)

Joint Venture A/C Dr
To Commission A/c

Commission Received on Account of Joint Venture by other co-venturers

Joint Venture A/C Dr
To Personal A/c of the co-Venturers

8. Unsold Stock taken over (self)

Purchases A/c Dr
To Joint Venture A/C

Unsold Stock Taken over by other co-venturers

Personal A/C of Co-venturers Dr
To Joint Venture A/C

9. Profit on Joint venture shared among co-venturers

Joint Venture A/C Dr
To Profit & Loss A/C (own share)
To Personal A/c of Co-Venturers (share of other co-venturers)

Loss on joint venture

Profit & Loss A/C Dr (own share)
Personal A/c of Co-Venturers Dr (share of other co-venturers)
To Joint Venture A/C

ILLUSTRATION 3

Das and Roy entered into a joint venture to construct a building for ₹ 240000 they provide the following information regarding the expenditure incurred by them materials: Das ₹ 68000 and

Roy ₹ 50000, construction material: Das ₹ 13000 and Roy ₹ 17000, wages: Roy ₹ 27000, Architects fees: Das ₹ 10000, Roy incurred licence fees ₹ 5000 and plant ₹ 20000.
Plant was revalued at ₹ 10000 at the end of the contract and Roy agreed to take it at this value. a contract of ₹ 240000 was received by Das.
Prepare joint venture account and Roy's account in the books of Das and Das account in the books of Roy.

Solution:

IN THE BOOKS OF DAS

Dr **Joint Venture A/C** **Cr**

Particulars	Amount ₹	Particulars	Amount ₹
To Bank A/C:		By Bank A/C	240000
Material	68000	By Roy's A/C (Plant taken Over)	10000
Construction Material	13000		
Architect's Fee	10000		
To Roy's A/C			
Material	50000		
Construction Material	17000		
Wages	27000		
License Fees	5000		
Plant	20000		
To Profit on Venture			
Profit and Loss A/C	20000		
Roy's A/C	20000		
	250000		**250000**

Dr **Roy's A/C** **Cr**

Particulars	Amount	Particulars	Amount
To Joint Venture A/C	10000	By Joint Venture A/C (expenses incurred)	119000
To Bank A/c (final settlement)	129000	By Profit on Venture	20000
	139000		139000

IN THE BOOKS OF ROY

Dr **Joint Venture A/C** **Cr**

Particulars	Amount	Particulars	Amount
To Das's A/C:		By Bank A/C	240000
Material	68000	By Plant A/C	10000
Construction Material	13000		
Architect's Fee	10000		
To Bank A/C			
Material	50000		
Construction Material	17000		
Wages	27000		
License Fees	5000		
Plant	20000		
To Profit on Venture			
Profit and Loss A/C	20000		
Das's A/C	20000		
	250000		**250000**

Dr **Das's A/C** **Cr**

Particulars	Amount	Particulars	Amount
To Joint Venture A/C	240000	By Joint Venture A/C (expenses incurred)	91000
		By Profit on Venture	20000
		By Bank A/C (final settlement)	129000
	240000		240000

METHOD: III MEMORANDUM METHOD

In the previous method, all co-venturers record all transactions relating to joint venture, in their books. . But, under the Memorandum Joint Venture Account Method each co-venturer records only those transactions that are concerned with him related to the joint venture. Under this method, each Co-venturer opens a Joint Venture Account including the name of the other Co-venturer. Memorandum Joint Venture Account is prepared exactly like Joint Venture A/c.

Let us assume that a joint venture agreement is entered into between A and B.

Journal Entries in their books are passed as follows:

S. No JOURNAL ENTRIES

1. A purchases goods for cash:

This transaction shall be recorded in the books of A only.

Joint Venture with B A/c Dr.

To Cash A/C

2. A incurs some expenditure on account of the joint venture:

It shall be recorded in A's books only.

Joint Venture with B A/c Dr.

To Cash A/c

3. B sells goods for cash:

No entry will be made in A's books. But the following entry will be made in B's books:

Cash Account Dr.

To Joint Venture with A A/c

4. B sends money to A:

It shall be recorded in B's books as follows:

Joint Venture with A A/c Dr.

To Cash/Bank A/c

It shall be recorded in A's books as follows:

Cash/Bank A/c Dr.

To Joint Venture with B A/c

5. For Profit or Loss on Joint Venture

Each Co-venturer will record only his share of profit or loss profit, the entries shall be:

For Profit

In the books of A

Joint Venture with B A/c Dr.

To Profit & Loss A/c

In the books of B

Joint Venture with A A/c Dr.

To Profit & Loss A/c

For Loss

In the books of A

Profit and Loss A/c Dr.

To Joint Venture with B A/c

In the books of B

Profit & Loss A/c Dr.

To Joint Venture with A A/C

At the end, each joint venture account with C-Venturers' is balanced and settlement is made by paying or receiving cash.

ILLUSTRATION 4

Pandey and Prakash enter into a joint venture sharing profits and losses equally. Pandey purchased goods for ₹. 5,000 for cash on January 1, 2019. On the same day Bought goods for ₹ 10,000 on credit and spend ₹ 1,000 on freight etc. Further expenses were incurred as follows: On 1.2.2019, ₹ 1,500 by Pandey, On 12.3.2019 ₹ 500 by Pandey. Sales were made by each one of them as follows:

15.1.2019	₹ 3,000 by Pandey
13.1.2019	₹ 6,000 by Prakash
15.2.2019	₹ 3,000 by Pandey
1.3.2019	₹ 4,000 by Prakash

Creditors for goods were paid as follows
1.2.2019 ₹ 5,000 by Pandey
1.3.2019 ₹ 5,000 by Prakash
On March 31, 2019 the balance of stock was taken over by Prakash at ₹ 9,000. The accounts between the co-venturers were settled by cash payment on this date. The co-venturers are entitled to interest at 12% per annum. Prepare necessary ledger accounts in the books of Co-venturers as per Memorandum Joint Venture Account Method.

Solution:

BOOKS OF PANDEY

Dr. Memorandum Joint Venture A/C Cr

Particulars	**₹**	**Particulars**	**₹**
To Pandey (cost of goods)	5,000	By Pandey (sales)	6,000
To Prakash (Cost of goods)	10,000	By Prakash (sales)	10,000
To prakash (Freight etc.)	1,000	By Prakash (interest)	50
To Pandey (expenses)	500	By Pandey (stock taken)	9,000
To Prakash (expenses)	1,500		
To Pandey (interest)	135		
To Profit transferred			
Pandey : 3457			
Prakash : 3458	6,915		
	25,050		25050

Dr. Joint Venture with Prakash A/C Cr

Date	**Particulars**	**₹**	**Date**	**Particulars**	**₹**

1.1.2019	To Bank A/c (Purchase)	5,000	15.1.2019	By Bank A/c (Sales)	3,000
1.2.2019	To Bank A/c (Creditors)	5,000	15.2.2019	By Bank A/c (Sales)	3,000
1.3.2019	To Bank A/c (Expenses)	500	15.3.2019	By Bank A/c	8,902
31.3.2019	To Interest a/c	135			
31.3.2019	To Profit & Loss A/C	3,457			
		14,092			14,902

BOOKS OF PRAKASH

Dr. **Joint Venture with Pandey A/C** **Cr**

Date	**Particulars**	**₹**	**Date**	Particulars	**₹**
1.1.19	To Bank A/c (Freight)	1,000	1.1.19	By Bank (Sales)	6,000
1.2.2019	To Bank A/c (Exp)	1,500	31.3.2019	By Bank (sales)	4,000
1.3.2019	To Bank A/c (Crs)	5,000	31.3.2019	By Goods A/c (Stock taken over)	9,000
31.3.2019	To Profit & Loss A/c	3,458	31.3.2019	By Interest A/C	50
31.3.2019	To Bank (Amount Paid for Final Settlement)	8092			
		19,050			19,050

Working Notes:

Calculation of Interest :

Payment by Pandey

Date	**Amount (₹)**	**Month**	**Product (₹)**
	(a)	(b)	(a)*(b)
1.1.2019	5,000	3	15,000
1.2.2019	5,000	2	10,000
1.3.2019	500	1	500
			25,000

Interest = 25,500 x 12% x 1/12 = ₹ 255

Receipts by Pandey

Date	Amount (₹)	Month	Product (₹)
	(a)	(b)	(a)*(b)
15.1.2019	3,000	2.5	7,500
15.2.2019	3,000	1.5	4,500
			12,000

Interest = 12,000 x 12% x 1/12 = 120

Net Interest due = 265 - 120 = ₹ 135

Payment by Prakash

Date	Amount (₹)	Month	Product (₹)
1.2.2019	1,500	2	3,000
1.3.2019	5,000	1	5,000
			11,000

Interest = 11,000 x 12% x 1/12 = ₹ 110

Receipts by Prakash

Date	Amount (₹)	Month	Product (₹)
1.3.2019	4,000	1	4,000
			16,000

Interest = 16,000 x 12% x 1/12 = ₹ 160

Net Interest due from B = 160 - 110 = ₹ 50

SAQ 4

D and K entered into a joint venture for the purpose of buying and selling second hand buses.D to make purchases and K to effect sales. The profit or loss was to be shared in 2:1. K remitted a sum of rupees 150000 to D towards the venture. D purchased 5 buses for Rs. 160000 and paid rupees 60,000 for their reconditioning and sent them to Calcutta.Also in Kirtan expense of rupees 5,000 in transporting the buses to Calcutta.

K sold buses for rupees 240000 and retained a fifth bus for himself at an agreed value of rupees 50000. He spent rupees 1000 on insurance, 20000 on garage rent, 2000 on brokerage and 400 on sundry expenses. Assuming the accounts were finally settled, repair the books of accounts using the memorandum method.

(Hint: Profit 59600)

9.7 TREATMENT OF SOME SPECIAL ITEMS

9.7.1 ABNORMAL LOSS:

This loss arises due to some uncontrollable/abnormal/unforeseen events like theft, fire, accident. Etc.. No treatment is done for abnormal loss in preparation of joint venture accounts because the effect of abnormal events is automatically represented into the final profit or loss shown by the joint venture account.

9.7.2 NORMAL LOSS:

This loss occurs due to normal reasons like shrinkage, leakage, evaporation, etc. No treatment is done in the joint venture account but it is adjusted while calculating the value of unsold stock

Value of Closing Stock = (Total Cost/Total Quantity - Normal Loss) X Unsold Stock

9.7.3 INTEREST ON INVESTMENT OR ON AMOUNT RECEIVED:

a. For Interest on investment, following journal entry is passed:

Joint Bank A/C...................... Dr		
To Interest A/C		(Received by self)
To Co-Venturer A/C		(Received by Co-venturer)

b. For interest on amount Received, following Journal Entry is passed:

Interest A/C	Dr	(Self)
Co-Venturer A/C	Dr	(Co-Venturer)
To Joint Venture A/C		

9.7.4 JOINT VENTURE CARRIED FOR MORE THAN ONE ACCOUNTING PERIOD:

In this case:

a) Stock should be valued on the basis of basic cost plus proportionate non recurring expenses and it should be shown in the memorandum joint venture account on the credit side at the end of the year and On the debit side of the memorandum joint venture account of the next year.
b) If the other co venturers are interested in interim settlement at the end of the first year, they should bring in the proportionate share in the value of closing stock, in their respective joint venture with co venturer account and finally settle their accounts.

9.7.5 STOCK IN HAND:

a) When the accounts are to be balanced at an interim stage, stock in hand is to be taken into account in order to calculate the correct profit and the amount due by one Co-venturer to other.

b) Is to be carried down in a joint venture account to calculate correct profit and the Co-venturers share in it.

c) The stock in hand is brought down as opening stock in joint venture account for the subsequent accounting period.

d) Is a portion to each venturer in the profit sharing ratio carried down in each party's personal account. The balance of personal account now shows the amount due to or from the other Co-venturer.

9.8 TEST YOUR KNOWLEDGE:

9.8.1 SHORT ANSWER TYPE QUESTIONS

1. Define Joint Venture
2. Why joint bank Account is opened?
3. What is the treatment of Abnormal Loss and Normal Loss?
4. What is the treatment of Bill Discounting in Joint Venture Accounts?
5. What accounts are opened when separate books of accounts are maintained for joint Venture?
6. Write a note on Memorandum Joint Venture Account.

9.8.2 LONG ANSWER TYPE QUESTIONS

1. Differentiate between:
   a. Joint Venture and Partnership
   b. Joint Venture and Consignment
2. What are the different Methods of recording Joint Venture Transactions?
3. What do you understand by Joint Ventures? What are its features? What are its Advantages?
4. Explain briefly various methods of recording the joint venture transactions without maintaining separate set of books.

9.8.3TEST YOUR UNDERSTANDING

1. A and B entered into joint venture to consign 100 bales of cotton piece and hired a commission agent Red to be sold later on the joint risk of A and B, sharing in proportion of 3/5 and 2/5 respectively in September 2020. A sends 60 bales at Rs. 1,300 each and pays for freight and other charges Rs. 900. B sends 40 bales at Rs. 1,250 each and pays for freight and other charges Rs. 800. All the bales are sold by broker for Rs. 150,000 out of which deducted Rs. 1,500 for his expenses and his commission at 3 % and balance remitted to consignors.
   You are required to pass necessary journal entries, joint venture account and prepare co-venturers' accounts.
   (Ans: Profit: 14300)

2. X and Y entered into Joint Venture to sell a consignment of timber sharing profits and losses equally. X provides timber from stock at mutually agreed value of Rs. 50000. He pays expenses amounting to Rs. 2500. Y incurs further expenses on cartage, storage and carriage of Rs. 6500 and receives cash for sales Rs. 30,000. He also takes over goods to the value of Rs. 10000 for his own use. At the close, X takes over the balance stock in hand which is valued at Rs. 11000. Pass Journal Entries to record the above transactions and open the necessary ledger accounts in the books of X and Y.
   (Profit: 8000)
3. A and B entered into a Joint venture involving the buying and selling of a sewing material with an agreement to share profit or losses in the ratio of 3:2. The cost of the material purchased was Rs. 30,000 which was paid by A, who drew a bill of Rs. 20,000 on B at three months' period. The bill was discounted by A at cost of Rs. 160. The transactions relating to the ventures are:
   i) A paid Rs. 200 for carriage, Rs. 600 for commission on sales and Rs. 100 for travelling expenses
   ii) B paid Rs. 80 for travelling expenses and Rs. 120 for sundry expenses
   iii) Sales made by A amounted to Rs. 21,400 less allowance for faulty goods Rs. 400
   iv) Sales made by B were Rs. 15,000.
   The remaining goods were retained by A and B for their private use and these were charged to them as Rs. 1600 and Rs. 2400 respectively. A was credited with a sum of Rs. 300 to cover the cost for warehousing and insurance. The expenses in connection with the discounting to the bill were to be treated as a charge against the venture. Prepare the ledger accounts in the books of both the parties and also the memorandum joint venture account.
   (Profit: 8440)

4. A and B enter into a Joint Venture for the construction of a building for a joint stock company. The contract price is Rs. 2,00,000. Incidental expenses paid by the co-venturers will be reimbursed to the extent of actual expenditure or Rs. 10,000 whichever is less. A spends Rs. 18,000 and B Rs. 12,000. The profits and losses are to be shared equally, but B, being a technical person, is entitled to a commission of 10% on the profit of the venture after charging such commission. Joint Bank Account is opened wherein A deposits Rs. 55,000, B Rs. 45,000 and C Rs. 30,000. B gives his own plant to the venture for Rs. 16,000. Materials worth Rs. 40,000 and wages of Rs. 60,000 are paid out of the Joint Bank Account.

   On completion of the contract, the company paid the agreed contract price (keeping Rs. 20,000 as retention money). The contract price was paid Rs. 60,000 in cash and the balance in equity shares of the company of Rs. 10 each at an agreed value of Rs. 12 per share. The shares were subsequently sold in the market @ Rs. 13 per share. A took over the unused materials at Rs. 2,000. B took over the plant at an agreed value of Rs. 4,000

and the retention money was taken over by B at Rs. 14,000. Show necessary ledger accounts in the books of the joint venture.
(Profit: 60000)

5. Pammy and Qureshi entered into a joint venture to construct a building for Joint stock company at a contract price of Rs. 12,50,000, payable Rs.1,00,000 in cash and Balance in the form of Fully paid up shares of the company. They opened a joint bank Account, wherein Pammy deposited Rs. 300000 and Qureshi deposited Rs. 150000.and decided to share profits and losses in the ratio of 3:2. Pammy and Qureshi bought material for Rs. 150000 in cash and material worth Rs. 500000 on credit from Ramesh. They paid Rs. 225000 for wages and Rs. 35000 for other expenses. Pammy and Qureshi supplied material worh Rs. 100000 and Rs. 40000 respectively. Pammy paid architect fees of Rs. 5000. The contract was duly completed. Ramesh was paid Rs. 490000 in full settlement. Pammy agreed to take up the shares of the company at Rs. 220000. Qureshi took over the remaining material at an agreed value of Rs. 35000.

   Prepare the necessary accounts using suitable method of Joint Venture Accounting.

   (Profit: 210000)

9.9 REFERENCES:

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B. COM

SEMESTER I

COURSE: FINANCIAL ACCOUNTING

UNIT 10: ACCOUNTING FOR INLAND BRANCHES

STRUCTURE

10.0 OBJECTIVES

After reading the chapter the learner should be able to:

1. **Describe the Branch accounting system.**
2. **Identify the types of branches.**
3. **Replicate the methods of maintaining branch accounts according to the types of branches.**
4. **Demonstrate the practical application of these methods in maintaining the books of accounts of Head office and Branch**

10.1 INTRODUCTION

The world has become a global village. Businesses nowadays are not confined to local, national or International boundaries. Whenever a business wants to tap more customers and these customers are scattered all over and cannot be tapped from one place, then it thinks of expanding to various places may be nationally or internationally. This can be achieved by carrying on the business from different establishments which may be in the same town, same city or from various parts of the country or even from distant countries of the world. The main establishment is called the Head office and the other establishments are called Branches.

Branches are opened to increase a sale in various areas which cannot be directly served from head office. invests funds to set up and run the branches. The profit of the branch belongs to the head office. The basic purpose of branch accounting is to ascertain the branch income, branch expenses, branch assets and branch liabilities. The branch accounts help the head office. to decide whether a particular branch is earning profits and should be continued.

Depending on the location, the Branches can be classified as:

1. Inland Branches: These are the branches that are situated within the territories of a country.
2. Foreign Branches: These are situated outside the country.

Branches, whether Inland or Foreign, are essentially a part of Head Office. The results of the head office cannot be calculated without clubbing it with branch results.

The Branch results consist of:

(i) Profit or Loss made by the Branch and

(ii) Assets and Liabilities at the end of the period

10.2 OBJECTIVES OF BRANCH ACCOUNTING

The objectives branch accounts are dependent on the nature of the business and specific requirements of a particular branch. The main objectives of Branch Accounting are:

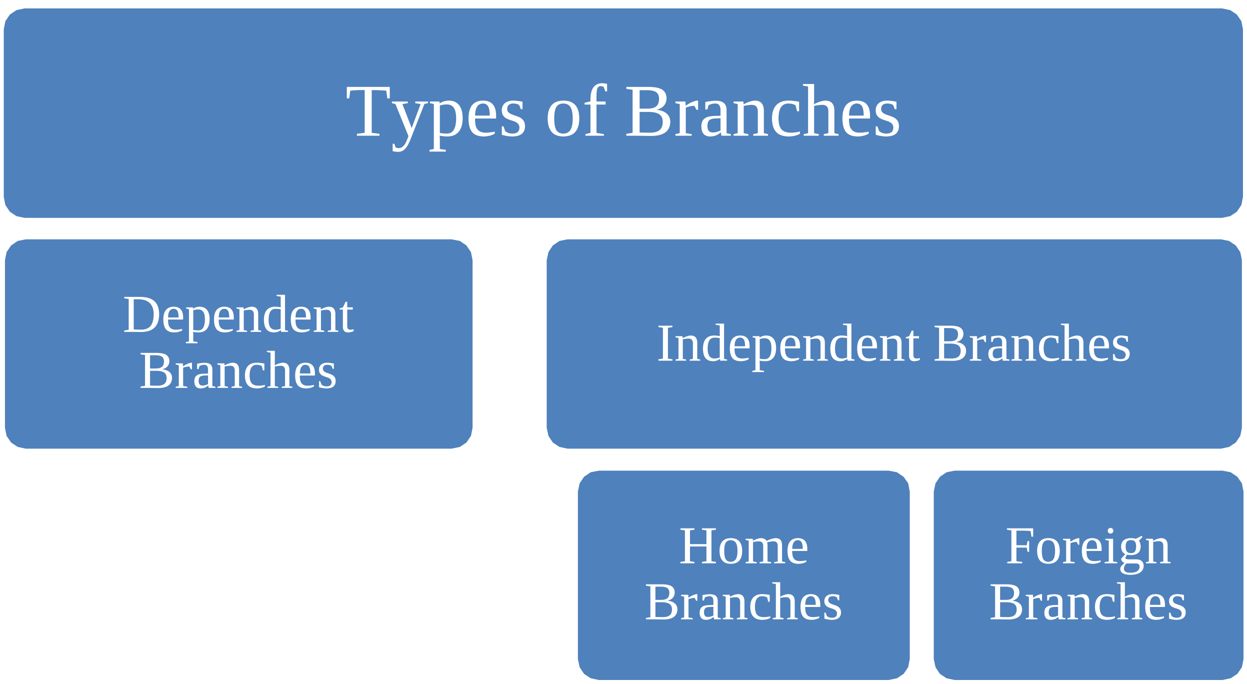
i) To know the profit or loss of each branch separately.

ii) To ascertain the financial position of each branch on a particular date.

iii) To know the cash and goods requirements of the various branches.
iv) To evaluate the progress and performance of each branch.
v) To calculate commission for payment to the managers, if based on profits of branch.
vi) To know the profitability of each branch and type of business for expansion of the business.
vii) To give concrete suggestions for the improvement in the working of the various branches.

10.3 TYPES OF BRANCHES

Branches are also classified into different types based upon their location, method of accounting, method of pricing goods sent by head office. to branches and so on.



10.3.1 DEPENDENT BRANCHES:

- These are the branches that depend upon the head office for ascertainment of results of operation.
- They do not maintain their own set of books. Head Office maintain the accounts of branches and branches do not maintain accounts.
- Only information relevant to the Branch activities, like, debtors, stock position, cash, etc., is recorded by branches.

10.3.2 INDEPENDENT BRANCHES:

- These branches maintain their own books of accounts and prepare their Trial Balance and ascertain their results through it.

- Independence is just with regards to the maintenance of books of accounts. All policy decisions are taken by the Head Office.

10.3.3 DIFFERENCE BETWEEN DEPENDENT AND INDEPENDENT BRANCH

S.No	Basis	Dependent Branch	Independent Branch
1.	**Meaning**	The branch receives goods from Head Office and selling them according to instructions of it is dependent branch.	The branch receives goods from Head Office and authorised to purchase them independently is independent branch.
2.	**Option to buy**	It cannot buy the goods from market.	It can buy the goods from market.
3.	**Option to Sell**	Sale goods sent by head office and follow the instructions of head office to sell the goods. i.e. on cash or on cash and credit both.	It can sell goods on cash or credit basis as the market condition prevails.
4.	**Expenses**	Head office sends cash to the branch to pay its expenses.	Pay expenses from its own cash balance.
5.	**Remittance of Cash**	Remit cash received, from cash sales or collection from debtors, daily to head office	It is not compulsory to remit cash daily. Cash can be sent to head office as desired by the branch.
6.	**Books of Accounts**	Maintains cash book, sales book, stock register etc.	Prepares own trial balance and final accounts.
7.	**Detailed Reports**	Reports of sales, cash, stock, expenses, etc. sent to head office regularly.	Only the trial balance and final accounts at the end of the year needs to be sent to head office.
8	**Ascertainment of Profit or Loss**	The profit or loss is calculated by preparing branch trading and profit and loss A/c.	The profit or loss is calculated by the branch and remitted to head office at the end of the year.
9	**Preparation of Balance Sheet**	Balance Sheet is not prepared	A combined Balance sheet of branch and head office is prepared by the branch.

10.4 METHODS OF ACCOUNTING

Methods of Accounting

Dependent Branch

- Debtors Method
  - Cost Price Method
  - Invoice Price Method
- Final Accounts System
- Stock and Debtors Method
- Wholesale Branch Method

Independent Branch

- Home Branch
  - Incorporation of Branch
  - Trial Balance in Head Office
    - Detailed Method
    - Abridged Method
- Foreign Branch

10.4.1 METHOD OF ACCOUNTING FOR DEPENDENT BRANCHES:

Since these branches do not keep any account and accounts are maintained by the head office. The system of maintaining accounts depends upon its size and the degree of control it wants to exercise. The head office can maintain its accounts of the Branch in any of the following Methods:

10.4.1.1 DEBTORS SYSTEM

- This method is used in case of concerns which are very small in size.
- For each branch a separate account is opened in the books of head office to record the transactions relating to each branch.
- Branch Accounts so opened are in the nature of Nominal Account.
- This method is further divided into two parts:

(A) Cost Price Method
(B) Invoice Price Method

TREATMENT OF CERTAIN ITEMS:

- **STOCK IN THE BEGINNING AND AT THE END**:
  - Stock in the beginning of the period is shown in the debit side of the branch account
  - Stock at the end of the period is shown on the credit side of the branch account.
  - Stock is shown at the cost price.
- **GOODS SENT TO THE BRANCH:**

- Goods sent to the branch during the year is shown on the debit side of the branch account at the cost price.
- If the goods are returned by branch to the Head office it is shown in the credit side of the Branch Account.

  OR

  It can be shown by way of a deduction from the 'Goods sent to the Branch' on the debit side of Branch Account.

