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FINANCIAL ACCOUNTING

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Financial Accounting

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INTRODUCTION

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If you ask a layman what financial accounting entails, he will probably say it is concerned with the recording of the financial transactions of a business, including the daily transactions. Actually, it is not merely about recording transactions but also about analysing them. It helps to review the results of the business at regular intervals. It tells the businessman whether his business is making profits or running losses.

It is the financial accounting that helps the owner of a business to chart out his future plans. Some of the important documents, such as the profit and loss account, the balance sheet, etc. which are the outcome of financial accounting, help managers to control and manage their business more efficiently. Financial reports give the details of costs and profits in relation to the budgets, sales and expenditure.

This book, *Financial Accounting*, is divided into fourteen units. Each unit begins with an Introduction and Objectives. They introduce the reader to the text and provide an overview of important concepts and topics. 'Check Your Progress' questions are interspersed within the text for ensuring that the concepts have been understood well. Each unit ends with a Summary, followed by a list of Key Words and Answers to 'Check Your Progress' Questions. Self-Assessment Questions and Exercises encourage the recollection of information as well as the application of concepts. Further Reading lists the names of other books that can be referred to, for similar topics.

BLOCK - I

BASICS OF BOOK KEEPING AND MAINTENANCE

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UNIT 1 MEANING AND SCOPE OF ACCOUNTING

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1.0 INTRODUCTION

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

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

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

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

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

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

1.1 OBJECTIVES

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

- Appreciate the need of accounting
- Explain the meaning of accounting
- Analyse the persons interested in accounting disclosures
- Identify the objectives of accounting
- Explain the relationship of accounting with other disciplines
- Explain the different branches of accounting
- Differentiate between management accounting and financial accounting

1.2 MEANING, NEED DEVELOPMENT AND VARIOUS USERS OF ACCOUNTING INFORMATION

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

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book-keeper's work is of a clerical nature and is increasingly being accomplished through the use of mechanical and electronical devices.

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

1.2.1 Difference between Book-keeping and Accounting

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

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

1.2.2 Is Accounting a 'Science' or an 'Art'?

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

Art is the technique which helps us in achieving our desired objective. Accounting is definitely an art. The American Institute of Certified Public Accountants also defines accounting as "the art of recording, classifying and summarizing the financial transactions". Accounting helps in achieving our

desired objective of maintaining proper accounts, *i.e.,* to know the profitability and the financial position of the business, by maintaining proper accounts.

Accounting and Accountancy

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

1.2.3 Various Users of Accounting Information

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

1. **Proprietors** A business is done with the objective of making profit. Its profitability and financial soundness are, therefore, matters of prime importance to the proprietors who have invested their money in the business.
2. **Managers** In a sole proprietary business, usually the proprietor is the manager. In case of a partnership business either some or all the partners participate in the management of the business. They, therefore, act both as managers as well as owners. In case of joint stock companies, the relationship between ownership and management becomes all the more remote. In most cases the shareholders act merely as rentiers of capital and the management of the company passes into the hands of professional managers. The accounting disclosures greatly help them in knowing about what has happened and what should be done to improve the profitability and financial position of the enterprise in the period to come.
3. **Creditors** Creditors are the persons who have extended credit to the company. They are also interested in the financial statements because these will help them in ascertaining whether the enterprise will be in a position to meet its commitment towards them both regarding payment of interest and principal.

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

1.3 OBJECTIVES AND FUNCTIONS OF ACCOUNTING

The following are the main objectives functions of accounting:

1. **To keep systematic records** Accounting is done to keep a systematic record of financial transactions. In the absence of accounting there would have been terrific burden on human memory which is most cases would have been impossible to bear.
2. **To protect business properties** Accounting provides protection to business properties from unjustified and unwarranted use. This is possible on account of accounting supplying the following information to the manager or the proprietor.
   (*i*) The amount of the propreitor's funds invested in the business.
   (*ii*) How much the business has to pay to others?
   (*iii*) How much the business has to recover from others?
   (*iv*) How much the business has in the form of (*a*) fixed assets, (*b*), cash in hand, (*c*) cash at bank, (*d*) stock of raw materials, work-in-progress and finished goods?