- **BRANCH EXPENSES PAID BY THE HEAD OFFICE:**
  - Branch expenses paid by the Head office are shown in the debit side of branch account.
- **BRANCH EXPENSES PAID BY BRANCH OFFICE:**
  - Expenses paid by the branch do not appear anywhere because they reduce the balance of cash in hand. Reduced balance of cash appears on the credit side of Branch Account.
- **TREATMENT OF BRANCH EXPENSES PAID BY OFFICE WHEN PETTY CASH SYSTEM IS MAINTAINED ON THE IMPREST SYSTEM:**
  - If petty cash is maintained at the branch on the imprest system, then the petty expenses paid by the branch manager are reimbursed by the Head office.
  - These expenses then take the form of expenses paid by the head office and are shown in the debit side of the branch account.
  - The petty cash balance at the end of the period must be shown on the credit side of the branch account at the same figure at which it appeared in the beginning.

- **DEPRECIATION ON THE BRANCH FIXED ASSETS:**
  - Depreciation on the branch fixed asset is not shown anywhere in the branch account.
  - Branch Account is debited with the value of branch fixed asset at the beginning and credited with the value after depreciation of branch fixed asset at the end.
- **BAD DEBTS, DISCOUNT ALLOWED, ALLOWANCES ETC.:**
  - Bad Debts, discount allowed to customers, allowances, returns from customers are not shown in the Branch Account because these accounts reduce the figure of debtors at the end.
- **CASH SALES AND CREDIT SALES:**
  - Cash and credit sales are not shown in the Branch Account.
  - These figures are replaced by remittances.
    Remittances = cash sales + cash received from customers.
- **PURCHASE OF FIXED ASSET:**

- When fixed asset is purchased by the branch book value of the fixed asset increases on the one hand and reduces the remittances (if purchased on cash) or increases the liabilities (if purchased on credit).

- **SALE OF FIXED ASSET BY BRANCH:**
  - The book value of the fixed asset is reduced on the one hand, and on the other hand it increases either the remittances (if the sale is for cash) or increases debtors at the end (if the sale is on credit)

(A) COST PRICE METHOD:

Following Journal Entries are passed under Cost Plus Method:

S. No	Transaction and Journal Entry
1.	**When goods are sent to branch by Head Office** Branch A/c Dr To Goods sent to Branch A/c
2.	**When goods are returned by branch to Head Office** Goods sent to Branch A/c Dr. To Branch A/c
3.	**When goods are supplied by Branch to another Branch at the instructions of Head office** Goods Sent to Branch A/c Dr To Branch A/c
4.	**When cheque is sent to the branch for expenses** Branch A/c Dr To Bank Account
5.	**When cash/cheque is received from the branch for remittances** Bank A/c Dr To Branch Account
6.	**When goods are supplied by Head Office but not yet received by Branch** Goods in Transit A/c Dr To Branch A/C
7.	**When Remittances sent by Head Office but not yet received by Branch** Cash in Transit A/C Dr To Branch A/c
8.	**For Closing Balance of Assets at the Branch** Branch Assets A/c Dr To Branch A/c

9	**For Closing Balance of Liabilities at the Branch** Branch A/c Dr To Branch Liabilities A/c
10.	**For transferring Profit or Loss to the Branch** **For Profit:** Branch A/c Dr To General Profit and Loss A/C **For Loss** General Profit and Loss A/C Dr To Branch A/C
11.	**For Closing Goods Sent to Branch** **For Trading Concerns:** Goods Sent to Branch A/C Dr To Purchases A/c **For Manufacturing Concerns:** Goods sent to Branch A/C Dr To Trading A/c

Dr. **Specimen of Branch A/C** **Cr**

Particulars	Amount	Particulars	Amount
To Balance b/d Cash in Hand Stock (Cost price) Sundry Debtors Fixed Assets Prepaid Expenses To Goods sent to Branch A/c Sent by Head Office Other Branches To Bank A/c (Expenses) To Balance c/d Sundry Creditors Outstanding Expenses To General Profit and Loss A/c (Profit) (Balancing figure)		By Balance b/d Sundry Creditors Outstanding Expenses By Bank A/c (Remittances) Cash Sales Received from Debtors By Goods sent to Branch A/c Returned by branch Returned directly to Head office by debtors By Balance c/d Cash in Hand Stock (Cost price) Sundry Debtors Fixed Assets Prepaid Expenses Goods in Transit Cash In Transit By General profit and Loss	

		A/c(loss) (Balancing Figure)	

ILLUSTRATION 1

Delhi Traders opened a branch at Chandigarh on 1st January 2020. From the following particulars, prepare Chandigarh Branch A/c using Debtor System.

Cash sent to branch for

Rent	₹ 1200
Salaries	₹ 3000
Misc. Expenses	₹ 1200
Goods sent to Branch	₹ 2600
Sales:	
Cash	₹ 10000
Credit	₹ 24000
Cash Received from debtors	₹ 20000
Debtors (at the end)	₹ 4000
Stock (at the end)	₹ 2300
Closing Bal. of Petty Cash	₹40

SOLUTION:

Dr **Chandigarh Branch A/c** **Cr**

Particulars	**Amount**	**Particulars**	**Amount**
To Goods Sent to Branch	20600	By Bank A/c (Remittances)	
To Bank A/c		Cash Sales	10000
Rent	1200	Received from Debtors	20000
Salaries	3000	By Branch Debtors A/C	4000
Misc. Exp	1200	By Branch Stock A/c	2300
To General Profit and Loss		By Branch Petty Cash A/c	40
A/c (Profit) (Bal. Fig)	10340		
	36340		36340

IMPORTANT NOTE: Sometimes it may happen that information relating to remittances from Branch Debtors may be missing in the question. To find out these remittances, Branch Debtors A/c is prepared.

SAQ 1

Akash Traders, Chandigarh opened a Branch at Zirakpur on 1st Jan 2020. The following information is available relating to the Branch for the year ended 2020.

Goods Sent to Branch	₹ 75000	Salaries paid by Head Office	₹ 15000
Cash Sales	₹ 50000	Office Exp. Paid by Head Office	₹ 12000
Credit sales	₹ 60000	Cash Remittances towards petty Cash	₹6000

Petty Cash at Branch on 31.12.2020 ₹ 500 Debtors at Branch on 31.12.20 ₹5000
Stock at Branch on 31.12.20 ₹27000
Prepare the Branch Account to show the Profit or Loss for the year 2020.
(Profit: 29500, Cash Received from Debtors: 55000)

(B) INVOICE PRICE METHOD

- Sometimes the head office may send goods at a price higher than the cost price.
- The price higher than the cost price is generally termed as invoice price.
- The difference between the invoice and the cost price is the loading.
- Invoice Price (Cost to Branch) = Cost of Head office + Mark up (Loading)
- In this case three additional entries are also to be passed in addition to the usual entries.

(i) To remove loading on opening stock

Stock reserve A/C Dr
To Branch A/C

(ii) To remove loading in goods sent to branch

Goods sent to branch Ac Dr
To Branch a/c

(iii) To remove loading on closing stock

Branch A/c Dr
To Stock Reserve A/c

Under this method, Branch A/C in the books of Head Office will appear as under:

Dr. Branch A/C Cr

Particulars	Amount	Particulars	Amount
To Balance b/d		By Balance b/d	
Cash in Hand		Sundry Creditors	
Stock (Invoice price)		Outstanding Expenses	
Sundry Debtors		By Bank A/c (Remittances)	
Fixed Assets		Cash Sales	
Prepaid Expenses		Received from Debtors	
To Goods sent to Branch less		By Goods sent to Branch A/c	
Returns (at Invoice Price)		(Returns at Invoice Price)	
To Bank A/c (Expenses)		By Balance c/d	
To Balance c/d		Cash in Hand	

Sundry Creditors Outstanding Expenses To Stock Reserve (loading on Closing Stock) To General Profit and Loss A/c (Profit) (Balancing figure)		Stock (Invoice price) Sundry Debtors Fixed Assets Prepaid Expenses Goods in Transit Cash In Transit By Goods sent to Branch (Loading) By Stock Reserve (Loading on Opening Stock) By General profit and Loss A/c(loss) (Balancing Figure)	

ILLUSTRATION 2:

Bata shoes Company has a branch in Chandigarh. Shoes are invoiced to Chandigarh Branch @20% profit on sales. Branch is instructed to remit cash to head office on daily basis. All expenses are met by head office except the petty expenses, which are met by the branch manager. From the details given below, prepare Branch A/c in the books of Bata Shoes Company:

Stock on 1st Jan 2020(invoice price)	15000
Sundry debtors on 1st Jan 2020	9000
Cash in hand on 1st Jan 2020	400
Office furniture on 1st Jan 2020	1200
Goods invoiced from the head office (invoice price)	80000
Goods returned to head office	1000
Goods returned by debtors	400
Cash received from debtors	30000
Cash sales	50000
Credit sales	30000
Discount allowed to debtors	30
Expenses paid by the head office	
Rent	1200
Salary	2400
Stationery	300
Petty expenses paid by the manager	280
Depreciation is to be provided on branch furniture at 10% p.a	
Stock on 31st December 2004 at invoice price	14000

SOLUTION:

Dr **Branch A/C** **Cr**

Particulars	**Amount**	**Particulars**	**Amount**
To Balance b/d		By bank remittances(cash sales+ amount received from debtors)	80000
Stock	15000	By balance:	
Debtors	9000	Stock	14000
Cash	400	Debtors	8490
Furniture	1200	Cash	120
To Goods Sent to Branch 80000		Furniture	1080
Less returns 1000	79000	By Stock reserve (Op. Stock)	3000
To Bank (Expenses)		By Goods sent to branch	15800
Rent	1200		
Salary	2400		
Stationary	300		
ToStockreserve (Closing Stock)	2800		
To Profit	11190		
	122490		122490

Dr **Debtors A/C** **Cr**

Particulars	Amount	Pariculars	Amount
To balance b/d	9000	By cash	30000
To sales credit	30000	By returns	480
		By discount	30
		By balance b/d	8490
	39000		39000

WORKING NOTES:

1. Loading on Closing Stock
   14000 x 20/100 = 2800
2. Loading on Opening Stock
   15000 x 20/100 = 3000
3. Goods sent to Branch
   79000 x 20/100 = 15800

10.4.1.2 STOCK AND DEBTORS METHOD

Under this method, the Head Office maintains for every Branch:

(i) Branch Stock A/c: This account records the physical flow of goods between Head office and Branch at Invoice Price. Sales are recorded at Selling Price.

(ii) Branch adjustment account: This account is a nominal account and calculates the gross profit or loss earned by branch. It records loading on opening stock, goods sent to branch, goods returned and closing stock. If the branch sells goods at a price different from the invoice price, then the difference between invoice price and selling price is also transferred to adjustment account.

(iii) Branch profit and loss account: This account is also a nominal account and calculates the net profit or loss earned by a branch. Sometimes separate profit and loss account is not prepared, in such case branch adjustment account is divided is divided into two parts, to calculate gross profit and net profit.

Apart from these following accounts are also maintained by head office in the usual manner as per double entry system

(iv) Branch Debtor A/c
(v) Branch expenses account
(vi) Branch cashaccount
(vii) Branch fixed asset account
(viii) Goods Sent to Branch A/c

Following Journal Entries are passed under this method:

S. No	Transaction and Journal Entry
1.	**For goods supplied to branch by Head Office** Branch Stock A/c Dr To Goods Sent to Branch (at invoice price of goods sent)
2.	**Goods returned by Branch to Head office** Goods sent to Branch A/c Dr To Branch Stock A/c
3.	**For Goods returned by Debtors to Branch** Branch Stock A/c Dr To Branch Debtors A/c
4.	**Return of goods by the customers (cash or credit) directly to head office** Goods sent to Branch A/c Dr To Branch Debtors or Cash A/c
5.	**Cash sales made by Branch** Branch Cash A/c or Bank A/c Dr To Branch Stock A/c (with Selling Price)

6.	**Credit Sales made by Branch** Branch Debtors A/c Dr To Branch Stock A/c
7.	**Mark-up/Loading on opening stock** Stock Reserve A/c Dr To Branch Adjustment A/c
8.	**Mark-up/Loading on Closing stock** Branch Adjustment A/c Dr To Stock Reserve A/c
9.	**Mark-up/Loading on Goods sent to Branch** Goods sent to branch A/c Dr. To Branch Adjustment A/c
10.	**Mark-up/Loading on Goods returned to Head Office** Branch Adjustment A/c Dr To Goods sent to Branch
11.	**Goods sold at a price more than the invoice price** Branch Stock A/c Dr To Branch Adjustment A/c
12.	**Goods sold at a price less than the invoice price** Branch Adjustment A/c Dr To Branch Stock A/c
13.	**Cash received from branch debtors by branch** Branch Cash/Bank A/c Dr To Branch Debtors A/c
14.	**For Bad debts, discount allowed to customers** **Bad Debts** Branch Bad debts A/c Dr To Branch Debtors A/c **Discount allowed** Discount Allowed A/C Dr To Branch Debtors A/c
15.	**Remittances from Head office to Branch** Branch Cash/Bank A/c Dr To Cash/Bank A/c
16.	**Remittance from Branch to Head office** • No entry • Entry for cash received by Head office from branch is passed which is similar to cash remitted if there is no cash in transit Cash/Bank A/c Dr To Branch Cash/Bank A/c

17.	**Expenses incurred by Branch** Branch Expenses A/c Dr To Branch Cash/Bank A/c
18.	**Transferring direct expenses to branch adjustment A/c** Branch Adjustment A/c Dr To Branch Expenses A/c
19.	**Transferring Indirect Expenses of branch to Profit and Loss A/c** Branch Profit & Loss A/c Dr To Branch Expenses A/c
20.	**Shortage in Branch stock account (normal)** Branch Adjustment A/c Dr To Branch Stock A/c **Shortage in Branch stock account (abnormal)** Branch Adjustment A/C Dr (with loading) Branch Profit and Loss A/c Dr (with cost price) To Branch Stock A/c
21.	**Transferring gross profit/gross loss in branch Adjustment to Branch Profit & Loss Account** **For gross profit** Branch Adjustment A/c Dr To Branch Profit & Loss A/c **For Gross Loss** Branch Profit and Loss A/c Dr To Branch Adjustment A/c
22.	**Transferring of Net profit or loss to general Profit & Loss Account** **For Net Profit** Branch Profit & Loss A/c Dr To General Profit & Loss **For Net loss** General Profit & Loss A/c Dr To Branch Profit & Loss A/c
23.	**Closing goods sent to Branch** Goods sent to Branch A/c Dr To Trading a/c/Purchases A/c

ILLUSTRATION 3:

From the following information, calculate the branch profits applying stock and debtors' method

Opening branch stock rupees 15000, opening branch debtors rupees 5000, goods sent to branch rupees 80000, Cash sent for expenses rupees 4000, cash sales rupees 25000, credit sales rupees 55000(including invoice price of rupees 5000), goods returned by branch to head office rupees 5000 goods received from other branches rupees 15000 actual branch expenses rupees 3800 discount allowed to Branch debtors rupees 1000, cash received from branch rupees 73000 and closing branch cash rupees 200. Goods are invoiced to branch at cost plus 25%

SOLUTION:

Dr **Branch Stock A/c** **Cr**

Particulars	**Amount**	**Particulars**	**Amount**
To Balance b/d To Goods sent to branch To Goods Received from other branch To Branch Adjustment A/c (Surplus)	15000 80000 15000 5000	By Branch Cash A/c By Branch debtors By Goods sent to Branch By Balance c/d	25000 55000 5000 30000
	115000		115000

Dr **Branch Debtors A/c** **Cr**

Particulars	**Amount**	**Particulars**	**Amount**
To Balance b/d To Branch Stock	5000 55000	By Discount Allowed By Branch Cash (transfer) By Balance c/d (Bal. Fig.)	1000 48000 11000
	60000		60000

Dr **Branch Cash A/c** **Cr**

Particulars	**Amount**	**Particulars**	**Amount**
To Cash A/c To Branch stock A/C To Branch Debtors A/c (Bal. Fig)	4000 25000 48000	By Branch expenses By Cash (remittance) By Bal C/d	3800 73000 200
	77000		77000

Dr	Branch Adjustment A/c		Cr
Particulars	**Amount**	**Particulars**	**Amount**
To Goods Sent to Branch (loading) (⅕ of 5000)	1000	By Stock Reserve (⅕ of 15000)	3000
To Stock Reserve (⅕ of 30000)	6000	By goods sent to Branch (loading) ⅕ of (80000+15000)	19000
Branch Profit & Loss A/c (Gross Profit)	20000	By Branch Adjustment A/c (Surplus)	5000
	27000		27000

Dr	Branch Profit & Loss A/c		Cr
Particulars	**Amount**	**Particulars**	**Amount**
To Discount Allowed	10000	By Branch Profit & Loss A/c (Gross Profit)	20000
To Branch expenses	3800		
To General Profit & Loss A/c	15200		
	20000		20000

SAQ 2

Rama Company of Calcutta started a branch in Chandigarh, to which goods were sent at 20% above cost. The branch makes both cash sales and credit sales. Branch Expenses are met from cash with branch and balance cash is remitted to Head office. Other information includes: Cost of goods sent to branch ₹ 100000, Goods received by branch till the end of the year at an invoice price ₹108000, credit sales ₹116000, Closing debtors ₹ 41600, Bad debts written off ₹400, Cash remitted to head office ₹ 86000, Closing balance of Cash ₹4000, Goods remitted to Head office during the year ₹6000, Closing Stock at branch at invoice price ₹ 24000.

Prepare necessary accounts as per stock and debtors method

(Ans: Cash Sales ₹34000, Gross Profit ₹70000, Net Profit ₹45600

10.4.1.3 FINAL ACCOUNTS SYSTEM

(A) COST BASIS

- In this method, the profit or loss of the branch is calculated by preparing the Trading and Profit & Loss A/c.

- These accounts are not made as the part of main accounting system and are prepared on memorandum basis.
- Hence, these accounts cannot be incorporated in the books of head office.
- Memorandum trading and Profit & Loss A/c is prepared on cost basis of stock to head office as well as goods transferred to or from head office.
- It means, if opening stock, closing stock or goods transferred to or from branch are given at the invoice price, we need to remove loading from these balances to arrive at cost price.
- Branch account under this method is a Personal Account.
- The account under this method is prepared in the same manner as under debtors system, with the difference that profit or loss is calculated by preparing Memorandum account and the final balance in the branch account is the balancing figure of branch account.

ILLUSTRATION 4:

Shobha and associates of Patiala transfer goods to its Pune Branch at its cost. The Head office remits all the expenses of the branch. Branch sell the goods at the instruction of Head office at a margin of 20% on invoice price. All cash collections are remitted to head office on weekly basis. Following information is available :

Opening Balances:

Stock at Branch	₹10000
Debtors at Branch	₹7000
Branch Furniture	₹10000
Petty Cash	₹1000

Other Transactions:

Goods sent to branch	₹100000
Cash sent to branch for expenses	₹5000
Cash Sales at Branch	₹42000
Credit sales at branch	₹72000
Cash received from debtors	₹38000
Bad Debts at branch	₹3000
Cash remitted by branch to head office	₹80000
Petty cas expenses at branch:	₹300

Closing Balance:

Stock at Branch	₹15000
Debtors at branch	₹38000

Depreciation on branch furniture is charged @10%. Prepare the necessary accounts using final accounts.

SOLUTION:

Dr **Branch Accounts** **Cr**

Particulars	Amount	Particulars	Amount
To Balance b/d		By Cash A/c	80000
To Branch Stock A/c	10000	By Bal c/d	
To Branch Debtors A/c	7000	Closing Branch Stock	15000
To Branch Furniture A/c	10000	Closing Branch Debtors	38000
To Petty Cash	1000	Closing Branch Furniture	9000
To Goods sent to Branch A/c	100000	Closing Balance petty cash	700
To Cash A/c	5000		
To Profit & Loss A/c (W. note 1)	9700		
	142700		142700

WORKING NOTE 1:

Dr **Memorandum Trading and Profit & Loss A/c** **Cr**

Particulars	Amount	Particulars	Amount
To Opening Stock	10000	By Sales A/c	114000
To Goods sent to Branch	100000	By Closing Stock	15000
To Gross Profit	19000		
	129000		129000
To Branch Expenses	5000	By Gross profit b/d	19000
To Bad debts	3000		
To Depreciation on furniture	1000		
To Petty Expenses	300		
To Net Profit	9700		
	19000		19000

SAQ 3 A merchant at Manali has a branch at Shimla to which he charges goods at cost plus 25%. The Shimla branch keeps its own sales ledger and transmits all cash received to the head office every day. All expenses are paid from the head office. The transactions for the branch are as follows:

Stock on 1-1-2020	₹22,000	Bad debts	₹600
Debtors on 1-1-2020	₹200	Allowance to customers	₹500

Petty cash on 1-1-2020	₹200	Returns inward	₹1,000
Sales (cash)	₹5,300	Cheques sent to branch:	
Goods sent to branch	₹40,000	Rent	₹1,200
Collection on ledger account	₹42,000	Wages	₹400
Goods returned to Head office	₹600	Salary and other expenses	₹1,800
Stock 31-12-2020	₹26,000	Debtors on 31-12-2020	₹4,000
Petty cash on 31-12-2020 include miscellaneous income of ₹50 not remitted			₹250
Ans: Net Profit: 19430, Branch A/c: 47300			

(B) WHOLESALE PRICE BASIS:

- Head office sends the goods to the Branch at a wholesale price, which the manufacturer transfers to the retailer.
- Branches in turn sell the goods to the customers at list price which is more than the wholesale price.
- Difference between the wholesale price at which the goods are received by these retail branches and the retail prices is profit earned by retail branches.
- This system is followed when a branch is treated as a profit centre.
- The real cost of the branch is wholesale price of the goods sent. But, wholesale price is also fixed at above cost. So if all goods are sold by the branch, then there is no problem. But the stock that remains unsold includes an element of profit made by the head office.
- To calculate the actual profit earned, the value of unsold stock with the branch is to be reduced from wholesale price to cost price.
- The following additional Journal Entries are passed:

  Profit & Loss A/c Dr (Whole sale price - cost Price)
  To Stock Reserve A/c

  Branch stock will be shown after deducting stock reserve.
  At the beginning of next year, reverse entry is passed.

IMPORTANT POINTS:

- Branch trading account is debited with the opening stock at invoice price.
- Branch trading account is credited with the retail price of goods sold.
- Branch Trading account is credited with closing stock at branch at invoice price (wholesale price)
- If any opening stock or closing stock is lying at the branch, the stock reserve account is opened.

ILLUSTRATION 5

Goods are sold to customers by branch at cost plus 100%. Wholesale price is cost plus 80%. Goods are invoiced to branch at wholesale price. From the following information, calculate the profit made at head office and branch for the year ended 31.12.2020.

	Head office	Branch
Stock on 1st jan 2020	220000	
Purchases	2150000	
Goods sent to branch at invoice price	950000	
Sales	2853000	946000
Closing Stock	260000	99000

Sales at head office are made only at wholesale price. Stock at branch is valued at invoice price.

SOLUTION:

Dr **Trading A/c** **Cr**

Particulars	**Head Office**	**Branch**	**Particulars**	**Head Office**	**Branch**
To Opening Stock	220000		By Sales	2853000	946000
To Purchases	2150000		By Goods sent to Branch	950000	
To Goods received from Head office		950000	By closing Stock	257222	98600
To Profit & Loss A/c (Gross Profit)	1690222	94600			
	4060222	1044600		4060222	1044600

Dr **Trading A/c** **Cr**

Particulars	**Head Office**	**Branch**	**Particulars**	**Head Office**	**Branch**
To Expenses			**By Gross Profit**	**1690222**	**94600**
To branch Stock Reserve (98600x80/180)	**43822**				
To Net Profit	**1646400**	**94600**			
	1690222	**94600**		**1690222**	**94600**

WORKING NOTES:

Let Cost price = ₹100

Sale price = Cost + 100%= ₹200

Whole sale price = cost + 80% = 180

Gross profit of Head office

Sale to outsiders = 2853000 x 80/180 =	1268000
Goods sent to branch = 950000 x 80/180 =	422222
Total	1690222

Gross profit to branch

946000 x 20/200 = Rs. 94600

10.4.2 METHOD OF ACCOUNTING FOR INDEPENDENT BRANCHES:

- Independent branches are the branches that purchase goods from the market besides getting the goods from the head office.
- They can also supply goods to the head office, pay expenses from the cash realised and deposit cash in their own account.
- The only link the branch has with the head office is that they are owned by the head office and whatever profit or loss is earned by the branch that belongs to the head office.
- Independent branches keep complete set of double entry books and prepare their own trial balance, trading and profit and loss account and balance sheet.
- These branches open head office account in their books. This account is debited by cash sent to the head office, goods supplied to head office, payment made by the branch for purchase of assets and loss to be borne by the head office and credited by cash received from the head office, goods received from the head office, depreciation of branch fixed assets, charge made by head office for rendering services and profit earned by the branch.
- The head office will also maintain a branch account for each branch. This account will have the same entries but on the reverse sides.

10.4.2.1 IMPORTANT TRANSACTIONS:

(a) PURCHASE OF BRANCH FIXED ASSETS

- Generally the fixed assets of the branch are maintained in the books of head office.
- When an asset is purchased, the following entries are passed.

(i) If the payment is made by the branch

In the books of Head Office

Branch Assets A/c Dr.
To Branch A/c

In the books of Branch

Head Office A/c Dr.

To Cash A/c

(ii) If the payment is made by the head office

In the books of Head Office

Branch Assets A/c Dr.

To Bank A/c

In the books of Branch

No Entry

(b) DEPRECIATION OF FIXED ASSETS

- As fixed assets are maintained in the books of head office so entries relating to depreciation will also be passed through head office account.