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

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

   Profit and Loss Account will help the management, investors, creditors, etc., in knowing whether running of the business has proved to be remunerative or not. In case it has not proved to be remunerative or profitable, the cause of such a state of affairs will be investigated and necessary remedial steps will be taken.
4. **To ascertain the financial position of business** The profit and Loss Account gives the amount of profit or loss made by the business during a particular period. However, it is not enough. The businessman must know about his financial position, *i.e.*, where he stands what he owes and what he owns? This objective is served by the Balance Sheet or Position Statement. The Balance Sheet is a statement of assets and liabilities of the business on a particular date. It serves as barometer for ascertaining the financial health of the business.
5. **To facilitate rational decision making** Accounting these days has taken upon itself the task of collection, analysis and reporting of information at the required points of time to the required levels of authority in order to facilitate rational decision making. The American Accounting Association has also stressed this point while defining the term ‘accounting’ when it says that accounting is, “the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information.” Of course, this is by no means an easy task. However, the accounting bodies all over the world and particularly the International Accounting Standards Committee, have been trying to grapple with this problem and have achieved success in laying down some basic postulates on the basis of which the accounting statements have to be prepared.

1.4 ACCOUNTING AND OTHER DISCIPLINES

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

1. **Proprietors** A business is done with the objective of making profit. Its profitability and financial soundness are, therefore, matters of prime

importance to the proprietors who have invested their money in the business.

2. **Managers** In a sole proprietary business, usually the proprietor is the manager. In case of a partnership business either some or all the partners participate in the management of the business. They, therefore, act both as managers as well as owners. In case of joint stock companies, the relationship between ownership and management becomes all the more remote. In most cases the shareholders act merely as rentiers of capital and the management of the company passes into the hands of professional managers. The accounting disclosures greatly help them in knowing about what has happened and what should be done to improve the profitability and financial position of the enterprise in the period to come.
3. **Creditors** Creditors are the persons who have extended credit to the company. They are also interested in the financial statements because these will help them in ascertaining whether the enterprise will be in a position to meet its commitment towards them both regarding payment of interest and principal.
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Accounting and other Disciplines

Accounting is closely related with other disciplines. It is, therefore, necessary for the accountant to have a working knowledge of these disciplines for effective performance of his job. The relationship between accounting and some of the other disciplines is being discussed in the following pages:

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Accounting and Economics

Economics is concerned with rational decision making regarding efficient use of scarce resources for satisfying human wants. The efficient utilisation of resources, particularly when they are scarce, is important both from the viewpoint of a business firm and of the country as a whole.

Accounting is considered to be a system which provides appropriate information to the Management for taking rational decisions. Of course, some non-accounting information is also useful for decision making. However, accounting provides a major and dependable data base for decision making. The basic objective of management of a business organisation is to maximise the wealth of its owners. This is also the objective of economics. Efficient use of scarce resources results in maximising the wealth of a nation. Thus, accounting and economics both have a similarity in the sense that both seek the optimum utilisation of resources of the firm or the nation, as the case may be. Moreover, the accountants have got the ideas such as value of assets, income, capital maintenance etc., from the economists. Of course, the accountants have suitably adapted these ideas keeping in view their own requirements and limitations. For instance, according to the economists, the value of an asset is the present value of all future earnings that can be derived from the asset. However, it is a real difficult or almost impossible task for one to estimate correctly the future earnings particularly when an asset has a very long life—say, 50 years or more. The accountants have, therefore, adopted a realistic basis for valuation of asset—the cost or the price paid for the acquisition of the asset. Similarly, the accountants' concept of marginal cost is different from the economists' concept of marginal cost. According to the accountants, the marginal cost represents the variable cost, *i.e.*, the cost which varies in direct proportion of output. Such cost remains fixed per unit of output. However, according to the economists the marginal cost refers to the cost of the producing one additional unit. Such cost per unit may increase or decrease depending upon the law of returns. For example, in case of law of increasing returns, the cost per unit would decrease while in case of law of decreasing returns, the cost per unit would increase.