In the books of Head Office

Branch Account Dr.

To Branch Asset A/c

In the Books of Branch

Profit & Loss A/c Dr.

To Head Office A/c

(c) HEAD OFFICE EXPENSES

If the services like administration or technical are rendered by the head office to the branch, then a proportionate charge for such expenses will be made to each branch by the head office.

The entry for such transaction will be:

In the books of Head Office

Branch Account Dr.

To Profit & Loss A/c

In the Books of Branch

Profit & Loss A/c Dr.

To Head Office A/c

(d) RECONCILIATION OF ITEMS IN TRANSIT

The balance shown by the head office account and branch account should always tally. If there is some difference, the reason for this may be due to some transactions that are recorded in the books of branch and not in the books of head office or vice-versa. Such transactions could be "Cash in Transit" and "Goods in Transit. To clear this difference, adjustment entry needs to be passed.

(1) For Cash in Transit

If cash is sent by branch but it has not been received by the head office, following adjustment entry is passed in the books of branch.

Cash in transit A/c Dr.

To Head Office A/c

Alternatively, the entry can also be passed in the books of Head office as:

Cash in Transit A/c Dr.

To Branch A/c

Cash in transit is an asset and it will be shown on the asset side of the Balance sheet

(2) For Goods in Transit

If goods are despatched by the head office and are not received by the branch till the end of the accounting period, following Journal entry is passed:

Goods in Transit A/c Dr

To Branch A/c

Goods in transit will appear on the asset side of the Balance Sheet.

(e) INTER-BRANCH TRANSACTIONS

When an organisation has more than one branch, it is possible that some transactions take place between the branches. This usually happens when the instructions are given by the Head Office. For example, a branch may be asked to transfer its surplus stock to some other branch which may need the same. In such a situation, the usual practice for the branch that is sending is to regard it as a transaction of returning the goods to the Head Office. Similarly, the receiving branch will regard it as a transaction of receiving the goods from the Head Office. Entries in this regard are passed in the books of the branches and the Head Office. These are as follows:

In the books of the Head Office

Receiving Branch A/c Dr.

To Sending Branch A/c

(Being goods transferred from .... branch to .... branch)

In the books of the sending branch

Head Office A/c Dr.

To Goods Sent to H.O. A/c

(Being goods sent to............. branch as per instructions of Head Office)

In the books of the receiving branch

Goods from Head Office A/c Dr.

To Head Office A/c

(Being goods received from............. branch under instruction from Head Office)

10.4.3 INCORPORATION OF BRANCH TRIAL BALANCE IN THE BOOKS OF HEAD OFFICE

An independent branch keeps full system of accounting and prepares its own final accounts. This does not mean that its year-end results will not form part of the final accounts of the Head Office. In fact, as in case of dependent branches, the assets and Liabilities and the profit or loss made by an independent branch shall also be included in the Consolidated balance sheet and General Profit and Loss Account respectively, of the Head Office,

The incorporation of branch balances involves two steps:

(i) incorporation of branch profit or loss, and

(ii) incorporation of branch assets and liabilities

10.4.3.1 METHODS OF INCORPORATION OF BRANCH TRIAL BALANCE CAN BE DONE IN TWO WAYS:

(a) Detailed Method

(b) Abridged Method

(a) DETAILED METHOD

Under this method, the Head Office prepares a proper Branch Trading and Profit & Loss Account and makes entries for all revenue items before incorporating the branch assets and liabilities in its books. The entries passed under this method are as follows:

1. FOR ITEMS ON THE DEBIT SIDE OF THE TRADING ACCOUNT

Branch Trading A/c Dr.
To Branch A/c

The items that appear on the debit side includes: Opening Stock, Purchase less returns, Wages, Manufacturing expenses.

2. FOR ITEMS ON THE CREDIT SIDE OF THE TRADING ACCOUNT

Branch A/c Dr.
To Branch Trading A/c

The items on the credit side includes: Sales less returns, Closing stock)

3. FOR BRANCH GROSS PROFIT

Branch Trading A/c Dr
To Branch Profit & Loss A/c

FOR LOSS

Branch Profit & Loss A/c Dr
To Branch A/c

4. FOR ITEMS ON THE DEBIT SIDE OF THE PROFIT AND LOSS ACCOUNT

Branch Profit & Loss A/c Dr.
To Branch A/c

5. FOR ITEMS ON THE CREDIT SIDE OF THE PROFIT & LOSS ACCOUNT

Branch A/c Dr
To Branch Profit & Loss A/c

6. FOR BRANCH NET PROFIT

Branch Profit & Loss A/c Dr.
To General Profit & Loss A/c

FOR NET LOSS

General Profit & Loss A/c Dr.
To Branch Profit & Loss A/C

7. FOR BRANCH ASSETS

Branch Assets A/c Dr.
To Branch A/c

8. FOR BRANCH LIABILITIES

Branch A/c Dr.

To Branch Liabilities A/c

ILLUSTRATION 6

On December 31, 2018, the Trial Balance of the Amritsar branch stood as follows:

Details	Dr.	Cr.
	₹	₹
Stock on January 1, 2018	12,000	
Furniture	4,800	
Debtors	11,200	
Goods received from H.O.	30,000	
Salaries, rent and expenses	4,400	
Cash in hand	1,600	
Head Office Account		20,000
Sales		43,600
Sundry creditors		400
	56000	68,000

Stock on December 31, 2018 was ₹ 7,200.

Pass the necessary journal entries to incorporate Amritsar branch balances in the Head Office books, and prepare the Amritsar Branch Account in thebooks of the Head Office.

SOLUTION:

In the Books of Head Office

Date	**Particulars**	₹	Rs
2018 Dec.31	Amritsar Branch Trading A/c Dr To Amritsar Branch A/c (Being incorporation of opening stock and goods received from HO.)(30000 + 12000)	42,000	42,000

Dec 31	Amritsar Branch A/c Dr.	50,800	
	To Amritsar Branch Trading A/c (Being incorporation of branch sales and closing stock) (43600 + 7200)		50,800
Dec 31	Amritsar Branch Trading A/c Dr. To Amritsar Branch P&L A/c (Being gross profit transferred to Branch P & L A/c)	10,800	10,800
Dec 31	Amritsar Branch P & LA/c Dr.	4400	
	To Amritsar Branch A/c (Being incorporation of branch expenses)		4,400
Dec 31	Amritsar Branch P & LA/c Dr.	6400	
	To General Profit & Loss A/c (Being incorporation of branch expenses)		6,400
Dec 31	Branch Closing Stock A/c Dr. Branch Furniture A/c Dr. Branch Debtors A/c Dr Branch Cash **A/c** Dr.	7,200 4,800 11,200 1,600	
	To Amritsar Branch A/c (Being incorporation of branch assets)		24,800
Dec 31	Amritsar Branch A/c Dr.	400	
	To Branch Creditors A/c (Being incorporation of branch liabilities)		400

Dr **Amritsar Branch A/c** **Cr**

Particulars	**₹**	**Particulars**	**₹**
To Balance b/d	20,000	By Branch Trading A/c	42,000
To Branch Trading A/c	50,800	By Branch P & L A/c	4400
To Creditors	400	By Closing Stock	7,200
		By Furniture	4,800
		By Debtors	11,200
		By Cash	1,600
	71,200		71,200

(b) ABRIDGED METHOD

- Incorporation of balances of branch in the books of Head Office can also be effected with the help of a short cut method known as the ‘abridged incorporation’.

- Under this method, Memorandum Branch Trading and Profit & Loss Account is prepared and journal entry is passed only for the net profit or net loss.
- In this method, the entries passed under the detailed incorporation method are replaced by just one entry which is as follows:

Branch Account Dr.
To General Profit & Loss A/c
(Being branch net profit incorporated)

In case of net loss, journal entry will be

General Profit & Loss A/c Dr.

To Branch A/c

SAQ 3

1. The short cut method of incorporating the branch balances is called___________
2. The branch net profit can be incorporated in the Head Office books by debiting ________________Account and crediting___________Account.
3. The net assets of the branch are equal to_____________of the Branch Account after the entry of branch net profit or net loss has been passed in the books of Head Office

ILLUSTRATION 7

A trading company in Ajmer opens a new branch in Pushkar which trades independently of branch office. The transactions of the branch related to year ended 31-3-2020 are as under:
Goods Supplied to head office ₹ 20000, Purchased from outsider on credit ₹15500 and on cash ₹3000, Credit sales ₹35000, Cash Sales ₹4600. Cash received from customers ₹30400, cash paid to creditors ₹14200, Expenses paid by branch ₹8950, Furniture purchased by branch ₹3500, Cash received from head office ₹4000, Remittances to Head office ₹11000.
Write off Depreciation @5%, A remittance of ₹2000 from head office to branch is in transit. Branch closing stock is valued at ₹12000.
Prepare the branch trading and profit and loss accounts in the books of head office after incorporation of the branch trial Balance.

SOLUTION

PUSHKAR BRANCH TRADING AND PROGIT & LOSS A/C

Dr **for the year ended 31-03-2020** **Cr**

Particulars	**Amount**	**Particulars**	**Amount**
To Goods Supplied by head		By Sales	

office	20000	Credit	35000
To Purchases		Cash	4600
Credit	15500	By Closing Stock	12000
Cash	3000		
To Gross profit	13100		
	51600		51600
To Expenses	8950	By Gross Profit	13100
To Depreciation on Furniture	175		
To Net Profit transferred to Profit & Loss A/c	3975		
	13100		13100

IN THE BOOKS OF HEAD OFFICE

Dr **Pushkar Branch A/C** **Cr**

Particulars	**Amount**	**Particulars**		**Amount**
To Cash	4000	By Furniture		3500
To Goods sent to Branch	20000	By Remittances	11000	
To Branch Furniture (dep.)	175	Less: In Transit	2000	9000
To General Profit & Loss A/c	3975	ByBalance c/d		15650
	28150			28150

ILLUSTRATION 8

A head office invoices goods to its branches at 20% less than the list price which is cost+100%.goods are sold to customers at list price .from the following particulars ascertain the profit made by the head office and branch.

	Head office	Branch
Stockinthebeginning(atinvoicepriceforbranch)	30000	1600
Purchases during the year	256000	-------
Goods sent to branch	40000	-------
Sales	180000	36000
Expenses	32000	5000

SOLUTION:

Let Cost Price be 100

Retail Price = 100+100% = 200
Invoice Price = 200 – 20 % = 160

Dr Trading and Profit & Loss A/c Cr

Particulars	Head Office (Rs)	Branch (Rs)	Particulars	Head office (Rs)	Branch (Rs)
To stock	30000	1600	By sales	180000	36000
Purchases	256000		Goods sent to branch	40000	
Goods from HO		40000	Closing stock	171000	12800
Gross profit	105000	7200			
	391000	48800		391000	48800
Expenses	32000	5000	Gross profit	105000	7200
Stock reserve (closing Stock) 12800x40/160	3200		Stock reserve (opening Stock) 1600x40/160	400	
Net profit	70200	2200			
	105400	7200		105400	7200

WORKING NOTE:

1. Calculationofclosingstock at HO Rs

Opening stockat cost	30000	
Add purchases	256000	
	286000	
Less:Cost of goods sold (18000x100/200)	90000	
	196000	
Less: Cost of goods senttobranch(40000x100/160)	25000	
Closing stockat HO		**171000**

2. Calculation of closing stock at branch Rs

Opening stock at invoice price	1600	
Add: Goods received from HO at invoice price	40000	
	41600	
Less: Goods sold at branch (36000x160/200)	28800	
Closing stock at branch at invoice price		**12800**

ILLUSTRATION 9

A Trading Company is having Head Office at Delhi and Branch office at Chandigarh. All purchases were made by head office. These goods were further processed and transferred to branch at processed cost plus 10%. All sales, whether by Head Office or by branch were made at uniform gross profit of 25% on cost after processing. Following information is further provided: Capital ₹220000, Drawings ₹ 25000, Purchases ₹1993350, Processing Cost ₹34650. Sales made by Head office ₹142000, Sales made by branch ₹640000.

Goods sent to branch ₹651200, Selling Expenses ₹241000, Debtors 322000, Creditors ₹585750, Branch Current A/c ₹205550, Balance at bank ₹196000.

Stock Tacking at branch disclosed shortage of ₹5000 (at selling price), Goods charged by head office to branch includes ₹11000 not received by branch during the year. There was cash in transit of ₹43750 from branch to head office. Cost of unprocessed goods at head office at the end of the year was ₹180000.

From the given information prepare trading and profit and loss account. Show the necessary calculations in the working notes.

SOLUTION:

Dr. **Trading and Profit & Loss A/C** **Cr.**

Particulars	Head Office(₹)	Branch (₹)	Particulars	Head Office(₹)	Branch (₹)
To Purchases	1993350		By Sales	142000	640000
To Goods received from Head Office (W. Note 2(i))		640200	By Goods sent to Branch	651200	
To Cost of Processing	34650		To Shortage of Goods (W.Note 2 (ii)		4400
To Gross Profit	343200	76800	By Closing Stock Processed(W. Note (i))	120000	72600
			Unprocessed(W.Note1(ii)	180000	
	2371200	717000		237200	717000
To Selling Expenses	241000		By Gross Profit	343200	76800
To Shortage of Stock		4400			
To Stock Reserve					
On Goods in Transit (11000 x 10/110)	1000				
On Branch Stock (72600 x 10/110)	6600				
To Net Profit	94600	72400			
	343200	76800		343200	76800

WORKING NOTES:

W. NOTE 1

Calculation of Closing Stock

Purchases	1993350

Add: Processing Cost	34650
	2028000
Less: Value of Unprocessed Goods	180000 (i)
	1848000
Less: Cost of Goods Sold (100/125 x 1420000)	1136000
	712000
Less: Cost of Goods Sent (100/110 x 651200)	592000
	120000 (ii)

W. NOTE 2

Calculation of Closing Stock at Invoice Price

Invoice value of goods sent to branch	651200
Less: Goods in Transit	11000
Goods received from branch	**640200 (i)**
Less: Invoice Value of Goods sold (640200 x 110/125)	563200
	77000
Less: Invoice value of goods disclosed as shortage (5000 x 110/125)	**4400 (ii)**
	72600

10.5 TEST YOUR KNOWLEDGE

10.5.1 SHORT ANSWER QUESTIONS

1. What are Independent Branches and Dependent Branches?
2. Explain Debtors System
3. Explain Stock and Debtors System
4. What is detailed method and abridged method?
5. Write two additional Journal entries required to be passed in Abridged Method.

10.5.2 LONG ANSWER QUESTIONS

1. What is the difference between Dependent and Independent Branch?
2. What are inter-branch transactions? What are the methods to deal with inter branch transactions?
3. Write the journal entries that need to be passed while incorporating various items of branch trial balance in the books of head office.
4. What adjustments need to be done when goods are invoiced by head office at cost plus profit to its branch? Show with the help of example

10.5.3 TEST YOUR UNDERSTANDING

1. Show the journal entries that will be passed by Surat branch to record the following transactions in its books.
    a. Goods amounting to ₹12,000 transferred from Surat branch to Lucknow branch under instructions from Calcutta Head Office assuming that Head Office keeps a control on inter-branch transactions.

b. Depreciation on Lucknow Branch Machinery ₹ 8,000 and Surat Branch Machinery ₹ 6,000, when the Branch Machinery Account is maintained in Head Office books.

c. A remittance of ₹12,000 made by Surat branch to Head Office on December 2, 2018 but received by the Head Office on January 10, 2019.

d. Goods worth ₹ 5,000 sent by Head Office to Surat branch on December 6, 2018 but received by the latter on January 4, 2019

2. A head office in Delhi sends goods to its branch at Kerela marked 20% above cost. From the followingparticularsshowhowthe Kerelabranchaccountwillappearin thehead office books.

Opening Balances at Branch:

Stock at Invoice Price	₹3600
Debtors	₹6000
Petty cash	₹60
Goods Supplied to Branch	₹60000
Remittance from the branch:	
Cashsales	₹12,000
Amount received from debtors	₹..42,000
Cheques sent to Branch	
Salary	₹1800
Rent and Taxes	₹300
Petty Cash	₹220
Closing Stock at Branch	₹6000
Closing debtors	₹9000
Petty Cash	₹40

(General Profit & Loss A/c: ₹7260)

3. The Kanpur branch of Wahi Bros. sent the following Trial Balance to Head Office, as on December 31, 2018:

	₹		₹
Sundry Debtors	12,000	Sundry Creditor	8,600
Cash in hand	6,250	Goods returned to H.O.	2,250
Furniture	1,900	Sales	1,12,500
Stock on 1-1-88	2,250	Head Office A/c	10,250
Goods from H.O.	34,000		
Purchases	66,450		
Wages & Salaries	5,500		
Trade Expenses	5,250		
	1,33,600		1,33,600

The stock on December 31, 2018 was ₹ 5,200. Pass the necessary journal entries to incorporate the above figures and show Branch A/c in Head Office books, and Trading and Profit & Loss A/c in the branch books.

(Profits: ₹6500)

4. A head office sends goods to its branch at cost plus 80%. Goods are sold to customers at cost plus 100%. Sales at Head office are made at a wholesale price. From the following particulars, ascertain the profits made by head office and branch on wholesale basis:

	Head Office	Branch
	(₹)	(₹)
Opening Stock	20000	
Purchases	200000	
Goods sent to branch at invoice price	90000	
Sales	270000	90000
Expenses	10000	4000

(Net Profit: ₹ 146000)

5. The following is the trial Balance of Chandigarh Branch as on 31-03-2020

Particulars	Dr	Cr
Kanpur Head Office		5000
Stock on 1st April 2019	6000	
Purchases	106400	
Goods received from Head Office	19000	
Sales		138000
Goods supplied to head office		6000
Salaries	4500	
Debtors	3700	
Creditors		1850
Rent	1960	
Office expenses	1470	
Bank Balance	1780	
Furniture	6000	
Depreciation on Furniture	400	

Total	150850	150850

Closing stock at branch is ₹7700. Chandigarh branch account on the head office books at the end of the year stood at ₹ 8700(Dr.). Goods in Transit to branch were ₹3700.

(a) Pass the necessary Journal Entries in the books of head office to incorporate given trial balance using detailed method.

(b) Pass the necessary Journal Entries in the books of head office to incorporate given trial balance using abridged method and prepare memorandum Branch Trading and Profit & Loss a/c

(c) Prepare Trading, profit & loss A/c of Chandigarh branch and its Balance sheet.

(d) Show Chandigarh branch A/c as it would be closed in the head office books

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10.7 SUGGESTED READINGS:

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B. COM
SEMESTER I

COURSE: FINANCIAL ACCOUNTING

UNIT 11: ACCOUNTING FOR ADMISSION OF A PARTNER, RETIREMENT AND DEATH OF A PARTNER IN PARTNERSHIP FIRM

STRUCTURE

11.0 OBJECTIVES

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

- define the rights that a new partner gets on his admission;
- know the effects of admission of a partner into the firm;
- calculate new profit-sharing ratio and sacrificing ratio among the partners;
- state the different methods of valuation of goodwill and make adjustment of Goodwill on admission of a new partner;
- determine the gain or loss on revaluation of assets and reassessment of liabilities and its treatment in the books of firm;
- prepare Memorandum revaluation account;
- distinguish between revaluation account and memorandum revaluation account;
- make adjustment of accumulated profits and losses and reserves appearing in the books of firm;
- prepare partners' capital accounts after admission of a new partner;
- prepare new balance sheet after admission;
- define the meaning and liability of retiring partner
- get an idea about the adjustments need to be done in case of retirement of a partner
- know the accounting treatments on death of a partner
- distribution of profit in case of death of partner
- prepare revaluation account
- prepare the executor's account

11.1 INTRODUCTION

A new partner may be admitted when the partnership firm needs more capital or persons with better managerial ability or both. With the admission of a new partner, existing agreement comes to an end and new agreement among all the partners including the new partner comes into existence. According to section 31 of Indian partnership Act, 1932, "A person can be admitted as a new partner if it is so agreed in the partnership deed or if all the existing partners agree for the admission in the absence of partnership deed.

After admission the new partner gets the following two rights:

1. Right to share future profits or losses of the firm
2. Right to share in the assets of the firm

At the same time, the new partner is liable for any liability of the firm that incurs after the admission.

New partner pays premium for goodwill for receiving share in future profits which is sacrificed by old partners and brings in capital to get right in the assets of the firm.

11.2 EFFECTS OF ADMISSION OF A PARTNER

When a new partner is admitted into a partnership firm, it has the following effects on the firm:

1. Old partnership agreement comes to an end and a new partnership agreement comes into force. But the firm continues.
2. New partner gets right to share future profits of the firm and the combined share of old partners in profits gets reduced. For the right to share future profits, new partner brings premium for goodwill.
3. New partner contributes agreed amount of capital in the firm.
4. New partner gets right to share in the assets of the firm and at the same time becomes liable for the liabilities of the firm.
5. Adjustment for accumulated profits (Losses) and reserves is made.
6. Assets and liabilities are revalued and necessary adjustments are made in the books of accounts
7. Goodwill of the firm is valued and adjusted through the partners' capital account.
8. Capital accounts of partners may be adjusted as per the agreement.

11.3 ADJUSTMENTS REQUIRED AT THE TIME OF ADMISSION OF A PARTNER

The following adjustments are required on admission of a new partner into the firm:

1. Change in profit sharing ratio: Determining new profit-sharing ratio and sacrificing ratio
2. Valuation and adjustment of goodwill
3. Adjustment of gain or loss arising on revaluation of assets and liabilities
4. Adjustment of reserves and accumulated profits and losses
5. Adjustment of capital on the basis of new profit-sharing ratio or as agreed

11.3.1 CALCULATION OF NEW PROFIT-SHARING RATIO AND SACRIFICING RATIO

When a new partner is admitted in the firm, he gets shares in future profits of the firm and share of old partners in future profits gets reduced. As a result, there is change in the profit-sharing ratio among the partners including new partner. Therefore, it is required to calculate new profit-sharing ratio and also the sacrificing ratio.

1. **NEW PROFIT-SHARING RATIO**: The ratio in which all partners including new partner will share future profits and losses of the firm.

2. **SACRIFICING PARTNER:** The partners whose shares have decreased as a result of change are known as sacrificing partners. They are usually the old partners of the firm
3. **SACRIFICING RATIO:** Ratio in which the old partners sacrifice their share in favour of new partner is called sacrificing ratio. This ratio is calculated by taking out the difference between old profit shares and new profit shares

Sacrificing ratio = Old Profit-sharing ratio - New Profit-sharing ratio

FOLLOWING CASES MAY ARISE FOR THE CALCULATION OF NEW PROFIT-SHARING RATIO:

Case I: When new partner's share is given but the question is silent about the sacrifice made by the old partners: In this case it is assumed that the old partner will share the remaining share in their old profit-sharing ratio.

ILLUSTRATION 1

A and B are partners sharing profits in the ratio 3:2. They admit C for 1/3rd share in future profits. Calculate the new ratio.

SOLUTION:

Share in Firm = 1

C's Share = 1/3

Remaining Profit = 1 - 1/3 = 2/3

This remaining share of 2/3 is divided between A and B in the ratio 3:2

So, A's new share = 2/3 × 3/5 = 6/15

B's new share = 2/3 × 2/5 = 4/15

C's share = 1/3 × 5/5 = 5/15

New ratio = 6/15: 4/15: 5/15 = 6:4:5

Sacrificing ratio= old profit-sharing ratio of old partners – new profit sharing of old partners

A= 3/5 – 6/15 =3/15

B= 2/5 – 4/15 = 2/15

So, sacrificing ratio of A and B partners is 3/15: 2/15 i.e., 3:2

Case II: When new partner purchases his share from old partners in a particular ratio: In this case the new ratio of the old partners will be calculated by deducting the proportion given to the new partner from the shares of old partner.

ILLUSTRATION 2

A and B are partners sharing in the ratio 3:2. They admit C as a new partner for 1/3rd share in future profits which he gets 1/9 from A and 2/9 from B. Calculate the new ratio.

SOLUTION:

A's old share = 3/5; A sacrifices in favour of C = 1/9

So, A's new share = 3/5 - 1/9 = 22/45

B's old share = 2/5; B sacrifices in favour of C = 2/9

So, B's new share = 2/5 - 2/9 = 8/45

C's new share = 1/9 + 2/9 = 3/9 or 15/45

New ratio = 22: 8: 15

Case III: When the old partners surrender a particular fraction of their share in favour of new partner: In this case following steps are followed:

1. Determine the share surrendered by the old partners.
2. Find the new share of the old partners by deducting share surrendered from their old share.
3. Calculate share of the new partner by taking the sum of surrendered share of old partners.
4. Calculate the new ratio.

ILLUSTRATION 3

A and B are partners sharing in the ratio 3:2. They admit C as the new partner. A surrender 1/3rd of his share and B surrenders 2/3rd of his share in favour of C. Calculate the new ratio.

SOLUTION:

A's old share = 3/5; A surrenders in favour of C = 3/5 x 1/3 = 3/15

A's new share = 3/5 - 3/15 = 6/15

B's old share = 2/5; B surrenders in favour of C = 2/5 x 2/3 = 4/15

B's new share = 2/5 - 4/15 = 2/15

C’s share = 3/15 + 4/15 = 7/15

New ratio = 6:2:7

CASE IV: When the new partner acquires his share entirely from the old partners: In this case the sacrificing partner share is calculated by deducting his sacrifice from his old share.

ILLUSTRATION 4

A and B are partners sharing in the ratio 3:2. They admit C for 1/5th share in profits which he acquires entirely from A. Calculate the new ratio.

SOLUTION:

A’s old share = 3/5; Sacrifice in favour of C = 1/5

A’s new share = 3/5 - 1/5 = 2/5

B’s share = 2/5

C’s share = 1/5

New ratio = 2:2:1

CASE V: When the new partner acquires his share from the old partners in the certain ratio: In this case the sacrifice of each partner is deducted from their old shares.

ILLUSTRATION 5

A and B are partners sharing profits in the ratio 3:2. C is admitted for 1/3rd share which he acquires from A and B in the ratio of 2:1. Calculate the new ratio.

SOLUTION:

A’s old share = 3/5, A’s sacrifice = 1/3 × 2/3 = 2/9

A’s new share = 3/5 - 2/9 = 17/45

B’s old share = 2/5, B’s sacrifice = 1/3 × 1/3 = 1/9

B’s new share = 2/5 - 1/9 = 13/45

C’s share = 1/3 × 15/15 = 15/45

New ratio = 17:13:15

ILLUSTRATION 6

X and Y are partners in a firm sharing profits and losses in the ratio 5:3. They admit Z into partnership. The new ratio 3:2:1. Calculate the Sacrificing Ratio.

SOLUTION:

X's sacrifice = X's old share - X's new ratio = 5/8 - 3/6 = 6/48

Y's sacrifice = Y's old share - Y's new ratio = 3/8 - 2/6 = 2/48

Thus, sacrificing ratio = 6:2 or 3:1

VALUATION AND ADJUSTMENT OF GOODWILL

GOODWILL

Goodwill is the good name or the reputation of the business, which is earned by a firm through the hard work and honesty of its owners. If a firm renders good services to the customers, the customers who feel satisfied will come again and again and the firm will be able to earn more profits in future. Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits earned by other firms in the same trade.

FEATURES OF GOODWILL

1. It is an intangible asset.

2. It is helpful in earning excess profits.

3. Its value is liable to constant fluctuations.

4. It cannot be sold separately like other physical assets.

CATEGORIES OF GOODWILL

I. PURCHASED GOODWILL: Purchased goodwill means goodwill for which a consideration has been paid e.g., when business is purchased the excess of purchase consideration paid over its net assets i.e. (Assets – Liabilities) is the Purchased Goodwill. It is separately recorded in the books because it is purchased by paying in the form of cash or kind.

CHARACTERISTICS

(i) It arises on purchase of a business or brand.

(ii) Consideration is paid for it so it is recorded in books.

(iii) It is shown in the balance sheet as an asset.

(iv) It is amortised (depreciated).

(v) Value is a subjective judgment & ascertained by agreement of seller & purchaser. It is approximate value and cannot be sold separately in the market or in parts.

II. SELF-GENERATED GOODWILL: It is also called as inherent goodwill. It is an internally generated goodwill which arises from a number of factors that a running business possesses due to which it is able to earn more profits in the future.

FEATURES

(i) It is generated internally over the years.

(ii) A true cost cannot be placed on this type of goodwill.

(iii) Value depends on subjective judgment.

(iv) It is shown in the balance sheet as an asset because proper cannot be assigned to it.

NEED FOR VALUING GOODWILL

Whenever the mutual rights of the partners change the party which makes a sacrifice must be compensated. This basis of compensation is goodwill, so we need to calculate goodwill.

Mutual rights change under following circumstances:

1. When profit sharing ratio changes

2. On admission of a partner

3. On Retirement or death of a partner

4. When amalgamation of two firms takes place

5. When partnership firm is sold.

METHODS OF CALCULATING GOODWILL

The following are the key methods of calculating goodwill:

1. Average Profit Method

2. Super Profit Method

3. Capitalisation Method

AVERAGE PROFIT METHOD

Under this method, the goodwill is valued at agreed number of 'years' of purchase of the average profits of the past few years. It is based on the assumption that a new business will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases a running business must pay in the form of goodwill a sum which is equal to the profits he is likely to receive for the first few years. The goodwill is calculated as follows:

Value of goodwill = Average Profit × Number of years of purchase

ILLUSTRATION 7

The profit for the last five years of a firm were as follows: year 1999 Rs.5,00,000; year 2000 Rs.4,45,000; year 2001 Rs.4,50,000; year 2002 Rs.3,98,000 and year 2003 Rs.4,00,000. Calculate goodwill of the firm on the basis of 4 years purchase of 5 years average profits.

SOLUTION:

Total Profit = 5,00,000 + 4,45,000 + 4,50,000 + 3,98,000 + 4,00,000 = Rs. 21,93,000

Average Profit = Total Profit/No. of years= 21,93,000/5 = Rs. 4,38,600

Goodwill = Average Profit × No. of years of Purchase= 4,38,600 × 4 = Rs. 17,54,400

SUPER PROFIT METHOD

The goodwill under the super profit method is ascertained by multiplying the super profits by certain number of years' purchase. Super profit is the excess profits earned over normal profit. The steps involved under the method are:

1. Calculate the average profit,
2. Calculate the normal profit on the capital employed on the basis of the normal rate of return,
3. Calculate the super profits by deducting normal profit from the average profits, and
4. Calculate goodwill by multiplying the super profits by the given number of years' purchase.

Normal profit = (Capital employed x Normal rate of return)/100

Super Profit = Actual Profit/Average profit – Normal Profit

ILLUSTRATION 8

A firm earns profit of 65,000 on a capital of 4,80,000 and the normal rate of return in similar business is 10%. Then the normal profit is 48,000 [10% of the 4,80,000]. The actual profit is 65,000(Average profit).

SOLUTION:

Super profit = Actual profit – Normal profit= 65,000 – 48,000= Rs17,000

If value of Goodwill is calculated by 3 years' purchase of super profit then,

Goodwill = super profit x 3 years' purchase =17000 × 3 = Rs.51,000

<u>CAPITALIZATION METHOD</u>

Under this method the goodwill can be calculated in two ways:

(a) By capitalising the average profits

(b) By capitalising the super profits

(a) Capitalisation of Average profit: In this method, the value of goodwill is assumed to be excess of the capital value of average profit over the actual capital employed. The key steps involved in this method are as follows:

1. Computation of capitalised value of average profit = Average Profits × 100/Normal Rate of Return

2. Computation of capital employed= Total Assets (excluding goodwill) – outside liabilities

3. Computation of goodwill = Capitalised value of average profits – Capital employed

ILLUSTRATION 9

A business has earned average profits of 40,000 during the last few years and the normal rate of return in a similar type of business is 10%. Ascertain the value of goodwill by capitalization method, given that the value of net assets of the business is 3,10,000.

SOLUTION:

Capital Employed = Net assets= Rs. 3, 10,000

Capitalised value of average profit = Average Profit × 100/Normal rate of profit

= 40,000 × 100/10= Rs 4,00,000

Goodwill = Capitalised value – Capital employed = 4, 00,000 – 3,10,000= Rs. 90,000

(b) Capitalisation of Super profit: In this method, the value of goodwill is calculated on the basis of super profit method. Following formula is applied:

Goodwill = Super profit × 100/Normal rate of profit

ILLUSTRATION 10

A firm earns a profit of 25,000 and has invested capital amounting to 2,20,000. In the same business normal rate of earning profit is 15%. Calculate the value of goodwill with the help of Capitalisation of super profit method.

SOLUTION:

Actual profit = Rs. 25,000

Normal profit = 2, 20,000 x 10/ 100 = Rs. 22,000

Super Profit = Actual Profit – Normal Profit

= 25,000 – 22,000= Rs 3,000

Goodwill = Super profit × 100/Normal rate of profit

= 3,000 × 100/15= Rs 20,000

11.3.2 ACCOUNTING TREATMENT OF GOODWILL

1.GOODWILL (PREMIUM) PAID PRIVATELY

If the goodwill premium is paid privately by the new partner to the old partners outside the business, then the same is not recorded in the books of accounts and hence no journal entry is recorded**.**

2.GOODWILL/PREMIUM BROUGHT IN CASH BY THE NEW PARTNER

When, the new partner brings his/her share of goodwill in cash, the amount brought in by the new partner is transferred to the existing partner in the sacrificing ratio. If there is any goodwill account in the balance sheet of existing partner, it will be written off immediately in existing ratio among the old partners. The journal entries are as follows:

a. For bringing premium (share of goodwill of new partner)

Cash/Bank A/c Dr
To Goodwill A/c

b. For transferring goodwill to the capital accounts of the old partners in their *sacrificing ratio*.

Goodwill A/c Dr
To Sacrificing Partner's Capital A/c (Individually)

However, instead of these two entries one can record only one entry given below:

Cash/Bank A/c Dr
To Sacrificing Partner's Capital A/c (Individually)

c. For writing off existing goodwill in balance sheet, *if any*, in old profit-sharing ratio

Existing/ Old Partner's Capital A/c (Individually) Dr.
To existing Goodwill A/c

3.WHEN THE NEW PARTNER DOES NOT BRING HIS/HER SHARE OF GOODWILL IN CASH

Sometimes the new partner is not able to bring goodwill in cash. In this case, the new partner's share of goodwill brought in is debited to his capital account and is transferred to the existing old partners in the sacrificing ratio. Also, the amount of goodwill existing in the books, if any, is written off by debiting the capital account of existing partners in their existing profit-sharing ratio.

1. For transferring new partner's share of goodwill to the capital accounts of the old partners in their *sacrificing ratio*.

New Partner's Capital A/c Dr
To Sacrificing Partner's Capital A/c (Individually)

2. For writing off existing goodwill in balance sheet, *if any*, in old profit-sharing ratio

Existing/ Old Partner's Capital A/c (Individually) Dr.
To existing Goodwill A/c

3. **When goodwill at full value is raised, it is credited to old partners' capital accounts and then it is written off by debiting all partners' capital accounts. In that case no goodwill is shown in the balance sheet. The following entries are recorded:**
   - **(a) Goodwill a/c Dr (Full Value)**
     To Old partners' capital a/c (old ratio)
   - **(b) All partners' capital a/c Dr (including new partner in new ratio)**
     To Goodwill a/c

4. <u>HIDDEN OR INFERRED OR IMPLIED GOODWILL</u>

Sometimes the value of goodwill is not specifically given and has to be inferred or implied from the arrangement of capital or profit-sharing ratio.

For example, A's capital is Rs 20,000 and B's Capital is Rs 15,000 and they share profits equally. C is admitted as a partner with Rs 18,000 as his capital for 1/4 share in the profits. The total capital of the firm now ought to be Rs 72,000 for the simple reason that if C contributes Rs 18,000 for 1/4 share, then for full or unit profit he ought to have contributed Rs 72,000 (18,000 x 4). But the total capital of A, B and C becomes only Rs 53,000 (20,000+15,000+18,000). So, the hidden value of the goodwill should be taken as Rs 19,000(72,000-53,000), so that the total capital becomes Rs 72,000.

11.3.3 ACCOUNTING TREATMENT OF ACCUMULATED PROFIT, RESERVES AND ACCUMULATED LOSS

Accumulated profits and reserves, if any existing in the Balance Sheet at the time of admission of a new partner, are distributed to existing partners in their old profit-sharing ratio. The following journal entry is made:

Accumulated profits and reserves A/c Dr
To old partner's capital A/c (Old profit-sharing ratio)

ILLUSTRATION 11

Following is the balance sheet as at 31st March, 2020 of A and B sharing profits and losses in the ratio of 3:2

Liabilities	Amount	Assets	Amount
Sundry creditors	95,000	Cash at Bank	10,000
General Reserve	15,000	Stock	20,000
Profit and Loss	20,000	Debtors	30,000
Capital Accounts		Plant and Machinery	50,000
A		Building	1,70,000
B	80,000		

	70,000		
Total	2,80,000	Total	2,80,000

On the above date C joined as a new partner for 1/5th share in future profits and losses on the following terms:

(i) C will bring in Rs. 1,00,000 for his capital

(ii) Goodwill of the firm was valued at Rs. 1,40,000 and C brings his share of goodwill

(iii) New profit-sharing ratio is 5:3:2

Pass necessary journal entries to record capital introduced by new partner, goodwill and accumulated profit and reserve. And also prepare new balance sheet.

SOLUTION:

Sacrificing ratio

Particulars	Old ratio=3:2	New ratio =5:3:2	Sacrificing ratio= Old- New=1:1
A B C	3/5 2/5 -	5/10 3/10 2/10	3/5-5/10=1/10 2/5-3/10=1/10

Journal Entries

1. Bank a/c Dr 1,00,000
   To C's Capital a/c 1,00,000
   (Being capital brought in by C)
2. Bank a/c Dr. 28,000 (1/5th of 1,40,000)
   To A's capital a/c 14,000
   To B's Capital a/c 14,000
   (Being goodwill brought in by C transferred to old partners' capital accounts in their sacrificing ratio)
3. General reserve a/c Dr 15,000
   Profit and Loss a/c Dr 20,000
   To A's Capital a/c 21,000
   To B's capital a/c 14,000
   (Being accumulated profit and general reserve transferred to old partners' capital accounts in their old profit-sharing ratio)

Partners' capital Account

Particulars	A	B	C	Particulars	A	B	C
To Balance c/d	1,15,000	98,000	1,00,000	By Balance b/d By Bank By accumulated profits and GR	80,000 14,000 21,000	70,000 14,000 14,000	- 1,00,000 ----
Total	1,15,000	98,000	1,00,000	Total	1,15,000	98,000	1,00,000

New Balance sheet

Liabilities	Amount	Assets	Amount
Sundry creditors	95,000	Cash at Bank 10,000+1,00,000+ 28,000	1,38,000
Capital Accounts		Stock	20,000
A	1,15,000	Debtors	30,000
B	98,000	Plant and Machinery	50,000
C	1,00,000	Building	1,70,000
Total	4,08,000	Total	4,08,000

11.3.4 ACCOUNTING TREATMENT OF REVALUATION OF ASSETS AND RE-ASSESSMENT OF LIABILITIES

When a new partner is admitted into the partnership, assets are revalued, and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for the purpose. This account is debited with all reduction in the value of assets and increase in liabilities and credited with increase in the value of assets and decrease in the value of liabilities. The difference in two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit-sharing ratio. The entries to be passed are:

1. For increase in assets
   Assets a/c Dr (Individually)
   To Revaluation a/c (with increase in assets)
2. For decrease in assets
   Revaluation a/c Dr (with decrease in assets)
   To Assets a/c (individually)
3. For increase in Liabilities

Revaluation a/c Dr (with increase in liability)

To liabilities a/c (individually)

4. For decrease in liabilities

   Liabilities a/c Dr (individually)

   To Revaluation a/c (with decrease in liabilities)

5. For Profit on revaluation

   Revaluation a/c Dr

   To old partners' capital a/c (old profit-sharing ratio)

6. For loss on revaluation

   Old partners' capital a/c Dr (old profit-sharing ratio)

   To Revaluation a/c

As a result of the above entries, the capital account balances of the old partners will change, and the assets and liabilities will have to be adjusted to their proper values. They will now appear in the New Balance Sheet (After admission) at revised figures.

Proforma of Revaluation Account

particulars	Amount	Particulars	Amount
• Assets (decrease in value) • Liabilities (increase in value) • Liabilities (unrecorded) • Profit transferred to old partners' capital a/c(BF) (individually in their old profit-sharing ratio)		• Assets (increase in value) • Liabilities (decrease in Value) • Assets (unrecorded) • Loss transferred to old partners' capital a/c(BF) (individually in their old profit-sharing ratio)	

ILLUSTRATION 12

Given below is the Balance Sheet of A and B, who are carrying on partnership business as on March 31, 2019. A and B share profits in the ratio of 2:1

Balance Sheet of A and B as at March 31, 2019

Liabilities	Amount	Assets	Amount
Bills payable	10,000	Cash in Hand	10,000
Sundry creditors	58,000	Cash at Bank	40,000
Outstanding expenses	2,000	Sundry debtors	60,000
Partners' capital accounts		Stock	40,000
A	1,80,000	Plant and machinery	1,00,000
B	1,50,000	Building	1,50,000
Total	4,00,000	Total	4,00,000

C is admitted as a new partner on the date of the balance sheet on the following terms:

1. C will bring in 1, 00,000 as his capital and 60,000 as his share of goodwill for 1/4th share in profits.
2. Plant is to be appreciated to 1, 20,000 and the value of buildings is to be appreciated by10%.
3. Stock is found overvalued by 4,000.
4. A provision for bad and doubtful debts is to be created at 5% of debtors.
5. Creditors were unrecorded to the extent of 1,000.

Prepare the revaluation account and new balance sheet after admission

SOLUTION:

Revaluation Account

Particulars	Amount	Particulars	Amount
Stock	4,000	Plant and Machinery	20,000
Provision for Bad and Doubtful Debts	3,000	Building	15,000
Creditors	1,000		
Profit on revaluation transferred to capital a/c of-			
A	18,000		
B	9,000		
Total	35,000	Total	35,000

Journal Entries in books of the firm

1. Entry for capital contribution
   Cash a/c Dr 1,00,000
   To C's Capital a/c 1,00,000
2. Entry for bringing goodwill
   Cash a/c Dr 60,000
   To A's Capital a/c 40,000
   To B's Capital a/c 20,000
   (in Sacrificing Ratio)

Balance sheet of the firm after admission as on 31st march 2019

Liabilities	Amount	Assets	Amount
Bills payable Sundry creditors (58,000+1,000) Outstanding expenses Capital A (1,80,000+18,000+40,000) B (1,50,000+9,000+20,000) C	10,000 59,000 2,000 2,38,000 1,79,000 1,00,000	Cash in Hand (1,00,000+10,000+ 60,000) Cash at Bank Sundry debtors (60,000-3,000) Inventory (40,000-4,000) Plant and Machinery (1,00,000+20,000) Building (1,50,000+15,000)	1,70,000 40,000 57,000 36,000 1,20,000 1,65,000
Total	5,88,000	Total	5,88,000

When the revised values are not to be recognized in the Books (Memorandum Revaluation Account)

Sometimes all the partners including the new partner may agree to keep the assets and liabilities at the old values even when they agree to revalue them. To record these adjustments, a Memorandum Revaluation Account is opened. This account is divided into two parts.

(a) In the first part the entries for the revaluation of assets and liabilities are made in the usual way as explained earlier.
The resultant profit or loss on revaluation in the first part of this account is transferred to the capital accounts of old partners only in the old profit-sharing ratio.

1. Revaluation A/c Dr.
   To Assets A/c (Individually) (Amount of reduction in value)
   To Liabilities A/c (Individually) (Amount of increase in value)
2. Assets A/c (Individually) Dr. (Amount of increase in value)
   Liabilities A/c (Individually) Dr. (Amount of reduction in value)

To Revaluation A/c

3. Revaluation A/c Dr. (Balancing Figure i.e., Profit)
   To Old Partners' Capital A/c (Individually in Old Profit ratio)

OR

Old Partners' Capital A/c Dr. (Individually in Old Profit Ratio)
   To Revaluation A/c (Balancing Figure i.e., Loss)

(b) Now, to complete the double entry, entries made in the first part of Memorandum Revaluation Account are reversed in the second part so that the values of the assets and liabilities remain unchanged.
The balance of the second part is transferred to the capital accounts of all the partners including new partner in their new profit-sharing ratio.

1. Assets A/c (Individually) Dr. (Amount of reduction in value)
   Liabilities A/c (Individually) Dr. (Amount of increase in value)
   To Memorandum Revaluation A/c
2. Memorandum Revaluation A/c Dr.
   To Assets A/c (Individually) (Amount of increase in value)
   To Liabilities A/c (Individually) (Amount of reduction in value)
3. All Partners' Capital A/c Dr. (Individually in New Ratio)
   To Memorandum Revaluation A/c (Balancing Figure)

OR

Memorandum Revaluation A/c Dr. (Balancing Figure)
   To All Partners' Capital A/c (Individually in New Profit ratio)

Note: Thus, if there is a profit in the first part there will be a loss of the same amount in the second part. The only point to be remembered is that the result of the first part of Memorandum Revaluation Account is shared by old partners in the old profit-sharing ratio, while the result of the second part is shared by all partners including the new one in the new profit-sharing ratio.

Proforma of Memorandum Revaluation Account

Particulars	Amount	Particulars	Amount
Decrease in Assets Increase in Liabilities Unrecorded Liabilities Profit (BF) transferred to old partners' capital Accounts		Increase in Assets Decrease in Liabilities Unrecorded Assets Loss (BF) Transferred to old partners' capital accounts	
	XXX ----------		XXX ------------
Increase in Assets		Decrease in Assets	

Decrease in Liabilities Unrecorded Assets Profit transferred to all partners' capital accounts including new partner		Increase in Liabilities Unrecorded Liabilities Loss transferred to all partners' capital accounts including new partner	

ILLUSTRATION 13

Following was the balance sheet A, B and C who were the equal partners as at 31st march, 2020

Liabilities	Amount	Assets	Amount
Bills payable	3,300	Cash	600
Creditors	6,000	Debtors	10,800
Capital A/Cs		Stock	11,400
A	16,800	Furniture	2,400
B	12,600	Building	19,500
C	6,000		
Total	44,700	Total	44,700

D is admitted as new partner from 1st April, 2020 for 1/4th share in the profits on the following terms:

(i) D should bring in Rs. 9,000 for goodwill and Rs. 15,000 for capital.
(ii) Stock and Furniture be depreciated by 10%.
(iii) A liability for 1,080 be created against bills discounted.
(iv) Provision for Bad debts be created at5%
(v) Building is undervalued by 8,500
(vi) The value of assets and liabilities other than cash are not to be altered

Prepare memorandum revaluation accounts, capital accounts and new balance sheet

SOLUTION:

STEP-1

Calculation of new profit-sharing ratio

Old profit-sharing ratio between A, B and C = 1:1:1 (Given)

Let the profit be 1

D's share = $1/4^{th}$ of 1= ¼= 3/12

Remaining profit =1- ¼= ¾

¾ will be shared between A, B and C equally

A's new share= 1/3 x 3/4= 3/12

B's new share=1/3 x 3/4= 3/12

C's new share= 1/3 x 3/4= 3/12

New profit sharing ratio between A, B, C and D = 3/12 : 3/12 : 3/12 : 3/12 =1:1:1:1

STEP-2

Calculation of sacrificing ratio

Particulars	Old ratio 1:1:1	New ratio 1:1:1:1	Sacrificing ratio= Old- New=1:1:1
A	1/3	1/4	1/3-1/4=1/12
B	1/3	1/4	1/3-1/4=1/12
C	1/3	1/4	1/3-1/4=1/12
D	-	1/4	

STEP-3

Entry for capital brought in by new partner

Cash A/C Dr 15,000

To D's Capital A/C 15,000

(Being capital brought in by D)

Cash A/c Dr 9,000

To A's capital 3,000

To B's capital 3,000

To C's capital 3,000

(Being goodwill brought in cash by new partner transferred to old partners' capital accounts in their sacrificing ratio)

STEP-4

Memorandum Revaluation Account

Particulars	Amount	Particulars	Amount
Stock Furniture Provision for bad debts Liability for bills discounted Capital accounts A B C	1,140 240 540 1,080 1,833 1,833 1,834 8,500	Building	8,500 8,500
Building	8,500	Stock Furniture Provision for bad debts Liability for bills discounted capital accounts A B C D	1,140 240 540 1,080 1,375 1,375 1,375 1,375
Total	8,500	Total	8,500

STEP -5

Preparation of capital accounts of partners

Particulars	A	B	C	D	Particulars	A	B	C	D
To memorandum revaluation To balance c/d	1,375 20,258	1,375 16,058	1,375 9,459	1,375 13,625	By Balance b/d By cash By memorandum Revaluatio	16,800 3,000 1,833	12,600 - 3,000 1,833	6,000 - 3,000 1,834	 15,000

					n				
	21,633	17,433	10,834	15,000		21,633	17,433	10,834	15,000

STEP -6

Preparation of cash Account

Particulars	Amount	Particulars	Amount
To Balance b/d To D's Capital To old partners' capital	600 15,000 9,000	By Balance c/d	24,600
Total	24,600	Total	24,600

STEP-7

Preparation of new balance sheet

Liabilities	Amount	Assets	Amount
Bills payable Creditors Capital A/Cs A B C D	3,300 6,000 20258 16,058 9,459 13,625	Cash Debtors Stock Furniture Building	24,600 10,800 11,400 2,400 19,500
Total	68,700	Total	68,700

DIFFERENCE BETWEEN REVALUATION ACCOUNT AND MEMORANDUM REVALUATION ACCOUNT

1. Revaluation account is prepared to find out the profit or loss on revaluation of assets and liabilities which appear in the new balance sheet at the new or revalued figures. Memorandum revaluation account is also prepared to record the effect of revaluation of assets and liabilities which of course are recorded at their old figures in the new balance sheet.

2. Revaluation account is not divided into two parts. But the memorandum revaluation account has two parts: first part for old partners and second part for all partners including the new partner.

3. The net result of revaluation of assets and liabilities in the revaluation account is transferred to old partners' capital accounts in the old profit-sharing ratio. In the case of memorandum revaluation account the first part is used to record the changes in the values of assets and

liabilities due to revaluation and in the second part the effect of the first part is cancelled. The balance of the first part is transferred to old partner's capital accounts in the old profit-sharing ratio while the balance of the second part is transferred to all partners including the new partner in the new profit-sharing ratio.

11.3.5 ADJUSTMENT OF PARTNER'S CAPITAL IN NEW PROFIT-SHARING RATIO

Sometimes, it is possible that the partners decide to adjust their capital so as to be proportionate to their profit-sharing ratio. If the capital of the new partner is given, the same can be used as a base for calculating the new capitals of the old partners. After making the necessary adjustments the partners can compare their new capital with the old capital and the partner whose capital falls short, will bring in the necessary amount and the partner who has a surplus, will withdraw excess amount of capital.