Accounting and Statistics

Statistics is the science of numbers. It is concerned with numerical data as well as various statistical techniques which are used for collection, classification, analysis and interpretation of such data. The statistical techniques are now increasingly used for managerial decision making.

Accounting is an important information tool. It provides significant information about the working of a business firm to the outsiders, *viz.,* shareholders, creditors, financial institutions, etc., and the insiders, *i.e.*, the management.

Accounting has a close relationship with statistics. A number of statistical techniques are used in collection, analysis and interpretation of the accounting data. For instance, computation of accounting ratios is based on statistical method, particularly averaging. Similarly, the technique of regression is being increasingly used for forecasting, budgeting and cost control. The techniques of standard deviation, co-efficient of variation are used for capital budgeting decisions. The technique of index numbers is used for computation of present value of an asset in case of accounting for price level changes.

Accounting and Mathematics

Accounting bears a close relationship with mathematics too. As a matter of fact the dual aspect concept which is the basic concept of accounting is expressed in the form of a mathematical equation. It is popularly termed as "accounting equation". The knowledge of mathematics is now considered to be a prerequisite for accounting computations and measurements. For example, computation of depreciation, ascertaining the cash price in case of hire-purchase and instalment systems, determination of the loan instalment, settling of lease rentals—all require use of mathematical techniques.

The introduction of computer in accounting has further increased the importance of mathematics for the accountants. The accountants are now increasingly making the use of statistics and econometric models for decision making. The use of the technique of operation research has made accounting all the more mathematical. In view of these developments, it would not be incorrect to say that a good accountant has to be a good mathematician too.

Accounting and Law

A business entity operates within a legal framework. An accountant records, classifies, summarises and presents the various transactions. Naturally, these transactions have to be in accordance with the rules and regulations applicable to such business entity. There are laws which are applicable in general to all business transactions, *e.g.*, the Indian Contract Act, the Sale of Goods Act, the Negotiable Instruments Act, etc. There are laws governing specific business entities, *e.g.*, the Companies Act is applicable to joint stock companies, the Banking Regulation Act is applicable to banking companies, the Insurance Act is applicable to insurance companies etc. While preparing the accounts of different business entities, the accountant has to keep in mind the specific provisions given by the specific Acts applicable to the specific business entities. Similarly, there are a number of industrial laws such as the Factories Act, the Payment of Wages Act, the Minimum Wages Act, the Employees Provident Fund and Miscellaneous Provisions Act, etc., governing payment of wages, salaries or other benefits to employees. The accountant has to abide by the provisions of these Acts and prepare and maintain appropriate records keeping in mind their provisions.

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Check Your Progress

1. Why is accounting considered an important tool?
2. What is an accounting equation?

1.5 ROLE OF ACCOUNTANTS

The Accountants are the persons who practice the art of accounting. The Accounting System and the Accountants who maintain it, provide useful services to the Society. The Accountants can broadly be classified into two categories.

1. Accountants in Public Practice
2. Accountants in Employment.

Accountants in Public Practice

The accountants in public practice offer their services for conducting financial audit, cost audit, designing of accounting system and rendering other professional services for a fee. Such accountants are usually members of professional bodies. In our country there are two recognised professional bodies for this purpose. They are (*i*) the Institute of Chartered Accountants of India and (*ii*) the Institute of Cost and Works Accountants of India.

The accountants in public practice are also known as professional accountants. Such accountants are the members of the professional accounting bodies. These accounting bodies usually require from their members the following:

(*i*) Getting themselves trained in the prescribed manner over a prescribed period.

(*ii*) Pass the examination conducted by the professional bodies.

(*iii*) Undertake to observe the generally accepted accounting principles enunciated by the professional bodies concerned.

(*iv*) Observe the Code of Ethics laid down by the concerned accounting body.