The partners can decide to maintain their new capital on the following basis:

- On the basis of new Partner's Capital and his profit-sharing ratio
- On the basis of the existing partner's capital account balances

ON THE BASIS OF NEW PARTNER'S CAPITAL AND HIS PROFIT-SHARING RATIO

If the capital of the new partner is given, the entire capital of the new firm will be determined on the basis of the new partner's capital and his profit-sharing ratio. Therefore, the capital of other partners is ascertained by dividing the total capital as per his profit-sharing ratio.

If the existing capital of the partner after adjustment is in excess of his new capital, the excess amount is withdrawn by partner or transferred to the credit of his current account. If the existing capital of the partner is less than his new capital, the partner brings the short amount or makes transfer to the debit of his current account.

The journal entries are made as under:

(i) When excess amount is withdrawn by the partner or transferred to current account.

Existing Partner's Capital A/c Dr.

To Bank A/c or Partner Current A/c

(Excess amount is withdrawn by the partner or transferred to current account)

(ii) For bringing in the Deficit amount or Balance transferred to current account.

Bank A/c or Partner Current A/c Dr

To Existing Partner's Capital A/c

(Bringing the Deficit amount or Balance transferred to current account)

ILLUSTRATION 14

A and B are partners sharing profit in the ratio of 5:3 with capital of Rs.80,000 and Rs.70,000 respectively. They admit a new partner C. The new profit-sharing ratio of A, B and C is 5:3:2 respectively. C brings Rs.40,000 as capital. The profit on revaluation of assets and reassessment of liabilities is Rs.6,400. It is agreed that capitals of the partner's should be in the new profit-sharing ratio. Calculate new capital of each partner.

SOLUTION:

Actual Capital of A and B

	A (Rs)	B (Rs)
Balance in Capital A/c	80,000	70,000
Add Profit on Revaluation (5 : 3)	4,000	2,400
Capital after Adjustment	84,000	72,400

Calculation of new capital of the firm and existing partner's capital

C's Share in the firm = 2/10

C's brings 40,000 for 2/10 Share

Total capital of the new firm in terms of C's capital

= 40,000 × 10/2= Rs. 2, 00,000

A's share in New Capital = 2,00,000 × 5/10 = Rs1,00,000

B's share in New Capital = 2,00,000 × 3/10 = Rs.60,000

On comparing A's adjusted capital with the new capital, we find that the A brings Rs.16,000 [1, 00,000 – 84,000] or the amount may be debited to his current account.

On comparing the B's adjusted capital with the new capital, we find that the B is to withdraw Rs12,400 [72,400 – 60,000] or the amount may be credited to his current account.

ON THE BASIS OF THE EXISTING PARTNER'S CAPITAL ACCOUNT BALANCES

Sometimes the capital of the new partner is calculated on the basis of existing partners. The partner is required to bring an amount proportionate to his/her share of profit. In such a case, new partner's capital will be calculated on the basis of adjusted capital of the existing partners.

ILLUSTRATION 15

The capital account of X and Y show the balance after all adjustments and revaluation are 100,000 and 50,000, respectively.

They admit Z as a new partner for 1/4 share in the profits. Z's capital is calculated as follows:

Total share = 1

Z's share in the profit = 1/4

Remaining share = 1 – 1/4 = 3/4

3/4 share of profit combined capital of X and Y = 100,000 + 50,000 = Rs.1,50,000

Total Capital of the firm = 1,50,000 × 4/3 = Rs.2,00,000

Z's capital for 1/4 share of profits = 2,00,000 × 1/4 = Rs50,000

Z brings in Rs.50,000 as his Capital

11.4 ACCOUNTING FOR RETIREMENT/DEATH OF A PARTNER

Retirement/death of a partner means a partner ceases to be a partner of the partnership firm. According to Section 32 of partnership Act, 1932 contemplates three ways in which a partner may retire from the firm. They are:

(i) If there is agreement about the retirement.

(ii) If all partners agree to his/her retirement

(iii) If the partnership is at will, by giving a written notice to the remaining partners of his decision to retire.

On retirement of a partner old partnership firm comes to an end and a new partnership among the remaining partners comes into force. However, the firm continues. The partner who has retired from a firm is called an outgoing partner. The firm is reconstituted by the remaining partners.

11.5 LIABILITY OF RETIRING PARTNER/OUTGOING PARTNER

A retiring partner remains liable for all the acts of the firm up to the date of retirement. On retirement the outgoing partner has to give a public notice of his retirement from the firm otherwise he remains liable to third parties for any acts of the firm even after his/her retirement.

11.6 ADJUSTMENTS REQUIRED ON RETIREMENT OF A PARTNER

(i) Computation of new profit-sharing ratio and gaining ratio
(ii) Treatment of goodwill
(iii) Revaluation of assets and reassessment of liabilities

(iv) Distribution of reserves and accumulated profits/losses

(v) Settlement of the Accounts due to Retired partner/outgoing partner

5.6.1 COMPUTATION OF NEW PROFIT-SHARING RATIO AND GAINING RATIO

Retirement or death of a partner leads to change in profit sharing ratio among the remaining partners as they acquire share of retiring or deceased partner. New profit-sharing ratio of the continuing or remaining partners and their gaining ratio are calculated. The ratio in which remaining or continuing partners share the profits or losses of the firm is called new profit-sharing ratio.

Gaining ratio: it is the ratio in which the continuing partners have acquired the share from the outgoing partner. Gaining Ratio = New Ratio - Old Ratio

ILLUSTRATION 16

A, B and C are partners sharing profits in the ratio of 5:3:2. Due to some personal reasons A retires from the partnership. Calculate the new profit-sharing ratio and gaining ratio of remaining partners.

SOLUTION:

1. Calculation of new profit-sharing ratio: In order to calculate new ratio of B and C, it is assumed that A's share of 5/10 will be taken up by B and C in their old profit-sharing ratio

B's new share = 3/10 + (5/10 □3/5) = 3/10 + 15/50 = 30/50

Raj's new share = 2/10 + (5/10 □ 2/5) = 2/10 + 10/50 = 20/50

Therefore, the new profit-sharing ration is30/50: 20/50 or 3:2

2. Calculation of gaining ratio: Gaining ratio = New share – Old share

(i) B's gain =3/5 – 3/10 = 3/10

(ii) C's gain =2/5 – 2/10 = 2/10

Gaining ratio of B and C is 3/10 :2/10 or 3:2

11.6.2 TREATMENT OF GOODWILL

At the time of retirement or death of a partner the retiring partner/representative of deceased partner is entitled to his share of goodwill because the goodwill has been earned by the firm with the efforts of all the existing partners. The valuation of goodwill will be done as per the agreement among the partners. It is possible that company will earn some profit in near future because of the existing goodwill of the company. Therefore, the retiring/deceased partner should be compensated for the same by the continuing partners in their gaining ratio. For this purpose, the retiring/deceased partner's capital will be credited.

1. When old goodwill appears in the books then first of all this is written off in the old ratio.

All Partners' capital A/c Dr (Old ratio)

To Goodwill A/c

2. After written off of goodwill adjustment of retiring partner's share of goodwill will be made through the following journal entry.

Remaining Partner's Capital A/c Dr. (in gaining ratio)

To Retiring/Deceased Partner's Capital A/c (share of goodwill of retiring partner)

ILLUSTRATION 17

A, B and C are partners sharing profits in the ratio 5:3:2. A retires and goodwill is valued at 54,000. New profit-sharing ratio of continuing partners will be equal. Pass the necessary journal entry.

SOLUTION:

Journal

B's Capital a/c	Dr 10,800	
C' Capital a/c	Dr 16,200	
To A's Capital a/c		27,000

(Being A's share of Goodwill raised debited remaining partners' capital a/c in gaining ratio)

Working Notes:

Total Goodwill= 54,000

A's share= 1/2 of 54,000= 27,000

New profit-sharing ratio of B and C= 1:1 (Given)

Calculation of Gaining Ratios

Gain of partner = New share – Old share

B's Old share =3/10

B’s new share = ½

B’s gain =1/2– 3/10 = 2/10

C’s Old share =2/10

C’s new share =1/2

C’s gain =1/2– 2/10 = 3/10

Therefore, gaining ratio is 2: 3

11.6.3 REVALUATION OF ASSETS AND REASSESSMENT OF LIABILITIES

In case of retirement or death of a partner the assets and liabilities of the firm should be revalued in the same way as at the time of admission of a partner. At the time of retirement/death some of the assets or liabilities may not have been shown at their current values. To ascertain the net profit and loss on revaluation of assets and liabilities Revaluation A/c is prepared.

The following journal entries are passed for the revaluation of assets and liabilities:

(i) For increase in the value of Assets

Asset A/c Dr.

To Revaluation A/c

(Increase in the value of assets)

(ii)For decrease in the value of Asset

Revaluation A/c Dr.

To Asset A/c

(Decrease in the value of assets)

(iii)For increase in the value of Liabilities

Revaluation A/c Dr.

To Liabilities A/c

(Increase in the value of Liabilities)

(iv)For decrease in the value of Liabilities

Liabilities A/c Dr.

To Revaluation A/c

(Decrease in the value of Liabilities)

(v) For unrecorded Assets

Asset A/c [unrecorded] Dr.

To Revaluation A/c

(Unrecorded asset recorded at actual value)

(vi) For unrecorded Liability

Revaluation A/c Dr.

To Liability A/c [unrecorded]

(Unrecorded Liability recorded at actual value)

(vii) For transfer of gain on revaluation:

Revaluation A/c Dr.

To All Partner’s Capital A/c (Old ratio)

(Profit on revaluation transferred to capital account in old profit-sharing ratio)

(viii)For transfer of loss on revaluation:

All Partner’s Capital Dr.

To Revaluation A/c

(Loss on revaluation transferred to capital account in existing ratio)

ILLUSTRATION 18

X, Y and Z are partners sharing profit in the ratio 1:2:3. X retires from the partnership. In order to settle his claim, the following revaluation of assets and liabilities 313as agreed upon:

(i) The value of Machinery is increased by 15,000.

(ii) The value of Investment is increased by 2,000.

(iii) A provision for outstanding bill standing in the books at 1,000 is now not required.

(iv) The value of Land and Building is decreased by 12,000.

Give journal entries and prepare Revaluation account.

SOLUTION:

Journal Entries

1. Machinery a/c Dr 15,000

   Investment a/c Dr 2,000

   Provision for Outstanding Bill Dr 1,000

   To Revaluation a/c 18,000

(Being increase in assets and decrease in liability)

2. Revaluation a/c Dr 12,000
   To land and Building a/c 12,000
   (Being decrease in assets)
3. Revaluation a/c Dr 6,000

   To X's capital a/c 1,000

   To Y's capital a/c 2,000

   To Z's capital a/c 3,000

(Being profit on revaluation)

Revaluation A/C

Particulars	Amount	Particulars	Amount
To Land and Building To profit on revaluation X Y Z	12,000 1,000 2,000 3,000	By Machine By Investment By provision for Bill	15,000 1,000 2,000
Total	18,000	Total	18,000

11.6.4 ACCOUNTING TREATMENT OF RESERVES AND UNDISTRIBUTED PROFITS OR LOSSES

At the time of retirement or death of a partner the amount of reserves and undistributed profits (losses), as shown in the Balance Sheet of the firm belongs to all the partners and is transferred to their capital accounts in old profit-sharing ratio.

For the purpose, the following journal entries are recorded:

(i) For distribution of undistributed profit and reserve.

Reserves A/c Dr

Profit and loss A/c (Profits i.e., credit balance) Dr

To All partners' capital A/c (individually)

(Reserves and undistributed profit transferred to partner's capital A/c in old profit sharing

ratio)

(ii) For distributing losses among all partners in the old ratio

All Partners' Capital A/c Dr

To P&L A/c (accumulated losses, i.e., debit balance)

To Deferred Revenue Expenditure A/c

The surplus available on some specific funds like workmen's compensation fund or investment fluctuation fund to meet certain obligations in future will be transferred to capital accounts of all the partners in their old ratio. For the purpose, the following journal entries are recorded:

Workman's Compensation Fund A/c Dr.

Investment Fluctuation fund A/c Dr.

To All Partners' capital A/c

(Surplus available on workmen's compensation fund and investment fluctuation fund transferred to partner's capital A/c in old profit-sharing ratio)

11.6.5 SETTLEMENT OF THE ACCOUNTS DUE TO RETIRED PARTNER

When a partner retires from business, his claim against the firm is determined by preparing his capital account incorporating therein all the adjustments in respect of his share of goodwill, accumulated profits or losses, profit/loss on revaluation of assets and liabilities, etc. Now the settlement of the claim depends on the provisions of the partnership deed. If nothing is given in the problem to be solved in respect of settlement of claim, the amount of claim is usually transferred to the Retiring partner's Loan Account for which the following entry is passed:

Retiring Partner’s Capital A/c Dr

To Retiring Partner’s Loan A/c

Note: Retiring partner’s loan a/c is shown as liability in the new balance sheet. If retiring partner’s loan is paid immediately then, it is no more shown as liability.

MODE OF PAYMENT

The outgoing partner’s account is settled as per terms of partnership deed, i.e., in lump sum immediately or in various installments with/without interest as agreed or partly cash immediately and partly in installments at the agreed intervals.

- **PAYMENT IN LUMP SUM**

If the full amount of claim is payable to the retiring partner on the date of retirement as per agreement, the amount will not be transferred to Loan Account but will be paid in cash or by cheque.

The following journal entry is made for disposal of-the amount payable to the retiring partner:

Retiring Partner’s Capital A/c Dr.

To Cash/Bank A/c

(Amount paid to the retiring partner)

- ***PAYMENT IN INSTALLMENTS***

In this case the amount due to retiring partner is paid in installments. In the absence of any agreement, section 37 of the Indian Partnership Act, 1932 is applicable.

*Note: As per the Sec 37 of Indian Partnership Act, 1932, outgoing partner is at liberty to receive either interest @ 6% p.a. till the date of payment or the share of profits which has been earned with his money.

An instalment consists of two parts:

(i) Principal Amount of instalment due to retiring partner

(ii) Interest at an agreed rate.

Interest due on loan amount is credited to retiring partners’ loan account. Instalment inclusive of interest then is paid to the retiring partner as per schedule agreed upon.

(i) On part payment in cash and balance transferred to his/her loan account.

Retiring Partner’s Capital A/c Dr.

To Cash/Bank A/c

To Retiring Partner's Loan A/c

(Part payment made and balance transferred to loan A/c)

(ii) Total amount due transferred to loan A/c

Retiring Partner's Capital A/c Dr.

To Retiring Partner's Loan A/c

(Total amount due transferred to loan A/c)

(iii) For interest due

Interest on loan A/c Dr

To Retiring Partners' Loan A/c

(Interest due on loan)

(iv) For payment of instalment

Retiring Partners' Loan A/c Dr

To Cash/Bank A/c

(Instalment inclusive of interest paid)

DEATH OF PARTNER

11.7 ACCOUNTING TREATMENT ON DEATH OF A PARTNER

The key difference between the retirement and death of partner is that normally the retirement takes place at the end of an accounting period whereas death can occur at any time. Hence, in the case of death of a partner his claim shall include:

- share in the profits of the firm up to the date of death
- interest on his capital up to the date of death
- share in the proceeds of joint life policy (if any) in addition to his share in the accumulated profits
- share of goodwill,
- profit or loss on revaluation of assets and liabilities

On the death of a partner, the accounting treatment regarding goodwill, revaluation of assets and reassessment of liabilities, accumulated reserves and undistributed profit are similar to that of the retirement of a partner.

11.8 ASCERTAINMENT OF SHARE OF PROFIT UP TO THE DEATH OF PARTNER

If the death of a partner occurs during the year, the representatives of the deceased partner are entitled to his/her share of profits earned till the date of his/her death. Such profit is ascertained by any of the following methods:

- Time Basis
- Turnover or Sales Basis

ON THE BASIS OF TIME

There are two methods used in ascertainment of profit on the basis of time:

1. On the basis of average profit of certain years: Under this method the calculation of profit is based on the average annual profit for the past few years say, 3 to 5 years. Then, the profit for the proportionate period is found out.

ILLUSTRATION 19

X, Y and Z are partners sharing profits equally. Z dies on April 30, 2004. The accounts of the firm are closed on Dec. 31. The profits for the past 3 years are: 2018 - 35,000; 2019 - 40,000 and 2020 - 60,000. Calculate the Z's share of profit from 1st April to 30th April2021.

SOLUTION:

The average profit for the past three years:

$$(35,000 + 40,000 + 60,000)/3 = \text{Rs. } 45,000$$

Profit for 4 months up to April 30, 2004 = 4/12 × 45,000 = Rs. 15,000

Z's share of Profit = 15,000 × 1/3 = Rs. 5,000

2. On the basis of last year's profit: Calculation of profit is based on the last year's profit.

ILLUSTRATION 20

The total profit of previous year is 3,60,000 and a partner dies three months after the close of previous year, the profit of four months= 3,60,000 ×4/12 = Rs.1,20,000

If the deceased partner took 2/10 share of profit, his/her share of profit till the date of death is1,20,000 × 2/10 = Rs 24,000.

ON THE BASIS OF TURNOVER

Under this method, the share of profit is calculated on the basis of the profit and the total sales of the last year. Thereafter, the profit up to the date of death is estimated on the basis of the sale of the last year. Profit is assumed to be earned uniformly at the same rate.

ILLUSTRATION 21

A, B and C are partners sharing profits and losses in the ratio of 2:1:1. B dies on March 1, 2021. Sales for the year 2021 amount to Rs 80,000, out of which Rs 25,000 are for a period from January 1, 2021 to March 1, 2021. The profit for the year is Rs. 40,000. Calculate the B's share of profit.

SOLUTION:

The Profit up to the date of B's death= (25,000/80,000) × 40,000= Rs.12,500

B's share = 12,500 × 1/4 = Rs. 3,125

Journal Entry for share of profit of deceased partner up to date of death is:

P/L suspense a/c Dr

To deceased partner's capital a/c

Note: P/L suspense a/c is shown as asset in the balance sheet till actual profit for the year of death of deceased partner is calculated.

11.9 SETTLEMENT OF EXECUTOR'S ACCOUNT

After the death of a partner the total amount due to him is transferred to his, executor's account and paid off as per the provisions of the partnership deed immediately or in instalments together with interest on the unpaid balance. As explained earlier the amount due to the deceased partner should include the amount standing to the credit of his Capital Account, a share in the accumulated profits, goodwill, joint life policy (if any), profit on revaluation of assets/liabilities.

The following entries should be passed for disposal of amount due to the deceased partner:

(a) The amount standing to the credit of deceased partner's capital is transferred to his executor's account, by recording the following entry:

Deceased partner's capital A/c Dr

To Deceased partner's executor's A/c

Deceased partner's executor's account will be settled as per the agreement between the firm and executors of the deceased partner. Unless otherwise mentioned Executor's account is shown as liability in new balance sheet.

(b) When the full amount is paid in cash, following entry is recorded:

Executor's A/c Dr

To Cash/Bank A/c

(c) When the settlement is made in installments, the following entries are made:

(i) For interest due:

Interest on executor's A/c Dr

To Executor's A/c

(ii) For payment of instalment on loan account

Executor's A/c Dr

To Cash/Bank A/c

ILLUSTRATION 22

Balance sheet as at 31st march 2020 of A, B and C partners in a firm sharing profits and losses in the ratio of 5:3:2 is as follows:

Liabilities	Amount	Assets	Amount
Capital A/Cs		Furniture	10,000
A	10,000	Machinery	40,000
B	15,000	Stock	15,000
C	20,000	Debtors	15,000
Creditors	30,000	Cash in hand	5,000
Profit and Loss	10,000		
Total	85,000	Total	85,000

B died on 31st May, 2020 and A and C decided to share future profits and losses in the ratio of 3:2. Average profit earned by the firm is 12,000. Following adjustments are agreed

(a) Maintain provision for bad and doubtful debts Rs. 1,000
(b) Stock is to be valued at Rs. 10,000

(c) Machinery be reduced by 10%
(d) Amount of Rs. 12,000 included in creditors no longer payable
(e) The goodwill of the firm was valued at Rs. 25,000 on B's death.

The amount payable to B was transferred to his executor's account. You are required to prepare revaluation account, partners' capital account and balance sheet of A and C.

SOLUTION:

STEP-1

Old profit-sharing Ratio between A, B and C= 5:3:2

New profit-sharing ratio between A and C= 3:2

STEP-2

Calculation of gaining ratio

Particulars	Old ratio=5:3:2	New ratio=3:2	Gaining ratio=New-old=1:2
A	5/10	3/5	3/5 – 5/10= 1/10
B	3/10	-	
C	2/10	2/5	2/5 – 2/10 =2/10

STEP-3

Treatment of Goodwill

Goodwill valued at Rs 25,000

Deceased partner's (B) share goodwill has been raised

His share in goodwill = 3/10 x 25,000= 7,500

A's capital a/c Dr 2,500

C's Capital a/c Dr 5,000

To Deceased partner's capital a/c (B's Capital a/c) 7,500

(Being B's share of goodwill raised and transferred to existing partners' capital a/cs in their gaining ratio)

STEP- 4

Calculation of share of profit of B (Deceased partner) till the date of death

Closing date = 31st march

Date of death = 31st may

Average profit earned per annum =12,000

Estimated profit for 2 months i.e., 31st March to 31st May 2020

= 2/12 x 12,000 = 2,000

B's share of such profit= 3/10 x 2,000= 600

Profit and Loss suspense a/c Dr 600

To B's capital a/c 600

(Being share of estimated profit transferred to B's capital a/c)

STEP-5

Distribution of Accumulated profits

Profit and Loss a/c Dr 10,000

To A's capital a/c 5,000

To B's capital a/c 3,000

To C's capital a/c 2,000

(Being accumulated profits distributed among all the partners in their old profit-sharing ratio)

STEP-6

Preparation of Revaluation A/C

Revaluation Account

Particulars	Amount	Particulars	Amount
To provision for bad and doubtful debts	1,000	By creditors	12,000
To stock	5,000		
To machinery	4,000		
To capital accounts			
A	1,000		

B C	600 400		
Total	12,000	Total	12,000

STEP -7

Preparation of capital accounts

Capital Accounts

Particulars	A	B	C	Particulars	A	B	C
To Goodwill	2,500	-	5,000	By Balance b/d	10,000	15,000	20,000
To B's executor a/c		26,700		By Goodwill		7,500	
To Balance c/d				By Revaluation	1,000	600	400
A	13,500		17,400	By profit and	5,000	3,000	2,000
C				Loss			
				By P/L suspense		600	
	16,000	26,700	22,400		16,000	26,700	22,400

STEP- 8

Preparation of new balance Sheet

Balance sheet after Death of B

Liabilities	Amount	Assets	Amount
Capital A/Cs		Furniture	10,000
A	13,500	Machinery	36,000
C	17,400	Stock	10,000
B's Executor a/c	26,700	Debtors	14,000
Creditors	18,000	Cash in hand	5,000
		P/L Suspense a/c	600
Total	75,600	Total	75,600

11.10 KEYWORDS

ACCUMULATED PROFITS: In the Balance Sheet, undistributed profits appear as a general reserve or a credit balance in the Profit & Loss Account.

GOODWILL: The reputation of the business, which is earned by a firm through the hard work and honesty of its owners.

NORMAL PROFITS: The amount of profit that can be predicted based on the normal rate of return.

REVALUATION ACCOUNT: An account created to determine the profit or loss resulting from asset and liability revaluation.
SACRIFICING RATIO: Ratio in which the old partners sacrifice their share in favour of new partner
SUPER PROFITS: Excess of average expected profits over normal profits
EXECUTORS: The representatives of a deceased partner who are entitled to a share of the deceased partner's estate.

11.11 SOME USEFUL BOOKS

Robert N Anthony, David Hawkins, Kenneth A. Merchant, *Accounting: Text and Cases*. McGraw-Hill Education, 13th Ed. 2013.

Charles T. Horngren and Donna Philbrick, *Introduction to Financial Accounting,* Pearson Education.

J.R. Monga, *Financial Accounting: Concepts and Applications*. Mayur Paper Backs, New Delhi.

M. C. Shukla, T.S. Grewal and S. C. Gupta. *Advanced Accounts. Vol.-I. S.* Chand & Co., New Delhi.

S.N. Maheshwari, and. S. K. Maheshwari. *Financial Accounting*. Vikas Publishing House, New Delhi.

Deepak Sehgal. *Financial Accounting.* Vikas Publishing H House, New Delhi.

Bhushan Kumar Goyal and HN Tiwari, *Financial Accounting*, International Book House

Goldwin, Alderman and Sanyal, *Financial Accounting*, Cengage Learning.

Tulsian, P.C. *Financial Accounting,* Pearson Education.
Compendium of Statements and Standards of Accounting. The Institute of Chartered Accountants of India, New Delhi

11.12 TERMINAL QUESTIONS/EXCERSISES

QUESTIONS

ADMISSION

1. What do you understand by admission of a partner? How is new partner admitted to the firm?

2. What is new profit-sharing ratio? How is it calculated in different cases?

3. What is sacrificing ratio? How is it calculated? Explain the significance of sacrificing ratio for admission of a partner.

4. Discuss the methods of valuation of goodwill on admission of a partner.

5. Explain the accounting treatment of goodwill in the books of firm on admission of a partner.

6. What is revaluation account? Why is revaluation account opened on admission of a partner? Give its accounting treatment in the books of firm.

7. Give accounting treatment of accumulated profits and losses and reserves appearing in the books of a firm on admission of a partner.

8. X and Y are partners sharing profits and losses in the ratio of 3:1. Calculate new profit-sharing ratio and sacrificing ratio in each of the following cases:

Case 1. Z is admitted with $1/8^{th}$ of the profits

Case 2. Z is admitted with conditions that Z acquires 1/12 from X and 1/6 from Y

Case 3. Z is admitted on the conditions that X surrenders 1/3rd of his share in favour of Z whereas Y surrenders 2/3rd of his share in favour of Z.

Case 4. Z is admitted into partnership on the conditions that Z acquires $1/4^{th}$ of his share from X and $3/4^{th}$ of his share from Y

(Answer: Case 1: New profit-sharing ratio- 21:7:4, Sacrificing ratio: 3:1

Case 2: New profit-sharing ratio- 8:1:3, Sacrificing ratio: 1:2

Case 3: New profit-sharing ratio- 6:1:5, Sacrificing ratio: 3:2

Case 4: New profit-sharing ratio- 9:1:6, Sacrificing ratio: 1:1)

9. Profits for last four years of a partnership firm ending 31^{st} march are:

2020-Rs. 12,000, 2019- Rs.18,000, 2018- Rs. 16,000 and 2017- Rs. 14,000

Capital employed is 1,00,000

Normal rate of profit is 10%

A and B were partners sharing profits and losses equally and they admit C as new partner into the firm.

Make a valuation of Goodwill by following the methods given below:

(a) Average profit method taking 3 years' purchase
(b) Super profit method taking two years' purchase
(c) Capitalization method

(Answer: (a): Rs. 45,000, (b): Rs:10,000, (c): Rs. 50,000)

10. Pass journal entries to record the following transactions on admission of new partner Z with partners X and Y who share profits and losses in the ratio of 3:2. Prepare revaluation a/c.

(a) The value of furniture is to be increased by Rs. 10,000

(b) Stock is undervalued by 10% whose book value is Rs. 18,000

(c) Machinery is overvalued by Rs. 20,000

(d) Bills Payable is shown in the balance sheet in excess by Rs.3,000

(e) Creditors is to be increased by Rs.6,000

(f) Other fixed assets of Rs.40,000 will be appreciated by 20%

(g) Provision for bad debts is to be maintained by 5% (Debtors Rs45,000)

(h) Outstanding expenses of Rs.4,000 was not disclosed in the balance sheet.

(i) Investment of Rs.12,000 not recorded in the balance sheet.

(Answer: Profit on revaluation: Rs. 2,550)

11. X and Y are partners in a firm sharing profits and losses in the ratio of 3:2. They admit Z as new partner with 1/8th share in the future profits of the firm, when their balance sheet stood as:

Balance Sheet

Liabilities	Amount	Assets	Amount
Creditors	20,000	Cash in hand	2,000
Bills Payable	12,000	Cash at bank	23,000
X's Capital	40,000	Inventory	10,000
Y's Capital	30,000	Debtors	25,000
		Plant and Machinery	42,000
Total	1.02,000	Total	1,02,000

Additional Information

(i) Goodwill is valued at 2 years purchase of the average profits of last three years which are Rs. 21,000, Rs24,000 and Rs. 27,000.

(ii) Z is to bring in cash his share of Goodwill

(iii) Z is to bring in cash Rs. 20,000 as his capital

Pass necessary journal entries recording the transactions and prepare the balance sheet of the firm after admission of Z. Also calculate the new profit-sharing ratio and sacrificing ratio.

(Answer: New profit-sharing ratio: 21:14:5, Sacrificing ratio: 3:2, Goodwill Rs. 48,000 Balance Sheet total: Rs. 1,28,000, Capitals: X- Rs. 43,600, Y-Rs. 32,400, Z-Rs. 20,000)

12. Following is the balance sheet of A and B who are sharing profits in the ratio of 1:1 as at 31st march 2021.

Liabilities	Amount	Assets	Amount
Capital A/Cs		Land and Buildings	25,000
A	15,000	Plant and Machinery	12,500
B	10,000	Stock	10,000
Bills payable	32,950	Debtors	4,850
		Cash in hand and cash at bank	5600
Total	57,950	Total	57,950

They agree to admit C into the partnership on the following conditions:

(i) C is to bring in Rs.8,000 as his capital and Rs. 4,000 as goodwill for 1/4th share in the firm.

(ii) Value of stock and plant machinery are to be reduced by 5%

(iii) A provision for doubtful debts is to be created for debtors

(iv) Land and building is to be appreciated by 10%

Prepare revaluation a/c, capital accounts of partners and balance sheet of the new firm. Pass necessary journal entries to record the above arrangements.

(Answer: New profit-sharing ratio: 3:3:2, Sacrificing ratio: 1:1, Profit on revaluation: Rs. 890, Balance Sheet total: Rs. 70,840, Capitals: A- Rs. 17,445, B-Rs. 12,445, C-Rs. 18,000)

13. A and B are partners sharing profits and losses in the ratio of 2:1. The balance sheet of the firm as on 31st march 2021 is as follows:

Liabilities	Amount	Assets	Amount
Sundry Creditors	25,000	Cash /Bank	5,000
General Reserve	18,000	Debtors	15,000
Capital A/Cs		Stock	10,000

A	75,000	Machinery	50,000
B	62,000	Building	1,00,000
Total	1,80,000	Total	1,80,000

They admit C into partnership on the same date on the following terms:

(a) C brings in Rs. 40,000 as his capital and he is given 1/4th share in profits
(b) C brings in Rs. 15,000 for goodwill
(c) Machinery is depreciated by 5% and Building is appreciated by 10%
(d) Creditors of Rs. 5,000 remains unrecorded
(e) Capitals of A and B are to be proportionate to that of C on their profit-sharing basis.

Pass journal entries, prepares and revaluation a/c, capital accounts and new balance sheet of the firm.

(Answer: New profit-sharing ratio: 2:1:1, Sacrificing ratio: 2:1, Profit on revaluation: Rs. 2500, Balance Sheet total: Rs. 1,90,000, Capitals: A- Rs. 80,000, B-Rs. 40,000, C-Rs. 40,000, Surplus Cash paid to A – Rs, 18,667, B- Rs. 33,833)

14. A and B are partners in a firm sharing profits and losses in the ratio of 3:1. They admit C as a new partner for 1/4th share in future profits of the firm. C is to bring Rs. 50,000 for his capital. The balance sheet of A and B as at 31st march 2020, the date on which C was admitted is:

Liabilities	Amount	Assets	Amount
Sundry Creditors	70,000	Cash /Bank	10,000
General Reserve	10,000	Debtors	34,000
Capital A/Cs		Stock	30,000
A	50,000	Investments	26,000
B	80,000	Plant and machinery	70,000
		Land and Building	40,000
Total	2,10,000	Total	2,10,000

Other terms agreed upon are:

(a) Goodwill is valued at 24,000
(b) Land and building are valued at Rs 60,000 and plant machinery is at Rs.65,000
(c) Provision for doubtful debts is to be maintained by 10%
(d) The capital of partners is to be adjusted on the basis of C's capital to the firm
(e) Excess or shortfall, if any be transferred to current accounts

Prepare revaluation account, partners' capital accounts and balance sheet of the new firm.

(Answer: New profit-sharing ratio: 9:3:4, Sacrificing ratio: 3:1, Profit on revaluation: Rs. 11,600, Balance Sheet total: Rs. 3,13,400, Capitals: A- Rs. 1,12,500, B-Rs. 37,500, C-Rs. 44,000, current account of A(Dr): Rs. 41,800, Current account of B(Cr) – Rs. 49,400)

15. P and Q are partners in a firm sharing profits and losses in the ratio of 2:1. They admit R as a new partner for 1/5h share in future profits of the firm. R is to bring Rs. 60,000 for his capital. The balance sheet of P and Q as at 31st march 2021, the date on which C was admitted is:

Liabilities	Amount	Assets	Amount
Creditors	50,000	Cash /Bank	10,000
Bills Payable	90,000	Debtors	25,000
General Reserve	10,000	Stock	30,000
Profit & Loss	20,000	Investments	55,000
Capital A/Cs		Plant and machinery	1,00,000
P	60,000	Land and Building	90,000
Q	80,000		
Total	3,10,000	Total	3,10,000

Other terms agreed upon are:

(a) R is to bring in Rs. 4,000 for goodwill
(b) Land and building are valued at Rs 75,000 and plant machinery is at Rs.1,05,000
(c) Provision for doubtful debts is to be maintained by 10%
(d) Equipment worth Rs.10,000 was unrecorded.
(e) Outstanding expenses Rs. 2,000 is to be recognized.

Prepare revaluation account, partners' capital accounts and balance sheet of the new firm.

(Answer: New profit-sharing ratio: 8:4:3, Sacrificing ratio: 2:1, Loss on revaluation: Rs. 4,500, Balance Sheet total: Rs. 3,71,500, Capitals: P- Rs. 79,667, Q-Rs. 89,833, R-Rs. 60,000)

16. Following is the balance sheet of A, B and C who are equal partners as at 31st march 2020.

Liabilities	Amount	Assets	Amount
Bills Payable	3,300	Cash /Bank	10,600
Sundry Creditors	6,000	Debtors	10,800
General Reserve	10,000	Stock	11,400
Capital A/Cs		Furniture	2,400
A	16,800	Land and Building	19,500

B C	12,600 6,000		
Total	54,700	Total	54,700

Other terms agreed upon are:

(a) D is admitted as a new partner for 1/4th share in profits of the firm and brings in Rs. 15,000 as capital and Rs. 9,000 as his share of goodwill
(b) Stock and furniture are depreciated by 10%
(c) A liability of Rs. 1,000 be created against bills discounted
(d) The value of building is undervalued by Rs.8,000
(e) The value of assets and liabilities is not be changed in new balance sheet except cash

Prepare revaluation account, Memorandum revaluation a/c, partners' capital accounts and balance sheet of the new firm. Pass necessary journal entries.

(Answer: New profit-sharing ratio: 1:1:1:1, Sacrificing ratio: 1:1:1, Memorandum revaluation A/c Balance: Rs. 5,620, Balance Sheet total: Rs. 78,700, Capitals: A- Rs. 23,601, B-Rs. 19,401, C-Rs. 12,803, D- Rs. 13,595)

RETIREMENT& DEATH

17. Distinguish between sacrificing and gaining ratio

18. Explain the procedure of calculating gaining ratio with an example

19. Explain the accounting treatment of goodwill on retirement/death of a partner.

20. Why are assets and liabilities revalued on retirement /death of a partner? Pass necessary journal entries to that effect.

21. What problems arise when a partner die? How would you deal with them as an Accountant?

22. Explain the procedure of estimation of profits up to the date of death on the basis of time and turnover/sales.

23. Calculate new profit-sharing ratio and gaining ratio in the following cases:

a) A, B and C were partners, sharing profits and losses in the ratio of 5:4:1. A retires/dies. Calculate new profit-sharing ratio between B and C. Also calculate gaining ratio between B and C.

b) A, B and C were partners sharing profits and losses in the ratio of 5: 3:2. B retires/dies. His share is taken by A and c in the ratio of 2:1. Calculate new profit-sharing ratio as well as gaining ratio between A and C.

c) A, B and C were partners sharing profits and losses in the ratio of 2:2:1. C retires/dies. His share is taken by B. calculate new profit-sharing ratio and gaining ratio.

d) A, b and C were partners sharing profit and loss in the ratio of 5:3:2. A retire/dies. B and C decide to share future profits and losses in the ratio of 3:2. Calculate new profit-sharing ratio and gaining ratio

e) X, Y and Z were partners sharing profits and losses in the ratio of 4:3:2. Z retires and surrenders $1/9^{th}$ of his share to X and the remaining to Y. Calculate new profit-sharing ratio and gaining ratio.

(Answer: (a) New profit-sharing ratio- 4:1, Gaining ratio: B only gains

(b) New profit-sharing ratio- 7:3, Gaining ratio: 2:1

(c) New profit-sharing ratio- 3:2, Gaining ratio: A only gains

(d) New profit-sharing ratio- 3:2, Gaining ratio: 3:2)

(e) New profit-sharing ratio- 38:43, Gaining ratio: 1:8)

24. Make necessary journal entries for adjustment of goodwill in the books of account of firm after retirement or death of a partner.

a) A, B, C and D are partners sharing profits and losses in the ratio of 2:1:2:1. On retirement/death of C, goodwill was valued at Rs. 72,000. A, B and D decided to share future profits equally. Calculate gaining ratio and Make adjustment entries for goodwill without opening the goodwill account.

b) X, Y and Z are partners sharing profits and losses in the ratio of 3:2:1. Z retires/ dies on which date goodwill was valued at Rs. 1,20,000. Calculate new profit-sharing ratio and gaining ratio and pass the necessary journal entries giving effect to goodwill account.

c) A, B and C were partners sharing profits and losses in the ratio of 3:2:1. C retired from the firm on that date goodwill was valued at Rs. 1,20,000. Pass the necessary journal entries raising goodwill for retiring partner's share. Also calculate new profit sharing and gaining ratio.

d) X, Y and Z are partners sharing profits and losses in the ratio of 2:3:5. Goodwill is appearing in their books at a value of Rs. 50,000 and on that date X retires. Goodwill is valued at Rs. 45,000. Y and Z decided to share the future profits equally. Pass necessary journal entries for goodwill.

e) A, B and C are partners sharing profits and losses in the ratio of 1: 2:3. C retires and his capital after making all adjustments for accumulated profits and reserves and profit / loss on revaluation Rs. 2,20,000. A and B agreed to pay him Rs. 2,50,000 in full settlement of his claim. Record necessary journal entry for the treatment of goodwill if the new profit-sharing ratio is 1:3.

(Answer: (a) New profit-sharing ratio- 2:1:1, Gaining ratio: 2:1:1

(b) New profit-sharing ratio- 3:2, Gaining ratio: 3:2

(c) New profit-sharing ratio- 3:2, Gaining ratio: 3:2

(d) New profit-sharing ratio- 1:1, Gaining ratio: Y gains only)

(e) New profit-sharing ratio- 1:3, Gaining ratio: 1:5)

25. Balance sheet of A, B and C partners sharing profits and losses in the ratio of 5:3:2 as at 31st March 2020 was:

Liabilities	Amount	Assets	Amount
Sundry creditors	15,000	Cash at Bank	27,000
Capital A/Cs		Debtors	15,200
A	46,000	Stock	12,800
B	34,000	Plant and machinery	35,000
C	25,000	Land and Building	30,000
Total	1,20,000	Total	1,20,000

B retires / dies on 1st April, 2020. A and c decided to share future profits and losses in the ratio of 3:1. Following adjustments are agreed:

(a) An amount of Rs. 1,200 included in debtors be written off as bad debts.
(b) Stock to be written down by Rs. 1,500
(c) Land and Building is written up by Rs. 11,000
(d) Plant and Machinery be reduced to Rs. 34,000
(e) Amount of Rs. 700 included in creditors no longer payable
(f) Firm had to pay Rs. 5,000 to an employee injured in an accident.

You are required to pass journal entries and also prepare revaluation account.

(Answer: New profit-sharing ratio: 3:1, Gaining ratio: 5:1, Profit on revaluation: Rs. 3,000, Retiring partners loan account (Partner B) -Rs. 34,900, Balance Sheet total: Rs. 1,27,300, Capitals: A- Rs. 47,500, C-Rs. 25,600)

26. Balance sheet of A, B and C partners in a firm sharing profits and losses in the ratio of 5:3:2 is as follows:

Liabilities	Amount	Assets	Amount
Capital A/Cs		Land and Building	60,000
A	92,000	Plant and Machinery	70,000
B	68,000	Stock	25600
C	50,000	Debtors	30,400
Sundry creditor	25,000	Cash in hand	5,500
Expense Payable	5,000	Cash at bank	48,500
Total	2,40,000	Total	2,40,000

On that date B retires from the firm and A and C decided to share future profits and losses in the ratio of 3:2. Following adjustments are agreed

(a) An amount of Rs. 1,000 included in debtors be written off as bad debts.
(b) Stock to be written down by Rs. 1,200
(c) Land and Building is written up by Rs. 11,000
(d) Plant and Machinery be reduced to Rs. 64,000
(e) Amount of Rs. 1,000 included in creditors no longer payable
(f) Firm had to pay Rs. 6,000 to an employee injured in an accident.
A and C decided that assets and liabilities shall continue to be shown at existing values other than cash and bank balance. Prepare Memorandum revaluation account.

(Answer: New profit-sharing ratio: 3:2, Gaining ratio: 1:2, Profit on revaluation: Rs. 2,200, Retiring partners loan account (Partner B) -Rs. 67,340, Balance Sheet total: Rs. 2,40,000, Capitals: A- Rs. 92,220, C-Rs. 50,440)

27. A, B and C are partners sharing profits and losses in the ratio of 3:2:1. C retires/dies. On the date of retirement, the following balances appear in the books of the firm:

General reserves Rs. 90,000

Profit and Loss account (Dr) Rs. 15,000

Employees' provident fund Rs 1,20,000

Workmen compensation fund Rs 12,000 which is no more required.

Pass journal entries for adjustment of these items on C's retirement.

(Answer: New profit-sharing ratio: 3:2, Gaining ratio: 3:2)

28. A, B and C are partners sharing profits and losses of a firm in the ratio of 3:2:1. Their balance sheet is at 31st March 2010 was:

Liabilities	Amount	Assets	Amount
Capital A/Cs		Land and Building	14,000
A	10,000	Plant and Machinery	6,000
B	10,000	Stock	7,000
C	10,000	Debtors	9,000
Sundry creditor	1,600	Cash in hand	600
General Reserve	6,000	Cash at bank	1,000
Total	37,600	Total	37,600

C retires from the business on 1st April. It was agreed that the amount due to him will be treated as loan. It was also agreed to adjust the value of assets as follows:

(a) Provision for bad debts be maintained on debtors by 10%.
(b) Stock is undervalued by Rs. 1,200
(c) Land and Building is written up by Rs. 10,000
(d) Plant and Machinery be increased to Rs. 12,000
(e) Goodwill of the firm is valued at Rs 15,000
(f) A and B will continue to carry on the business and shall share profits and losses equally in future.

Prepare Revaluation account, partners' capital accounts and balance sheet of new firm after retirement.

(Answer: New profit-sharing ratio: 1:1, Gaining ratio: B only gains, Profit on revaluation: Rs. 16,300, Retiring partners loan account (Partner C) -Rs. 16,217, Balance Sheet total: Rs. 53,900, Capitals: A- Rs. 21,150, B-Rs. 14,933)

29. A, B and C are partners sharing profits and losses of a firm in the ratio of 3:2:1. Their balance sheet is at 31st March 2010 was:

Liabilities	Amount	Assets	Amount
Capital A/Cs		Land and Building	14,000
A	10,000	Plant and Machinery	6,000
B	10,000	Stock	7,000
C	10,000	Debtors	9,000
Sundry creditor	3,000	Cash in hand	1, 600
General Reserve	7,000	Cash at bank	2,400
Total	40,000	Total	40,000

C retires from the business on 30th June, 2010. It was agreed that the amount due to him will be treated as loan. It was also agreed to adjust the value of assets as follows:

(a) Provision for bad debts be maintained on debtors by 5%.

(b) Stock is undervalued by Rs. 1,500
(c) Land and Building is written up by Rs. 10,200
(d) Plant and Machinery be increased to Rs. 12,600
(e) Goodwill of the firm is valued at two years' purchase of average profit. Average profit is Rs. 30,000
(f) C' share of profit up to the date of retirement be calculated on the basis of average profit
(g) A and B will continue to carry on the business and shall share profits and losses equally in future.

Prepare Revaluation account, partners' capital accounts, partner's loan account and balance sheet of new firm after retirement.

(Answer: New profit-sharing ratio: 3:2, Gaining ratio: 3:2, Profit on revaluation: Rs. 17,850, Retiring partners loan account (Partner C) -Rs. 25,392, Balance Sheet total: Rs. 59,100, Capitals: A- Rs. 16,425, B-Rs. 14,283)

30. Balance sheet as at 31st march 2020 of A, B and C partners in a firm sharing profits and losses in the ratio of 5:3:2 is as follows:

Liabilities	Amount	Assets	Amount
Capital A/Cs		Furniture	6,000
A	12,000	Machinery	35,000
B	16,000	Stock	15,000
C	12,000	Debtors	15,000
Sundry creditor	22,000	Cash in hand	3,000
General reserve	12,000		
Total	74,000	Total	74,000

B died on 31st March, 2020 and A and C decided to share future profits and losses in the ratio of 3:2. Following adjustments are agreed

(f) An amount of Rs. 1,000 included in debtors be written off as bad debts.
(g) Stock to be written down by Rs. 1,200
(h) Machinery be reduced by 10%
(i) Amount of Rs. 1,000 included in creditors no longer payable
(j) The goodwill of the firm was valued at Rs. 25,000 on B's death.

The amount payable to B was transferred to his executor's account. You are required to prepare revaluation account, partners' capital account and balance sheet of A and C.

(Answer: New profit-sharing ratio: 3:2, Gaining ratio: 1:2, Loss on revaluation: Rs. 4,700, B's executor's A/C -Rs. 25,690, Balance Sheet total: Rs. 68,300, Capitals: A- Rs. 13,150, C- Rs. 8,460)

31. Balance sheet as at 31st march 2020 of A, B and C partners in a firm sharing profits and losses in the ratio of 3:2:1 is as follows:

Liabilities	Amount	Assets	Amount
Capital A/Cs		Investments	1,41,000
A	1,80,000	Machinery	1,80,000
B	1,50,000	Stock	1,32,000
C	1,20,000	Debtors	30,000
Bills Payable	30,000	Cash in hand	48,000
Loan	36,000		
General reserve	15,000		
Total	5,31,000	Total	5,31,000

C died on 31st May, 2020 and A and B decided to share future profits and losses equally. Following adjustments are agreed

(a) Stock to be written down by Rs. 10,000
(b) Machinery be reduced by 10%
(c) Amount of Rs. 1,000 included in Bills payable no longer to be paid
(d) The goodwill of the firm was to be valued at two years' purchase of average profits of last three years which were Rs. 1,20,000
(e) C's share of profit till the date of death was to be calculated on the basis of last year's profit. Last year profit was Rs. 3,00,000.

Prepare partners' capital account, revaluation account and new balance sheet. C's capital account balance is to be transferred to his executor's account.

(Answer: New profit-sharing ratio: 1:1, Gaining ratio: B only gains, Loss on revaluation: Rs. 27,000, C's executor's A/C -Rs. 1,66,333, Balance Sheet total: Rs. 5,11,333, Capitals: A- Rs. 1,74,000, B-Rs. 1,06,000)

B.COM

SEMESTER I

COURSE: FINANCIAL ACCOUNTING

UNIT-12 ACCOUNTING FOR DISSOLUTION OF PATNERSHIP FIRM

STRUCTURE

12.0 OBJECTIVES

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

- understand the concept of dissolution
- difference between dissolution of partnership and dissolution of partnership firm

- make necessary treatments in the books on dissolution under various cases
- enlist the procedure for settlement of accounts
- understand the meaning of piecemeal distribution and its mechanism
- know how to make accounting treatment on sale of a partnership firm to a company

12.1 INTRODUCTION

In previous unit, you have studied that when a partner retires or dies, the partnership ends, but the firm can continue. However, under some situations, the firm must be discontinued and closed, which is referred to as dissolution of firm. When a partnership firm dissolves, its assets must be sold, external liabilities must be paid, and partner claims must be settled. In this unit, you will learn about the various forms and types of dissolution, as well as the accounting entries that must be made when the firm's assets are sold and liabilities are paid and also the settlement of the partners' accounts.

12.2 MEANING OF DISSOLUTION

The term "dissolution" refers to discontinuance. When it comes to the relationship between partners, it's termed as dissolution of partnership, and when it comes to the partnership, it's called dissolution of the firm. According to the Partnership Act, 1932 "The dissolution of partnership between all the partners of a firm is called the dissolution of the firm. The legislation distinguishes between partnership dissolution and a firm dissolution.

Dissolution of partnership means, the partners' relationship changes, but the firm may continue to operate under the same name if the partners so want. On the other hand, dissolution of a firm means the complete closure of the firm's business.

12.2.1 DISSOLUTION OF PARTNERSHIP

Dissolution of partnership means change in relationship among the partners but the firm continues. For instance, reconstitution of partnership on admission or retirement or death of a partner is called dissolution of partnership. On the other hand, dissolution of firm means business of the firm is discontinued or closed and the firm is wound up or dissolved. According to section 39 of partnership Act, 1932, "Dissolution of firm means dissolution of partnership among all the partners in the firm." The firm comes to an end i.e., the business is closed permanently.

12.2.2 DISSOLUTION OF PARTNERSHIP FIRM

On dissolution of the firm, the business of the firm stops its affairs and winds up by selling the assets and by paying the liabilities and discharging the claims of the partners. The dissolution of partnership among all partners of a firm is called dissolution of the firm.

The different methods of dissolution are as follows:

(i) **BY MUTUAL CONSENT:** Section 40 provides that a firm may, at any time, be dissolved with the consent of all the partners. This applies to all cases whether the firm is for a fixed period or otherwise.

(ii) **BY AGREEMENT**: Section 40 also provides for the dissolution of a firm in accordance with a contract between the partners. The contract providing for dissolution may have been incorporated in the partnership deed itself or in a separate agreement.

(iii) **BY THE INSOLVENCY OF ALL THE PARTNERS BUT ONE**: If all the partners or all the partners but one become insolvent, there is dissolution of the firm. Section 41 calls this as compulsory dissolution.

(iv) **BY BUSINESS BECOMING ILLEGAL:** Section 41 provides that a firm is dissolved by the happening of any event which makes it unlawful for the business of the firm to be carried on. But, if the partnership relates to more than one adventure, the illegality of one or more of them does not prevent the lawful adventure from being carried on by the firm.

(v) **PARTNERS BECOMING ALIEN ENEMIES**: Section 41 also covers cases of partnership between persons some of whom become alien enemies by a subsequent declaration of war. In such a case partnership is dissolved, because trading with an alien enemy is against public policy. Section 41 covers cases of compulsory dissolution of firm by operation of law.