(*v*) Subject themselves to disciplinary proceedings whenever it is alleged that the member has violated the Code of Ethics laid down by the concerned body.

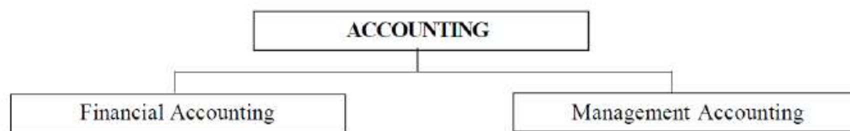
Accountants in Employment

These are the accountants who are employed in non-business entities or business entities. Non-business entities are a diverse set of organisations including Educational Institutions, Government, Churches, Museums,

Hospitals, etc. Their object is not to earn profit. The accountants employed by business entities are frequently called 'Management Accountants' since they report to, and are the part of the entity's management. These accountants provide information for the tax returns, budgeting, routine operating of the business decisions, investment decisions, performance evaluation and external financial reporting of the business. Most of these accountants are also members of a professional accounting body. Of course, it is not necessary.

1.6 BRANCHES OF ACCOUNTING

In order to satisfy the needs of different people interested in the accounting information, different branches of accounting have developed. They can broadly be classified into two categories:



(*i*) **Financial Accounting** It is the original form of accounting. It is mainly confined to the preparation of financial statements for the use of outsiders like shareholders, debenture holders, creditors, banks and financial institutions. The financial statements, *i.e*., the Profit and Loss Account and the Balance Sheet, show them the manner in which operations of the business have been conducted during a specified period.

(*ii*) **Management Accounting** It is accounting for the management, *i.e.*, accounting which provides necessary information to the management for discharging its functions. According to the Chartered Institute of Management Accountants, London, "Management accounting is the application of professional information in such a way as to assist the management in the formation of policies and in the planning and control of the operations of the undertaking." It covers all arrangements and combinations or adjustments of the orthodox information to provide the Chief Executive with the information from which he can control the business, *e.g*., information about funds, costs, profits, etc.

Management accounting covers various areas such as cost accounting, budgetary control, inventory control, statistical methods, internal auditing etc.

1.7 DIFFERENCES BETWEEN MANAGEMENT ACCOUNTING AND FINANCIAL ACCOUNTING

Financial accounting and management accounting are closely interrelated since management accounting is to a large extent rearrangement of the data provided by financial accounting. Moreover, all accounting is financial in the

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sense that all accounting systems are in monetary terms and management is responsible for the contents of the financial accounting statements. In spite of such a close relationship between the two, there are certain fundamental differences. These differences can be laid down as follows:

1. **Objectives:** Financial accounting is designed to supply information in the form of Profit and Loss Account and Balance Sheet to external parties like shareholders, creditors, banks, investors and Government. Information is supplied periodically and usually such in which management is not much interested. Management accounting is designed principally for internal use by the management.
2. **Analysing performance:** Financial accounting portrays the position of business as a whole. The financial statements like income statement and balance sheet report on overall performance or status of the business. On the other hand, management accounting directs its attention to the various divisions, departments of the business and reports about the profitability, performance etc., of each of them. Financial accounting deals with the aggregates and, therefore, cannot reveal what part of the management action is going wrong and why. Management accounting provides detailed analytical data for these purposes.
3. **Data used:** Financial accounting is concerned with the monetary record of past events. It is a post-mortem analysis of past activity and, therefore, out of date for management action. Management accounting is an accounting for future and, therefore, it supplies data both for present and future duly analysed and in detail in the “management language” so that it becomes the basis for management action.
4. **Monetary measurement:** In financial accounting only such economic events find a place which can be described in money. However, the management is equally interested in non-monetary economic events, *viz.*, technical innovations, personnel in the organisation, changes in the value of money etc. These events affect the management’s decision and, therefore, management accounting cannot afford to ignore them. For example, change in the value of money may not find a place in financial accounting on account of “going concern concept”, but while effecting an insurance policy on an asset or providing for replacement of an asset, the management will have to take into account this factor.
5. **Periodicity of reporting:** The period of reporting is much longer in financial accounting as compared to management accounting. The Income Statement and the Balance Sheet are usually prepared yearly or in some cases half-yearly. The management requires information at frequent intervals, and, therefore, financial accounting fails to cater to the needs of the management. In management accounting, there is more emphasis on furnishing information quickly and at comparatively short intervals as per the requirements of the management.