(vi) **BY NOTICE OF DISSOLUTION OF PARTNERSHIP AT WILL:** Section 43 provides that where the partnership is at will, a partner may give a notice in writing to the other partners of his intention to dissolve the firm.

(vii) **DISSOLUTION BY COURT (S.44):** At the suit of a partner, the court may dissolve a firm on any of the following grounds:

(a) **IF A PARTNER HAS BECOME OF UNSOUND MIND**: The application in this case may be made by any of the partners or by the next friend of the insane partner. In the case of insanity of a dormant partner, the court will not order dissolution, unless a very special case is made out for dissolution.

(b) **PERMANENT INCAPACITY OF A PARTNER:** The court may order for dissolution of partnership, if a partner becomes permanently incapable of performing his duties as a partner. The application for dissolution, in such a case, may be made by any of the partners and not by the incapacitated partner.

(c) **MISCONDUCT OF A PARTNER AFFECTING THE BUSINESS:** If a partner is guilty of conduct which is likely to affect prejudicially the carrying on of the business of the firm, the court may order dissolution.

(d) **WILLFUL AND PERSISTENT DISREGARD OF PARTNERSHIP AGREEMENT BY A PARTNER**: If a partner willfully and persistently commits a breach of the partnership agreement regarding management, or otherwise conducts himself in such a way that is not reasonably practicable for the other partners to carry on business in partnership with him, the court may order dissolution.

(e) **TRANSFER OF INTEREST OR SHARE BY A PARTNER:** If a partner transfers, in any way (e.g., by sale, mortgage or charge), his whole interest in the partnership to a third party (outsider) or allows his share to be charged in execution of a decree against him or allows the same to be sold for arrears of land revenue or for charges recoverable as land revenue, the court may dissolve the partnership.

(f) **THE COURT CAN ALSO DISSOLVE PARTNERSHIP:** where the business of the firm cannot be carried on except at a loss. The court can order dissolution even though the partnership is for a fixed period [Rehmat-un-nisa-v. Price, 42 Bom. 380].

(g) **JUST AND EQUITABLE:** The court can order dissolution on any other ground which in the opinion of the court is a fit ground for dissolution of partnership.

12.3 TREATMENT OF FIRM'S DEBTS AND PRIVATE DEBTS

Under section 49 of the Indian Partnership Act, the following provisions shall apply in case of firm's debts and private debts:

(i) The creditors of the firm (third party liabilities) should be paid out of the assets of the firm. If there is any surplus, it will be divided among the partners as per their claims which can be utilised for paying the private liabilities of the partners.

(ii) Similarly, the private property of each partner is applied towards the payment of his private debts and surplus, if any is applied towards payment of firm's debt.

12.4 ACCOUNTING TREATMENT

12.4.1 TREATMENT OF DISSOLUTION OF FIRM

On dissolution of a firm, the books of the firm will have to be closed. Assets are realized, liabilities are paid and the balance, if any is distributed among the partners. In case of deficiency, the shortfall is met by the partners from their private property. Assets and liabilities a/cs are closed by transferring them to a realization a/c.

Realization is an account in which assets excluding cash in hand and bank are transferred at their book values and all external liabilities are transferred at their book values also except partners' loan a/c, accumulated profits and losses and reserves and partners' capital a/c. The object of opening the realization a/c is to close the books of accounts of the dissolved firm and to determine gain or loss on realization of assets and liabilities. The following journal entries are recorded on dissolution of firm:

1. For closing the assets accounts:

Realization A/c Dr.

To Sundry Assets A/c (at Book Values)

(Being assets closed)

*Note: The following items on the assets side of the Balance Sheet are not transferred to the Realization Account:

(a) Undistributed loss (i.e., Debit Balance of Profits and Loss account) & fictitious assets or deferred revenue expenditures such as preliminary expenses;

(b) Cash in hand, and Cash at Bank

(c) Provisions and reserves against assets should be closed by crediting the Realization Account.

2. For closing the Liabilities accounts

External Liabilities A/c Dr (Book Values)

To Realization A/c

(Being Transfer of external liabilities)

3. Treatment of Accumulated Reserves and Profit/loss

All the balance of Reserve or Undistributed Profit, Reserve fund or other reserves are transferred to partner's capital account in their profit-sharing ratio. The following entries are to be passed:

Reserve A/c Dr.
Profit and Loss A/c Dr.
Any Other fund A/c Dr
To Partner's Capital A/c
(Transfer of profit and reserves)

Note: In case of Loss reverse entry is recorded.

4. For Sale of Assets

Cash/Bank A/c Dr.

To Realization A/c

(Being sale of assets)

5. For assets taken over by the partner

Partner's Capital A/c Dr.

To Realization A/c

(Being Assets taken over by partner)

6. For Payment of liabilities in cash

Realization A/c Dr.

To Cash/Bank A/c

(Being payment of liabilities)

7. Payment of liabilities by the partners

Realization A/c Dr.

To Partner's Capital A/c

(Being liabilities taken over by partner)

8. For Settlement of loan given by the partner

Partner's Loan A/c Dr.

To Bank A/c

(Being Partner's loan paid off)

9. For Payment of realization expenses:

(a) When realization expenses are paid by firm:

Realization A/c Dr.

To cash A/c

(Being expenses paid off)

(b) When realization expenses are paid by partner on behalf of the firm:

Realization A/c Dr.

To Partner's capital A/c

(Being payment of realization expenses by partner on behalf of the firm)

10. For Closing of realization A/c

The balance in the realization account would show either profit or loss on realisation. It is transferred to Partner's capital accounts in their profit-sharing ratio.

(a) In case of profit, the following entry is to be passed:

Realization A/c Dr.

To Partner's Capital A/c

(Being Profit on realization transferred)

(b) In case of loss, Reverse entry is to be passed.

Partner's Capital A/c Dr.

To Realization A/c

(Being Loss on realization transferred)

FORMAT OF REALIZATION ACCOUNT

Realization Account

Particulars	Amount	Particulars	Amount
1. All assets a/c (Book Value) except cash/bank 2. Cash/bank a/c (payment of external liabilities) 3. Partner capital a/c (if any liability paid by partner) 4. Cash/bank a/c (Expenses on realisation) 5. Partners' capital a/c (if realisation expenses paid by partner) 6. Partners' capital accounts (for transferring profit on realisation)		1. All external liabilities (Book Value) 2. Cash/bank a/c (amount realised on sale of assets) 3. Partners' capital a/c (if any asset is taken over by partner) 4. Partners' capital accounts (transferring loss on realisation	

12.4.2 TREATMENT OF GOODWILL

Section 55 provides that in settling the accounts of a firm after dissolution, goodwill shall subject to the contract between the partners, be included in the assets.

Where the goodwill of a firm is sold after dissolution, a partner may carry on a business competing with that of the buyer and he may advertise such business but subject to agreement between him and the buyer, he may not (a) use the firm's name; (b) represent himself as carrying on business of the firm; or (c) solicit the custom of persons who were dealing with the firm before its dissolution.

Any partner may, upon the sale of goodwill of a firm, make an agreement with the buyer that such partner will not carry on any business similar to that of the firm within a specified period or within specified local limits. Such an agreement shall be void if the restrictions imposed are unreasonable.

There is nothing special in treatment of goodwill on dissolution of a firm. On dissolution of a firm:

(i) If goodwill appears in the Balance Sheet, it is treated like any other asset and is transferred to realization account to close the goodwill account. The entry will be-

Realisation a/c Dr
    To Goodwill a/c

(ii) If Goodwill is purchased by any one of the partners,
Partner's Capital A/c Dr
    To Realization Account

(iii) If cash is realized by selling goodwill, then
Cash a/c Dr
    To Realisation

(iv) If no goodwill a/c appears in the balance sheet, no record is made for this.

12.4.3 TREATMENT OF UNRECORDED ASSETS OR LIABILITIES

Unrecorded assets and liabilities are those assets/liabilities that have been written-off from the books of accounts but physically still exist in the operation. For example, there is an old typewriter, which is still in working condition though its book value is zero. Similarly, there may be some liabilities, which do not appear in the Balance Sheet, but actually they are still there. For example, a bill discounted with bank, on dissolution it was dishonored and had to be taken up by the firm for payment purposes.

The following journal entries will be passed to record such transactions:

1. For sale of unrecorded assets for cash:

Cash/Bank A/c Dr.
    To Realization A/c
(Being sale of unrecorded assets)

2. For unrecorded assets taken over by the partner

Partner's Capital A/c Dr.

    To Realization A/c

(Being unrecorded assets taken over by partner)

3.For Payment of unrecorded liabilities in cash

Realization A/c Dr.

To Cash/Bank A/c

(Being payment of unrecorded liabilities)

4. Payment of unrecorded liabilities in cash by the partner on behalf of the firm

Realization A/c Dr.

To Partner's Capital A/c

(Being payment of unrecorded liabilities by partner on behalf of the firm)

12.5 SETTLEMENT OF ACCOUNTS

Usually, the Partnership Deed contains an accounting clause according to which the final accounts between partners are settled. In the absence of such an agreement, Section48 provides as follows:

- The losses must be paid first from profits, next out of capital and lastly, if necessary, by contribution of each partner in proportion to his share in profits.
- The assets of the firm, including sums contributed by partners to make up deficiency of capital, shall be applied as follows:
  (a) in paying debts of the firm to outsiders;
  (b) in paying each partner rateably for advances made by him to the firm as distinct from capital;
  (c) in paying each partner, rateably, amount due for capital contribution, and
  (d) the residue in paying each partner in accordance with his share in the profits of the firm.
- Finally, partners' capital accounts are to be closed.
  The procedure of closing partners' capital accounts will be different in each of the following cases:
  Case-1: when all the partners are solvent
  Case-2: when some of the partners are solvent and others are insolvent. (Garner vs Murray Rule)
  Case-3: when all the partners are insolvent.

  Case-1: WHEN ALL THE PARTNERS ARE SOLVENT
  - All assets' accounts (Except cash/bank and fictitious assets) and liabilities accounts (except accumulated profits and reserves, partners' loan accounts and also partners' capital a/c) are closed by transferring them to realisation a/c.
  - Partners' loan a/c is paid directly.

- Fictitious accounts like accumulated losses, preliminary expenses, deferred revenue expenditure etc are closed by transferring to partners' capital accounts
- All accumulated profits, reserves, funds no more to be payable will also be closed by transferring to partners' capital accounts.
- Partners' capital accounts are prepared. If partners' capital accounts show debit balance (deficiency), they are required to bring in cash to the firm from their private property. If partners' capital accounts show credit balance (surplus), cash is paid to them for final settlement.
- Finally, cash/Bank account is prepared to ensure that it is balanced.

ILLUSTRATION 1

The following is the Balance Sheet of A and B as on 31st March 2021.

Liabilities	Amount	Assets	Amount
Creditors A's Loan B's Loan Reserve A's Capital B's Capital	38,000 10,000 15,000 5,000 10,000 8,000	Bank Stock Debtors Furniture Plant Investment Profit and Loss a/c	11,500 6,000 19,000 4,000 28,000 10,000 7,500
	86,000		86,000

The firm was dissolved on 31st March, 2021on the following terms:

1. A agreed to take the Investments at Rs. 8,000

2. Other Assets were realized as follows:

Stock Rs. 5,000; Debtors Rs. 18,500; Furniture Rs. 4,500; Plant Rs. 25,000

3. Expenses on realization amounted to Rs. 1,600.

4. Creditors agreed to accept Rs. 37,000.

The profits and losses were shared in the ratio of 2:1. You are required to prepare Realization A/c, Partner's capital A/c and Bank A/c.

SOLUTION:

Realization Account

Particulars	Amount	Particulars	Amount

To Stock To Debtors To Furniture To Plant To Investment To cash a/c (37000+ 1600)	6,000 19,000 4,000 28,000 10,000 38,600	By Creditors By A's capital a/c By cash a/c (5000+18500+4500+25000) By Loss on realisation transferred to capital A/Cs A 4,400 B 2,200	38,000 8,000 53,000 6,600
Total	1,05,600	Total	99,000

Partners' capital Account

Particulars	A	B	Particulars	A	B
To Realisation a/c (Investment) To realisation a/c (Loss) To P/L a/c To Bank a/c (surplus paid)	8,000 4,400 5,000 -	- 2,200 2,500 4,967	By Balance b/d By Reserve By Bank a/c (deficiency brought)	10,000 3,333 4,067	8,000 1,667 -
	17,400	9,667		17,400	9,667

Bank A/C

Particulars	Amount	Particulars	Amount
To Balance b/d To Realisation a/c To A's Capital a/c	11,500 53,000 4,067	By A's Loan a/c By B's Loan a/c By Realisation a/c By B's capital a/c	10,000 15,000 38,600 4,967
Total	68,567	**Total**	68,567

12.6 ACCOUNTING OF DISSOLUTION OF THE PARTNERSHIP FIRM INCLUDING INSOLVENCY OF PARTNERS (GARNER V/S MURRAY RULE)

CASE-2: when some of the partners are solvent and others are insolvent.

In case one partner or more than one partner are insolvent and the remaining partners are solvent, then solvent partners are required to compensate the loss (deficiency) of insolvent partner. Now, the problem arises as to how to compensate that deficiency or in what ratio the solvent partners are required to compensate.

This deficiency is to be compensated in two ways:

(1) This deficiency (Loss) is to be shared by solvent partners in their profit-sharing ratio like other business losses, or

(2) The deficiency is shared according to **Garner Vs. Murray** rule. According to this rule, the loss is to be shared among the solvent partners in the ratio of their opening capitals, **if the fixed capitals are maintained.**

But **if the capitals are fluctuating**, all necessary adjustments in respect of reserves or profit and loss account, etc., should first be made to their capital accounts (but without adjusting the loss on realization). The loss is to be shared among the solvent partners in the ratio of such adjusted capitals just before dissolution.

when a partner is insolvent, the following procedures may be applied as follows:

a) Realization a/c is prepared in the usual way and profit or loss on realization is transferred to partners' capital accounts.
b) All assets (except cash/bank a/c and fictitious a/c) and all liabilities (except accumulated profits and reserves and partners' Loan a/c) are transferred to Realisation a/c
c) Partners' loan is paid directly.
d) Fictitious assets, accumulated profits and reserves are transferred to partners' capital a/c
e) If anything is received from the private estate of the insolvent partner, it should be credited to his capital account.
f) The debit balance (Deficiency) in the capital account of the insolvent partner should be borne by solvent partners in the ratio of capitals as they stand just before dissolution (or in the ratio of fixed capitals, if capitals are fixed).
g) The solvent partners are required to bring in cash to make good their share of loss on realization.
h) The solvent partners will then draw out cash according to their claims.
i) Finally, Cash/Bank account is prepared to ensure that it is balanced.

ILLUSTRATION 2

The following is the balance sheet of A, B and C. on March 31, 2012:

Liabilities	Amount	Assets	Amount
Creditors	20,000	Cash	6,000
General Reserve	15,000	Debtors	10,000
Capital Accounts:		Stock	20,000
A	25,000	Furniture	10,000
B	15,000	Machinery	20,000
		C's Capital (Overdrawn)	9,000
Total	75,000	Total	75,000

C is insolvent but his estate pays Rs 2,000. It is decided to wind up the partnership. The assets realized as follows: debtors, Rs 7,500; stock, Rs 16,000 furniture, Rs 7,000; and machinery, Rs 14,000. The cost of winding up came to Rs 2,500. Give accounts to close the books of the firm (1) if the capitals are fixed, and (2) if the capitals are fluctuating.

SOLUTION:

1. **If Fixed Capitals**

Realization A/C

Particular	Amount	Particulars		Amount
To debtors	10,000	By Creditors a/c		20,000
To stock	20,000	By cash a/c (realisation of assets)		44,500
To Furniture	10,000	By loss on realisation transferred to capital a/cs		
To Machinery	20,000	A	6,000	18,000
To cash a/c (payment to creditors)	20,000	B	6,000	
To cash (realisation cost)	2,500	C	6,000	
Total	82,500	Total		82,500

Capital Accounts

Particulars	A	B	C	Particulars	A	B	C
To Balance b/d	-	-	9,000	By Balance b/d	25,000	15,000	-
To Loss on realisation	6,000	6,000	6,000	By General Reserve	5,000	5,000	5,000
To C's capital (8,000 in the ratio	5,000	3,000		By cash a/c (private			2,000

of 25:15)				property)			
To cash (settlement)	25,000	17,000		By Cash (Loss on realisation)	6,000	6,000	
				By A's capital			5,000
				By B's capital			3,000
	36,000	26,000	15,000		36,000	26,000	15,000

Calculation of Deficiency of Insolvent partner "C"

C's credit Total = 5,000+ 2,000=7,000

C's Debit Total = 9,000 + 6,000=15,000

Deficiency = 15,000-7,000= 8,000

Since capital accounts are fixed as per Garner Vs Murray rule, deficiency will be shared by solvent partners A and B in their opening capital ratio i.e., 25,000: 15,000= 25:15

Cash A/C

Particulars	Amount	Particulars	Amount
To Balance c/d	6,000	By Realisation a/c (creditors)	20,000
To Realisation	44,500	By realisation (expense)	2,500
To C's capital (Pvt Property)	2,000	By A's capital (Settlement)	25,000
To A's Capital	6,000	By B's Capital (Settlement)	17,000
To B's capital	6,000		
Total	64,500	Total	64,500

If capital accounts are fluctuating

Realization A/C

Particular	Amount	Particulars	Amount
To debtors	10,000	By creditors	
To stock	20,000	By cash a/c (realisation of assets)	44,500
To Furniture	10,000		
To Machinery	20,000	By loss on realisation transferred to capital a/cs	
To cash (payment to creditors)	20,000		
To cash (realisation cost)	2,500	A 6,000	18,000
		B 6,000	
		C 6,000	
Total	82,500	Total	82,500

Capital Accounts

Particulars	A	B	C	Particulars	A	B	C
To Balance b/d	-	-	9,000	By Balance b/d	25,000	15,000	-
To Loss on realisation	6,000	6,000	6,000	By General Reserve	5,000	5,000	5,000
To C's capital (8,000 in the ratio of 3:2)	4,800	3,200		By cash a/c (private property)			2,000
To cash (settlement)	25,200	16,800		By Cash (Loss on realisation)	6,000	6,000	
				By A's capital			4,800
				By B's capital			3,200
	36,000	26,000	15,000		36,000	26,000	15,000

A's Adjusted Capital = 25,000+5,000=30,000

B's Adjusted Capital=15,000 + 5,000=20,000

Capital ratio before dissolution= 30,000:20,000=3:2

So, the deficiency of insolvent partner C (Rs.8,000) is to be borne by A and B in the adjusted capital ratio i.e., 3:2;

Cash A/C

Particulars	Amount	Particulars	Amount
To Balance c/d	6,000	By realisation a/c(creditors)	20,000
To Realisation	44,500	By realisation (expense)	2,500
To C's capital (Pvt Property)	2,000	By A's capital (Settlement)	25,200
To A's Capital	6,000	By B's Capital (Settlement)	16,800
To B's capital	6,000		
Total	64,500	Total	64,500

CASE-3: when all the partners are insolvent.

The following steps are used to close the books of accounts of a partnership firm:

- All assets are except cash/bank a/c and fictitious assets are only transferred to realisation a/c.
- Fictitious accounts are transferred to partner's capital accounts.
- Accumulated profits and reserves are also transferred to partners' capital accounts.

- Profit or loss on realisation is transferred to all partners' capital accounts in their profit and loss sharing ratio.
- **Liabilities are not transferred to realisation a/c.**
- Cash/Bank account is opened to determine the balance of cash available for payment of liabilities.
- All liabilities are discharged directly on the basis of available cash in the firm to the extent possible. If there is shortfall, it is transferred to Deficiency account.
- Partners' capital accounts then are closed by transferring the balance to **Deficiency Account**.
- Finally, it is ensured that Deficiency account is balanced.

ILLUSTRATION 3

A and B were equal partners in a firm. Their balance sheet stood as at 31st march, 2020 when the firm was dissolved.

Liabilities	Amount	Assets	Amount
Creditors A's capital	3,200 400	Plant and Machinery Furniture and Fixtures Sundry Debtors Stock Cash a/c B's Capital	1,200 300 500 400 180 1020
Total	3,600	Total	3,600

Assets are realized as follows:

Plant and Machinery Rs. 600; Furniture Rs.100; Debtors Rs. 400; Stock Rs. 300

Realization Expenses Rs. 140 and B's private contributes Rs. 140 only

A and B became insolvent. Give accounting treatment to close the books of the firm.

SOLUTION:

Realization A/C

Particulars	Amount	Particulars	Amount
To plant and machinery To Furniture and Fixture To sundry debtors To stock To cash a/c (realisation expenses)	1,200 300 500 400 140	By cash a/c plant and machinery 600 Furniture and Fixture 100 sundry debtors 400 stock 300 by loss on Realisation transferred	1,400

		to partners' capital a/c A B	 570 570
Total	2,540	Total	2,540

Cash A/C

Particulars	Amount	Particulars	Amount
To Balance b/d To realisation (realisation of assets) To B's capital	180 1,400 140	By Realisation (Expenses) **By creditors (BF) (final payment to creditors)**	140 1,580
Total	**1,720**	**Total**	**1,720**

Creditors' a/c

Particulars	Amount	Particulars	Amount
To cash To **Deficiency A/C**	1,580 1,620	By Balance b/d	3,200
Total	3,200	Total	3,200

Partners' Capital Accounts

Particulars	A	B	Particulars	A	B
To balance b/d To loss on realisation	 570	1,020 570	By Balance b/d By cash (Pvt Estate) By **Deficiency a/c**	400 70	 140 1, 450
total	570	1,590	Total	570	1,590

Deficiency Account

Particulars	Amount	Particulars	Amount
To A's capital a/c To B's capital a/c	170 1,450	By creditors	1,620
Total	1,620	Total	1,620

12.7 PIECEMEAL DISTRIBUTION

On dissolution of partnership firm, it is assumed that all assets are realized simultaneously and liabilities are paid together. However, the process of realizing the assets may take place at different points of time (in installments over a period of time) and liabilities are discharged as and when cash is realized from assets. Such a process of gradual distribution of money is known as “Piecemeal Distribution”.

PRIORITY OF DISTRIBUTION

When assets are realized gradually, the cash available is utilized in the following order:

(a) To meet the realization expenses
(b) To pay off creditors (outside liabilities)
(c) To pay off partners’ Loan
(d) To pay off partners’ capital

The following methods are used for distribution of cash under piecemeal distribution:

(i) Surplus Capital Method
(ii) Maximum Loss Method

SURPLUS CAPITAL METHOD:

This method is used when the following two conditions are satisfied-

(a) Partners’ profit-sharing ratio is not as per their capital contribution
(b) All the partners are solvent and likely to remain so.

The following principles are applied while distributing cash available among the partners’ capital accounts:

- The partner with absolute surplus capital is first paid off.
- Then partner with surplus capital is paid off second and
- At last payment is to be made to the partners as per their profit-sharing ratio.
- The unpaid balance of capital accounts will represent loss on realisation and this loss will be exactly in their profit-sharing ratio

CALCULATION OF ABSOLUTE SURPLUS CAPITAL AND SURPLUS CAPITAL

STEP 1 Calculate adjusted capital of all partners

Adjusted capital= capital account + current Capital account + Reserves or profit/Loss

STEP 2 Adjusted capitals are divided by profit sharing ratio. The smallest quotient is taken as

Base capital

STEPS 3 Calculate **Relative capital**

Relative Capital= Base Capital x profit sharing ratio of each partner

STEP 4 Calculate **Surplus capital**

Surplus Capital = Adjusted capital of each partner – Relative capital of each partner

STEP 5 Divide surplus Capital by profit sharing ratio of each partner. The smallest quotient is called **Revised Base Capital**.

STEP 6 Again calculate **revised relative capital** by multiplying revised capital base and profit-sharing ratio.

Step 7 calculate **absolute surplus capital**

Absolute surplus capital= surplus capital – revised relative capital

ILLUSTRATION 4

From the following information calculate surplus capital and absolute surplus capital.

Partners' capital accounts as per the balance sheet are-

A's capital Rs. 40,000; B's Capital Rs. 25,000; C's Capital Rs. 10,000

General Reserves as per the balance sheet Rs. 12,000

Profit sharing ratio= 3:2:1

SOLUTION:

Steps	Particulars	A	B	C
	Capital accounts	40,000	25,000	10,000
	General Reserve (3:2:1)	6,000	4,000	2,000
Step 1	**(a) Adjusted Capital**	46,000	29,000	12,000
	(b) Profit sharing ratio	3	2	1
Step 2	(a) / (b) (Base capital being smallest i.e., 12,000)	15,333	14,500	**12,000**
Step 3	Relative capital= 12,000 x profit sharing ratio	36,000	24,000	12,000
Step 4	**Surplus Capital**= Step 1 - Step 3	10,000	5,000	NIL
Step 5	Revised Base Capital= step 4/ profit sharing ratio (Revised Base capital –being smallest i.e., 2,500)	3,333	**2,500**	NIL
Step 6	Revised Relative Capital= 2,500 x profit sharing ratio	7,500	5,000	NIL
Step 7	**Absolute surplus capital** = surplus capital- revised relative capital	**2,500**	NIL	NIL

ILLUSTRATION 5

A, B and C are partners sharing profits and losses in the ratio of 3:2:1. Their balance sheet is as follows:

Liabilities	Amount	Assets	Amount
Creditors	10,000	Cash	17,000
A's Loan	5,000	Machinery	20,000
Capital Accounts		Stock	3,000
A	24,000	Debtors	2,000
B	16,000	Investment	23,000
C	10,000		
Total	65,000	Total	65,000

The firm was dissolved and assets were realized in installments as follows:

1st installment Rs. 20,000; 2nd installment Rs. 12,000; 3rd installment Rs. 3,000

Realization Expenses was Rs. 2,000

Prepare statement showing how the amounts realized should be distributed as and when they are received.

SOLUTION:

Calculation of surplus capital and absolute capital

Steps	Particulars	A	B	C
	Capital accounts	24,000	16,000	10,000
Step 1	**(a) Adjusted Capital**	24,000	16,000	10,000
	(b) Profit sharing ratio	3	2	1
Step 2	(a)/ (b) (Base capital being smallest i.e., 8,000)	**8,000**	8,000	10,000
Step 3	Relative capital= 8,000 x profit sharing ratio	24,000	16,000	8,000
Step 4	**Surplus Capital**= step 1 - Step 3	NIL	NIL	2,000

Statement Showing Priority of Distribution

1. Realisation Expense Rs 2,000

2. A’s Loan Rs 5,000
3. Creditors Rs. 10,000
4. Partners’ capital- balance amount

Statement showing Distribution of proceeds of Realisation

Particulars	Amount available	Realisation Expenses	A’s Loan	Creditors	A’s capital	B’s capital	C, capital
Amount Due		2,000	5,000	10,000	24,000	16,000	10,000
Cash Balance	17,000						
1st instalment	20,000						
	37,000						
Less Realisation Expenses	2,000	2,000					
Less A’s Loan	5,000		5,000				
Less creditors	10,000			10,000			
Balance due	20,000	-	-	-	24,000	16,000	10,000
Balance	2000						
Less paid to C (Surplus Capital)							2,000
Balance Due	18,000				24,000	16,000	8,000
Balance	18,000				9,000	6,000	3,000
Less paid to A, B and C (3:2:1)	12,000				15,000	10,000	5,000
2nd instalment realised	12,000				6,000	4,000	2,000
Less paid to A, B and C (3:2:1)							
Balance Due	3,000				9,000	6,000	3,000
3rd instalment realised							
Less paid to A, B and C (3:2:1)	3,000				1,500	1,000	500
Balance Due (Being loss on realisation)	--				7,500	5,000	2,500

MAXIMUM LOSS METHOD:

This method is suitable when a partner or partners is known to be insolvent or is likely to be insolvent. The following steps are used under this method for distribution:

(a) Every instalment is considered as final realization.
(b) The maximum possible loss (Balance due-assets realized) is distributed among all the partners' capital accounts in the profit-sharing ratio assuming the remaining assets worthless.
(c) If a partner's share of maximum possible loss is more than the amount standing to the credit of his capital account, he should be treated as insolvent and his deficiency should be debited to the capital accounts of the solvent partners in the proportion of their capitals which stood on the dissolution date as stated under the Garner V/s. Murray Rule.
(d) This process is repeated till the negative balance is abolished.
(e) The partners having positive balance are paid off first.
(f) This process is to be applied for all subsequent realisation

ILLUSTRATION 6

P, Q and R are partners sharing profit and loss in the ratio of 3:2:1. Their balance sheet is given as at 31st march, 2020.

Liabilities	Amount	Assets	Amount
Capital accounts		Plant and machinery	30,000
P	40,000	Investment	20,000
Q	30,000	Sundry Debtors	15,000
R	10,000	Stock	15,000
Total	80,000	Total	80,000

They dissolved the firm and the assets were realized as follows:

1st realization Rs. 10,000; 2nd realization Rs. 15,000; 3rd and final realization Rs. 25,000

SOLUTION:

Statement showing Distribution of cash realization on capital accounts under Maximum Loss method

Particulars	Total	P	Q	R
(1) Distribution of Rs. 10,000 (1st Realization) Balance Due Less probable Loss assuming	80,000	40,000	30,000	10,000

remaining assets worthless 80,000-10,000=70,000 in 3:2:1	70,000	35,000	23,333	11,667
		5,000	6,667	(-) 1,667
Deficiency of R's Capita written off against P and Q in their capital ratio i.e., 4:3		953	714	(-) 1,667
Amount paid to partners		4,047	5,953	NIL
(2) Distribution of Rs. 15,000 (2nd Realization)				
Balance Due after making payment	70,000	35,953	24,047	10,000
Less possible loss assuming remaining assets worthless (70,000-15,000) (3:2:1)	55,000	27,500	18,333	9,167
Amount paid to partners	15,000	8,453	5,714	833
(3) Distribution of Rs. 25,000 (final Realization)				
Balance Due	55,000	27,500	18,333	9,167
Less possible loss assuming remaining assets worthless (55,000-25,000) i.e., 30,000 in 3:2:1	30,000	15,000	10,000	5,000
Amount paid to partners	25,000	12,500	8,333	4,167

Summary of amount paid to partners' capital

Particulars	P	Q	R
1st Realisation	4,047	5,953	-
2nd Realisation	8,453	5,714	833
Final realisation	12,500	8,333	4,167
Total Rs 50,000	25,000	20,000	5,000

12.8 SALE OF A PARTNERSHIP FIRM TO A COMPANY

For getting the benefits of a company form of businesslike limited liability, perpetual succession, easy access to funds, transferability of shares and many more, a partnership firm may be converted in to a joint stock company in two ways:

(i) The partnership firm itself converts in to a company. This is called floatation of a new company to take over the business of the firm.

(ii) The partnership is sold to a company. It is called absorption of partnership firm by the company.

In either of the above cases two parties are associated. They are:

(i) **Partnership firm** which is to be dissolved otherwise called also selling entity/business. The books of accounts of the partnership firm are closed in the same way as the dissolution of firm which has been discussed earlier in this chapter.

(ii) **The company** which purchases the partnership firm. It is also called purchasing company.

PURCHASE CONSIDERATION

When a partnership firm is sold to a company, the assets and liabilities of the firm are taken over by the company and in return the company pays a fixed agreed amount of money to the partnership firm which is known as purchase consideration. It is paid in the form of:

(i) Cash

(ii) Shares (Both equity and preference shares)

(iii) debentures

(iv) other securities

Or

(v) Combination of two or more of these

In the absence of agreement shares received from purchasing company should be distributed among the partners in the profit-sharing ratio.

ACCOUNTING TREATMENT FOR SALE OF A PARTNERSHIP FIRM TO A COMPANY

(i) Accounting Entries in the books of the Selling firm (Partnership Firm)

(ii) Accounting Entries in the books of the Purchasing Company

ACCOUNTING ENTRIES IN THE BOOKS OF THE SELLING FIRM

1. For closing the asset accounts taken over by the company

Realization A/c Dr.

To Sundry Assets A/c (Individually at Book Values)

(Being assets A/Cs closed)

*Note: The following items on the assets side of the Balance Sheet are not transferred to the Realization Account unless otherwise it is taken over by the company)

(a) Undistributed loss (i.e., Debit Balance of Profits and Loss account) & fictitious assets or deferred revenue expenditures such as preliminary expenses;

(b) Cash in hand, and Cash at Bank, will be the opening balance of the Cash/Bank account.

(c) Provisions and reserves against assets should be closed by crediting the Realization Account.

2. For closing the Liabilities accounts taken over by the company

External Liabilities A/c Dr (Individually at Book Values)

To Realization A/c

(Being Transfer of external liabilities)

2. For purchase consideration due

Purchasing Company a/c Dr

To Realization a/c

(Purchase consideration due)

4. Treatment of Accumulated Reserves and Profit/loss

All the balance of Reserve or Undistributed Profit, Reserve fund or other reserves is transferred to partner's capital account in their profit-sharing ratio. The following entries are to be passed:

Reserve A/c Dr.

Profit and Loss A/c Dr.

Any Other fund A/c Dr

To Partner's Capital A/c

(Transfer of profit and reserves)

Note: In case of Loss reverse entry is recorded.

5. For realization of assets not taken over by the firm

Cash/Bank A/c Dr.

To Realization A/c

(Being sale of assets not taken over by the firm)

6. For assets taken over by the partner

Partner's Capital A/c Dr.

To Realization A/c

(Being Assets taken over by partner)

7. For recording unrecorded assets

Asset's a/c Dr.

To partners' capital a/c

(Being unrecorded assets)

8. For realization of unrecorded assets not taken over by the company

Bank a/c Dr

To Assets a/c

(Being assets realized)

Or

If unrecorded assets are taken over by the company, then entry will be

Realization a/c Dr

To Assets a/c

(Being unrecorded assets taken over by the company)

9. For Payment of liabilities not taken over by the company

Realization A/c Dr.

To Cash/Bank A/c

(Being payment of liabilities)

10. Payment of liabilities by the partners

Realization A/c Dr.

To Partner's Capital A/c

(Being liabilities taken over by partner)

11. For recording unrecorded liabilities

Partners' capital a/c Dr

To liabilities a/c

(Being recording of unrecorded liabilities)

12. For payment of unrecorded liabilities not taken over by the firm

Liabilities a/c Dr

To cash / Bank a/c

(Being unrecorded liabilities paid)

Or

If unrecorded liabilities are taken over by the company, then entry will be

Liabilities a/c Dr

To Realization a/c

(Being unrecorded liabilities taken over by the company)

13. For Settlement of loan given by the partner

Partner's Loan A/c Dr.

To Partners' capital a/c

(Being Partner's loan transferred to partners' capital a/c)

14. For Payment of realization expenses:

(a) When realization expenses are paid by firm:

Realization A/c Dr.

To cash A/c

(Being expenses paid off)

(b) When realization expenses are paid by the purchasing company

No Entry

15. For Closing of realization A/c

The balance in the realization account would show either profit or loss on realization. It is transferred to Partner's capital accounts in their profit-sharing ratio.

(a) In case of profit, the following entries are to be passed:

Realization A/c Dr.

To Partner's Capital A/c

(Being Profit on realization transferred)

(b) In case of loss, Reverse entry is to be passed.

Partner's Capital A/c Dr.

To Realization A/c

(Being Loss on realization transferred)

16. For transferring partners' current accounts to partners' capital accounts

Partners' current a/c Dr

To partners' capital a/c

(Being transfer of current accounts)

17. For settlement of purchase consideration by the company

Cash/Bank a/c Dr

Shares in purchasing company Dr

Debentures in purchasing company Dr

To purchasing company a/c

(Being purchase consideration settled)

18. For final adjustment of partners' capital accounts

Partners' capital a/c Dr

To Cash/Bank a/c

To Shares in purchasing company

To Debentures in purchasing company

(Being partners' capital accounts closed)

ACCOUNTING ENTRIES IN BOOKS OF THE PURCHASING COMPANY

Purchasing company will record all the assets and liabilities at the values taken over.

If the purchase consideration payable is more than the net assets acquired, the excess amount is goodwill. if the purchase consideration payable is less than the net assets acquired, the difference is capital reserve.

Net Assets= Assets taken over – Liabilities taken over

1. Entry for assets and liabilities taken over

   Asset's a/c (taken over at agreed value) Dr

   Goodwill a/c Dr (Balancing Figure)

   To Liabilities a/c (taken over at agreed value)

   To Selling Firm's a/c (Purchase consideration)

   To Capital Reserve (Balancing Figure)

   (Being firm purchased)

Note: In the above entry either goodwill or capital reserve will appear depending upon debit or credit balance.

2. For settlement of Purchase consideration by the company
   Selling Firm a/c Dr
   To cash/Bank a/c
   To share capital a/c
   To Debenture a/c
   (Being purchase consideration paid to the selling firm)
3. For realization expenses paid by the company
   Goodwill a/c Dr

To cash/Bank a/c

(Being realization expenses paid by the company)

ILLUSTRATION 7

A and B were partners sharing profits and losses in the ratio of 3:2. On 31 March, 2020 X Ltd Company acquired the partnership firm of A and B on the following terms and conditions:

Fixed assets are taken over at Rs. 4, 00,000
Debtors are taken over at Rs. 60,000
Stocks are taken over at Rs.20,000
Creditors are taken over by the X Ltd to be discharged
All other assets and liabilities are realised and discharged by the partnership firm.
Investment is realised at Rs. 50,000
Realisation expense Rs. 5,000 paid by the firm and purchase consideration is agreed to be Rs. ,6,50,000 for which X Ltd agreed to issue shares.
The balance sheet of the firm as at 31st March, 2020 is given as follows:

Liabilities	Amount	Assets	Amount
Creditors	60,000	Fixed assets	5,00,000
Bills Payable	40,000	Debtors	70,000
A's Loan a/c	55,000	Stock	35,000
Partners' capital		Investments	40,000
A	3,20,000	Cash a/c	10,000
B	1,80,000		
Total	6,55,000	Total	6,55,000

Pass journal entries in books of the partnership firm and X Ltd. Company and prepare balance sheet in the books of X ltd. Company.

SOLUTION:

Journal Entries in Books of the partnership Firm

1. For transferring assets taken over by the company to realization a/c at book values
   Realization a/c Dr 6, 05,000
   To Fixed Assets a/c 5, 00,000
   To Debtor a/c 70,000
   To Stock a/c 35,000

(Being transfer of assets taken over by the company to realization a/c at book values)

2. For Realisation of investment by the firm

Cash a/c	Dr 50,000	
To investment a/c		40,000
To realisation a/c		10,000

(Being investment realised by the firm)

3. For transferring liabilities taken over by the company to realization a/c at book values

Creditor's a/c	Dr 60,000	
To Realization a/c		60,000

(Being transfer of liabilities taken over by the company to realization a/c at book values)

4. For discharge of liabilities by the firm

Bills Payable a/c	Dr 40,000	
To cash a/c		40,000

(Being discharge of liabilities by the firm)

5. For transfer of partners' loan a/c to their capital accounts.

A's Loan a/c	Dr 55,000	
To A's Capital a/c		55,000

(Being transfer of partners' loan a/c to their capital accounts)

6. For purchase consideration due

X Ltd. Company a/c	Dr 6,50,000	
To Realization a/c		6,50,000

(Being purchase consideration due)

7. For Realization Expense paid by the firm

Realization a/c	Dr 5,000	
To Cash a/c		5,000

(Being Realization Expense paid by the firm)

8. For receipt of purchase consideration

Shares in X Ltd a/c	Dr.6,50,000	
To X Ltd. Company a/c		6,50,000

(Being receipt of purchase consideration)

9. For profit on realization

Realization a/c	Dr 1,10,000	
To A's capital		66,000
To B's capital		44,000

(Being profit on realization)

10. For final adjustment of partners' capital accounts

A's Capital a/c	Dr 4,41,000	
B's Capital a/c	Dr 2,24,000	
To Share in X ltd		6, 50,000
To cash a/c		15,000

(Being final adjustment of partners' capital accounts)

Realization Account

Particulars	Amount	Particulars	Amount
To Fixed Assets To Debtors To Stock To Cash (realization expense) To Profit on realization A's capital B's capital	5,00,000 70,000 35,000 5,000 66,000 44,000	By Creditors By Cash (investment) By X Ltd.	60,000 10,000 6,50,000
Total	7,20,000	Total	7,20,000

Cash Account

Particulars	Amount	Particulars	Amount
To Balance b/d To Investment To Realization	10,000 40,000 10,000	By Bills payable By Realization By Partners' capital a/c A B	40,000 5,000 9,000 6,000
	60,000		60,000

Partners' Capital Accounts

Particulars	A	B	Particulars	A	B
To cash To Shares in X Ltd	9,000 4,32,000	6,000 2,18,000	By Balance b/d By profit on realization By A's Loan	3,20,000 66,000 55,000	1,80,000 44,000
Total	4,41,000	2,24,000	Total	4,41,000	2,24,000

JOURNAL ENTRIES IN THE BOOKS OF X LTD COMPANY

1. For assets and liabilities taken over at agreed values

Fixed Assets a/c	Dr 4,00,000
Debtors' a/c	Dr 60,000
Stock a/c	Dr 20,000
Goodwill a/c	Dr 2,30,000

To Creditors a/c 60,000
To Partnership Firm a/c (PC) 6,50,000
(Being assets and liabilities taken over at agreed values)

2. For payment of Purchase consideration
Partnership Firm a/c Dr 6,50,000
To Share Capital 6,50,000
(Being payment of Purchase consideration)

Balance Sheet of X Ltd. Company

Liabilities	Amount	Assets	Amount
Share Capital Creditors	6,50,000 60,000	Fixed assets Debtors Stocks Goodwill	4,00,000 60,000 20,000 2.30,000
Total	7,10,000	Total	7,10,000

12.9 KEY WORDS

DISSOLUTION: Break-up or discontinuance or closure.

DISSOLUTION OF PARTNERSHIP: Reconstitution of partnership on admission or retirement or death of a partner or insolvency of a partner but the business continues as usual.

DISSOLUTION OF PARTNERSHIP FARM: The business of the firm stops its affairs and winds up by selling the assets and by paying the liabilities and discharging the claims of the partners.

GARNER V/S MURRAY RULE: The deficiency (loss) of an insolvent partner to be shared by solvent partners in their opening capitals, **if the fixed capitals are maintained.** But **if the capitals are fluctuating**, all necessary adjustments in respect of reserves or profit and loss account, etc., should first be made to their capital accounts (but without adjusting the loss on realization). The loss is to be shared among the solvent partners in the ratio of such adjusted capitals just before dissolution.

INSOLVENT PARTNER: A partner who is unable to pay off his debts in full.

COST OF WINDING-UP: The cost of realisation of assets and paying off liabilities at the time of dissolution.

12.10 SOME USEFUL BOOKS

Robert N Anthony, David Hawkins, Kenneth A. Merchant, *Accounting: Text and Cases*. McGraw-Hill Education, 13th Ed. 2013.

Charles T. Horngren and Donna Philbrick, *Introduction to Financial Accounting,* Pearson Education.

J.R. Monga, *Financial Accounting: Concepts and Applications*. Mayur Paper Backs, New Delhi.

M. C. Shukla, T.S. Grewal and S. C. Gupta*. Advanced Accounts. Vol.-I. S.* Chand & Co., New Delhi.

S.N. Maheshwari, and. S. K. Maheshwari. *Financial Accounting*. Vikas Publishing House, New Delhi.

Deepak Sehgal. *Financial Accounting.* Vikas Publishing H House, New Delhi.

Bhushan Kumar Goyal and HN Tiwari, *Financial Accounting,* International Book House

Goldwin, Alderman and Sanyal, *Financial Accounting*, Cengage Learning.

Tulsian, P.C. *Financial Accounting*, Pearson Education.

Compendium of Statements and Standards of Accounting. The Institute of Chartered Accountants of India, New Delhi

12.11 TERMINAL QUESTIONS/EXCERSISES

QUESTIONS

DISSOLUTION OF PARTNERSHIP FIRM

1. What is dissolution of firm/ How is it different from dissolution of partnership?
2. Discuss the different modes of dissolution of a firm.
3. Explain the provisions of section 48 of partnership Act, 1932 regarding the settlement of accounts of partnership firm on its dissolution.
4. How is payment of firm's debt and private debts dealt with on dissolution of a partnership firm?
5. What are the accounting treatments on dissolution of a firm? Discuss them.
6. What are the journal entries necessary to be made to close the books of accounts on dissolution of a firm?
7. What is the difference between revaluation account and realization?

8. (When all partners are solvent) Balance sheet of a firm as at 31st march 2018 was:

Liabilities	Amount	Assets	Amount
Capital A/Cs		Freehold property	8,00,000
X	5,00,000	Investments	2,00,000
Y	4,00,000	Sundry debtors	1,00,000
Z	3,00,000	Stock	1,50,000
Sundry creditors	2,00,000	Cash at bank	3,00,000
Profit and Loss a/c	1,50,000		
Total	15,50,000	Total	15,50,000

The partnership firm was dissolved on the above date. X took over the investments at a value of Rs. 1, 90,000. Cash realized was:

Freehold property Rs. 9, 00,000

Sundry debtors Rs. 90,000

Stock Rs. 1, 40,000

Creditors were paid at discount of 5%. Expenses of realization came to Rs. 20,000.

Pass the journal entries and prepare realization account, partners' capital accounts and bank account to close the books.

(Answer: Profit on Realization- Rs. 60,000; Cash paid to partners on settlement: X – Rs. 3,80,000; Y –Rs.4,70,000; Z – Rs. 3,70,000)

9. (When all partners are solvent) A, B and C are partners in a firm sharing profits in the ratio of 2:1:1. Their balance sheet as at 31st march, 2018 was as follows:

Liabilities	Amount	Assets	Amount
Creditors	50,000	Goodwill	30,000
Capital A/Cs		Land and Building	80,000
A	80,000	Plant and Machinery	56,000
B	80,000	Stock	54,000
C	60,000	Debtors	48,000
		Cash	2,000
Total	2,70,000	Total	2,70,000

The firm was dissolved on that date. Assets realized: Goodwill Rs. 20,000; Land Building Rs. 1,00,000; plant and Machinery Rs 50,000; stock Rs. 28,000 and debtors 50% of book value.

Realization expenses were Rs. 2,000. Prepare realization account, capital accounts of partners and cash account to close the books of accounts of the firm.

(Answer: Loss on Realization- Rs. 48,000; Cash paid to partners on settlement: A –Rs. 56,000; B – Rs. 68,000; C -Rs.48,000)

10. (When some partners are solvent and others are insolvent) The following is the balance sheet of X, Y and Z. on March 31, 2020:

Liabilities	Amount	Assets	Amount
Bills payable	20,000	Bank	6,000
Profit and Loss a/c	15,000	Sundry Debtors	10,000
Capital Accounts		Stock	20,000
X	15,000	Furniture and Fixtures	10,000
Y	25,000	Plant and Machinery	20,000
		Z's Capital	9,000
Total	75,000	Total	75,000

Z is insolvent but his estate pays Rs 4,000. It is decided to wind up the partnership. The assets realized as follows: sundry debtors, Rs 6,500; stock, Rs 15,000 furniture and fixture, Rs 6,000; and plant and machinery, Rs 16,000. The cost of winding up came to Rs 3,000. Give accounts to close the books of the firm (1) if the capitals are fixed, and (2) if the capitals are fluctuating. Follow Garner vs Murray rule.

(Answer: Loss on Realization- Rs. 19,500; Cash paid to partners on settlement: X – Rs. 17,562; Y – Rs. 25,938; Deficiency of Z Rs. 6,500 brought by X – Rs. 2,438 and Y – Rs. 4,062 if capital is fixed; if capital is fluctuating Deficiency of Z Rs. 6,500 brought by X – Rs. 2,600 and Y – Rs. 3,900)

11.(When all partners are insolvent) A and B are partners sharing profits and losses in the ratio of 3:2 in a firm. Their balance sheet stood as at 31st march, 2020 when the firm was dissolved.

Liabilities	Amount	Assets	Amount
Bills payable Account	6,400	Machinery	2,400
A's capital	800	Furniture	600
		Sundry Debtors	1,000
		Stock	800
		Cash a/c	320
		B's Capital	2,080
Total	7,200	Total	7,200

Assets are realized as follows:

Machinery Rs. 1,200; Furniture Rs.200; Debtors Rs. 800; Stock Rs. 600
Realization Expenses Rs. 200 and B's private contributes Rs. 100 only
A and B became insolvent. Give accounting treatment to close the books of the firm.

(Answer: Loss on Realization- Rs. 2,200; Cash paid to partners on settlement: A – Rs. 17,562; B – Rs. 25,938; Deficiency for bills payable – Rs. 3,380; Capital deficiency: A – Rs. 520, B – Rs. 2,860)

PIECEMEAL DISTRIBUTION

12. From the following information calculate surplus capital and absolute surplus capital.

Partners' capital accounts as per the balance sheet are-
X's capital Rs. 80,000; Y's Capital Rs. 50,000; Y's Capital Rs. 20,000
General Reserves as per the balance sheet Rs. 24,000
Profit sharing ratio= 2:2:1
(Answer: Surplus capital: A – Rs. 40,000; B - Rs.10,000; Base capital – Rs. 24,800)

13. X, Y and Z are partners sharing profits and losses in the ratio of 3:2:1. Their balance sheet is as follows:

Liabilities	Amount	Assets	Amount
Bills Payable	10,000	Bank Balance	17,000
Y's Loan	5,000	Machinery	21,000
Capital Accounts		Stock	2,000
X	24,000	Debtors	5,000
Y	16,000	Investment	20,000
Z	10,000		
Total	65,000	Total	65,000

The firm was dissolved and assets were realized in installments as follows:
1st installment Rs. 24,000; 2nd installment Rs. 18,000; 3rd installment Rs. 6,000
Realization Expense was Rs. 1,000
Prepare statement showing how the amounts realized should be distributed as and when they are received under

(a) Capital surplus Method
(b) Maximum Loss method

(Answer: Refer to illustration 5)

SALE OF A PARTNERSHIP FIRM TO A COMPANY

14. X and Y were partners sharing profits and losses in the ratio of 7:3. On 31 March, 2020. A Ltd Company acquired the partnership firm of A and B on the following terms and conditions:

Plant and Machinery is taken over at Rs. 3, 00,000
Debtors are taken over at Rs. 50,000

Stocks are realised by the firm for Rs.20, 000
Creditors are taken over by the A Ltd to be discharged
All other assets and liabilities are realised and discharged by the partnership firm.
Investment is realised at Rs. 30,000
Realisation expense Rs. 12,000 paid by the firm and purchase consideration is agreed to be Rs. ,6,00,000 for which A Ltd agreed to issue shares.
The balance sheet of the firm as at 31st March, 2020 is given as follows:

Liabilities	Amount	Assets	Amount
Creditors	50,000	Plant and Machinery	4,00,000
Bills Payable	30,000	Debtors	50,000
Y's Loan a/c	20,000	Stock	45,000
Partners' capital		Investments	55,000
X	3,00,000	Cash a/c	50,000
Y	2,00,000		
Total	6,00,000	Total	6,00,000

Pass journal entries in books of the partnership firm and A Ltd. Company and prepare balance sheet in the books of X ltd. Company.

(Answer: Balance sheet of the company: Rs, 6,50,000; Goodwill – Rs. 3,00,000)