6. **Precision:** There is less emphasis on precision in case of management accounting as compared to financial accounting since the information is meant for internal consumption.
7. **Nature:** Financial accounting is more objective while management accounting is more subjective. This is because management accounting is fundamentally based on judgement rather than on measurement.
8. **Legal compulsion:** Financial accounting has more or less become compulsory for every business on account of the legal provisions of one or the other Act. However, a business is free to install or not to install a system of management accounting.

The above points of difference between financial accounting and management accounting prove that management accounting has a flexible approach as compared to rigid approach in the case of financial accounting. In brief, financial accounting simply shows how the business has moved in the past while management accounting shows how the business has to move in the future.

1.8 LIMITATIONS OF ACCOUNTING

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

1. **Provides only limited information** There are now no set patterns of business on account of radical changes in business activities. An expenditure may not bring an immediate advantage to the business but it may have to be incurred because it may bring advantage to the business in the long run or may be necessary simply to sell the name of the business. The management needs a lot of varied information to decide whether on the whole it will be justifiable to incur a particular expenditure or not. Financial accounting fails to provide such information.
2. **Treats figures as single, simple and silent items** Financial accounting fails to make the people realize that accounting figures are not mere isolated phenomena but they represent a chain of purposeful and pertinent events. The role of accountant these days is not only of a book-keeper and auditor, but also that of a financial adviser. Recording of transactions is now the secondary function of the accountant. His primary function now is to analyse and interpret the results.
3. **Provides only a post-mortem record of business transactions** Financial accounting provides only a post-mortem record of business transactions since it records transactions only on historical basis. These days business decisions are made on the basis of estimates and projections

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rather than historical facts. Of course, past records are helpful in making future projections but they alone are not sufficient. Thus, needs of modern management demand a break-up from the principles and practice of traditional accounting.

4. **Considers only quantifiable information** Financial accounting considers only those factors which are capable of being quantitatively expressed. In modern times, the concept of welfare state has resulted in increased government interference in all sectors of the national economy. The management has, therefore, to take into account government decisions over and above purely commercial considerations. Some of these factors are not capable of being quantitatively expressed and hence their impact is not reflected in financial statements.
5. **Fails to provide informational needs of different levels of management** The shareholders are only rentiers of capital. The business is run in reality by different executives, each an expert in his area. These executives have powers based on the level of management to which they belong. There are usually three levels of management—top management, middle management and lower management. The type of information required by each level of management is different. The top management is mainly concerned with the policy decisions. They, therefore, are interested in knowing about the soundness of the plans, proper structuring of the organization, proper delegation of authority and its effectiveness. The middle management executives function as coordinators. They must know: (*i*) What happened? (*ii*) Where it happened? and (*iii*) Who is responsible? The lower management people function as operating supervisors. They should get information regarding effectiveness of their operations. The reports submitted to them should give details about the planned performance, actual performance and the deviations with their reasons. Financial accounting does not have a built-in system to provide all such information.

1.9 ACCOUNTING SYSTEM AND PROCESS

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

1. **Single entry system** An incomplete double entry system can be termed as a single entry system. According to Kohler, “it is a system of book-keeping in which as a rule only records of cash and personal accounts are maintained, it is always incomplete double entry, varying with circumstances”. This system has been developed by some business houses, who for their convenience, keep only some essential records.

Since all records are not kept, the system is not reliable and can be used only by small firms.

2. **Double entry system** The system of 'double entry' book-keeping which is believed to have originated with the Venetian merchants of the fifteenth century, is the only system of recording the two-fold aspect of the transaction. This has been, to some extent, explained while discussing the 'dual aspect concept' earlier in this unit. The system recognises that every transaction has a two-fold effect. If some one receives something then either some other person must have given it, or the first mentioned person must have lost something, or some service etc., must have been rendered by him.

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1.9.1 Accounting Equation

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

Assets = Equities

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

Assets = Liabilities + Capital

or Capital = Assets – Liabilities

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

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

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

Thus:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

11. Further capital invested 1,000
12. Borrowed from *P* 1,000

Solution:

Accounting Equation: Assets = Liabilities + Capital

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No.	Transaction	Assets	=	Liabilities	+	Capital
		₹		₹		₹
1.	Anil started business with cash ₹5,000	5,000	=	0	+	5,000
2.	Purchased goods on credit for ₹400	400	=	400	+	0
	New Equation	5,400	=	400	+	5,000
3.	Purchase goods for cash ₹100	+ 100				
		– 100	=	0	+	0
	New Equation	5,400	=	400	+	5,000
4.	Purchased furniture ₹50	+ 50				
		– 50	=	0	+	0
	New Equation	5,400	=	400	+	5,000
5.	Withdrew for personal use ₹70	– 70	=	0	–	70
	New Equation	5,330	=	400	+	4,930
6.	Paid rent	– 20	=	0	+	– 20
	New Equation	5,310	=	400	+	4,910
7.	Received interest ₹10	+ 10	=	0	+	10
	New Equation	5,320	=	400	+	4,920
8.	Sold goods consisting ₹50 on credit for ₹70	+ 70				
		– 50	=	0	+	20
	New Equation	5,340	=	400	+	4,940
9.	Paid to creditors ₹40	– 40	=	– 40	+	0
	New Equation	5,300	=	360	+	4,940
10.	Paid for salaries ₹20	– 20	=	0	–	– 20
	New Equation	5,280	=	360	+	4,920
11.	Further capital Invested	1,000	=	0	+	1,000
	New Equation	6,280	=	360	+	5,920
12.	Borrowed from *P* ₹1,000	1,000	=	1,000	+	0
	New Equation	7,280	=	1,360	+	5,920

1.9.2 Double Entry System and Single Entry System

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

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

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

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

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

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

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

Systems of Accounting

There are basically two systems of accounting:

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

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

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

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

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

Check Your Progress

3. What is accrual system of accounting?
4. What is single entry system in accounting?

1.10 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Accounting is an important information tool. It provides significant information about the working of a business firm to the outsiders, viz., shareholders, creditors, financial institutions, etc., and the insiders, i.e., the management.
2. Accounting bears a close relationship with mathematics too. As a matter of fact the dual aspect concept which is the basic concept of accounting is expressed in the form of a mathematical equation. It is popularly termed as "accounting equation".
3. Accrual system is a system in which accounting entries are made on the basis of amounts having become due for payment of receipt.
4. Single entry system is an incomplete double entry system can be termed as a single entry system. According to Kohler, it is a system of book-keeping in which as a rule only records of cash and personal accounts are maintained, it is always incomplete double entry, varying with circumstances".

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1.11 SUMMARY

- Accounting has rightly been termed as the language of the business. The basic function of a language is to serve as a means of communication. Accounting also serves this function. It communicates the result of business operations to various parties who have some stake in the business, viz., the proprietor, creditors, investors, Government and other agencies.
- Some people take book-keeping and accounting as synonymous terms, but they are different from each other. Book-keeping is mainly concerned with recording of financial data relating to the business operations in a significant and orderly manner.
- Any organized knowledge based on certain basic principles is a 'science'. Accounting is also a science. It is an organized knowledge based on scientific principles which have been developed as result of study and experience.
- Accounting is of primary importance to the proprietors and the managers. However, other persons such as creditors, prospective investors, employees, etc., are also interested in the accounting information.
- Accounting is closely related with other disciplines. It is, therefore, necessary for the accountant to have a working knowledge of these disciplines for effective performance of his job.
- The Accountants are the persons who practice the art of accounting. The Accounting System and the Accountants who maintain it, provide useful services to the Society. The Accountants can broadly be classified into two categories.
    1. Accountants in Public Practice
    2. Accountants in Employment.
- In order to satisfy the needs of different people interested in the accounting information, different branches of accounting have developed. They can broadly be classified into two categories: Financial accounting and management accounting..
- Financial accounting and management accounting are closely interrelated since management accounting is to a large extent rearrangement of the data provided by financial accounting. Moreover, all accounting is financial in the sense that all accounting systems are in monetary terms and management is responsible for the contents of the financial accounting statements.

1.12 KEY WORDS

- **Accounting:** The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the users of information.
- **Financial Accounting:** The art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are at least in part of a financial character and interpreting the results.
- **Management Accounting:** The presenting of accounting information in such a way as to assist the management in the creation of the policy and in the day-to-day operations of the undertaking.

1.13 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State the two systems of accounting.
2. Differentiate between double and single entry systems of accounting.
3. What are the two branches of accounting?

Long Answer Questions

1. Analyse the limitations of accounting.
2. Discuss the differences between management accounting and financial accounting.
3. Explain the relationship of accounting with other disciplines.
4. Describe the various users of accounting information.

1.14 FURTHER READINGS

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UNIT 2 ACCOUNTING PRINCIPLES AND STANDARDS

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Structure

2.0 Introduction
2.1 Objectives
2.2 Meaning and Types of Accounting Concepts
2.3 Accounting Conventions and their Types
2.4 Accounting Principles
2.5 Accounting Standards
    2.5.1 Introduction to Accounting Standards Issued by ICAI
2.6 Answers to Check Your Progress Questions
2.7 Summary
2.8 Key Words
2.9 Self Assessment Questions and Exercises
2.10 Further Readings

2.0 INTRODUCTION

It has already been stated in Unit 1 that accounting is the language of business through which normally a business house communicates with the outside world. In order to make this language intelligible and commonly understood by all, it is necessary that it should be based on certain uniform scientifically laid down standards. These standards are termed as accounting principles.

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

(*i*) Accounting Concepts[2]

(*ii*) Accounting Conventions

Accounting Concepts

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

(*i*) Separate Entity Concept

(*ii*) Going Concern Concept

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

(*iii*) Money Measurement Concept
(*iv*) Cost Concept
(*v*) Dual Aspect Concept
(*vi*) Accounting Period Concept
(*vii*) Periodic Matching of Cost and Revenue Concept
(*viii*) Realisation Concept

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Accounting Conventions

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

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

2.1 OBJECTIVES

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

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

2.2 MEANING AND TYPES OF ACCOUNTING CONCEPTS

Let us study the different accounting concepts.

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

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

2. **Going Concern Concept:** According to this concept it is assumed that the business will continue for a fairly long time to come. There is neither the intention nor the necessity to liquidate the particular business venture in the foreseeable future. On account of this concept, the accountant while valuing the assets does not take into account forced sale value of assets. Moreover, he charges depreciation on fixed assets on the basis of their expected lives rather than on their market value.

It should be noted that the 'going concern concept' does not imply permanent continuance of the enterprise. It rather presumes that the enterprise will continue in operation long enough to charge against income, the cost of fixed assets over their useful lives, to amortise over appropriate period other costs which have been deferred under the actual or matching concept, to pay liabilities when they become due and to meet the contractual commitments. Moreover, the concept applies to the business as a whole. When an enterprise liquidates a branch or one segment of its operations, the ability of the enterprise to continue as a going concern is normally not impaired.

The enterprise will not be considered as a going concern when it has gone into liquidation or it has become insolvent. Of course, the receiver or the liquidator may endeavour to carry on business operations for some period pending arrangement with the creditors or the final buyer for the sale of the business as a going concern, the going concern status of the concern will stand terminated from the date of his appointment or will be at least regarded as suspended, pending the results of his efforts.

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

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

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

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

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

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

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

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

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

Capital (Equities) = Cash (Assets)

10,000 = 10,000

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

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Equities = Assets

or Liabilities + Capital = Assets

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

Equities = Assets

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

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

Equities = Assets

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

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

6. **Accounting Period Concept:** According to this concept, the life of the business is divided into appropriate segments for studying the results shown by the business after each segment. This is because though the life of the business is considered to be indefinite (according to going concern concept), the measurement of income and studying the financial position of the business after a very long period would not be helpful in taking proper corrective steps at the appropriate time. It is, therefore, absolutely necessary that after each segment or time interval the businessman must 'stop' and 'see back', how things are going. In accounting such a segment or time interval is called 'accounting period'. It is usually of a year.

At the end of each accounting period an Income Statement and a Balance Sheet are prepared. The Income Statement discloses the profit or loss made by the business during the accounting period while the Balance Sheet depicts the financial position of the business as on the last day of the accounting period. While preparing these statements a proper distinction has to be made between capital and revenue expenditure.

7. **Periodic Matching of Costs and Revenue Concept:** This is based on the accounting period concept. The paramount objective of running a business is to earn profit. In order to ascertain the profit made by the business during a period, it is necessary that 'revenues' of the period should be matched with the costs (expenses) of the period. The term matching, means appropriate association of related revenues and expenses. In other words, income made by the business during a period can be measured only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue. The question when the payment was received or made is 'irrelevant'. For example, if a salesman is paid commission in January, 2011, for sales made by him in December, 2010, the commission paid to the salesman in

January, 2011 should be taken as the cost for sales made by him in December, 2010. This means that revenues of December, 2010 (*i.e.*, sales) should be matched with the costs incurred for earning that revenue (*i.e.*, salesman's commission) in December, 2010 (though paid in January, 2011). On account of this concept, adjustments are made for all outstanding expenses, accrued incomes, prepaid expenses and unearned incomes, etc., while preparing the final accounts at the end of the accounting period.

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

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

However, there are certain exceptions to this concept:

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

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

2.3 ACCOUNTING CONVENTIONS AND THEIR TYPES

In this section, we will discuss the accounting conventions.

1. **Conservatism:** In the initial stages of accounting, certain anticipated profits which were recorded, did not materialise. This resulted in less acceptability of accounting figures by the end-users. On account of this reason, the accountants follow the rule 'anticipate no profit but provide for all possible losses' while recording business transactions. In other words, the accountant follows the policy of "playing safe". On account of this convention, the inventory is valued 'at cost or market price whichever is less'. Similarly, a provision is made for possible bad and doubtful debts out of current year's profits. This concept affects principally the category of current assets.

The convention of conservatism has become the target of serious criticism these days especially on the ground that it goes against the convention

of full disclosure. It encourages the accountant to create secret reserves (*e.g*., by creating excess provision for bad and doubtful debts, depreciation etc.), and the financial statements do not depict a true and fair view of the state of affairs of the business. The Income Statement shows a lower net income, the Balance Sheet understates assets and overstates liabilities.

The research studies conducted by the American Institute of Certified Public Accountants have indicated that conservatism concept needs to be applied with much more caution and care if the results reported are not to be distorted.

2. **Full disclosure:** According to this convention accounting reports should disclose fully and fairly the information they purport to represent. They should be honestly prepared and sufficiently disclose information which is of material interest to proprietors, present and potential creditors and investors. The convention is gaining more importance because most of big businesses are run by joint stock companies where ownership is divorced from management. The Companies Act, 1956 not only requires that Income Statement and Balance Sheet of a company must give a true and fair view of the state of affairs of the company but it also gives the prescribed forms in which these statements are to be prepared.[3] The practice of appending notes to the accounting statements (such as about contingent liabilities or market value of investments) is in pursuance to the convention of full disclosure.

3. **Consistency:** According to this convention, accounting practices should remain unchanged from one period to another. For example, if stock is valued at "cost or market price whichever is less", this principle should by followed year after year. Similarly, if depreciation is charged on fixed assets according to diminishing balance method, it should be done year after year. This is necessary for the purposes of comparison. However, consistency does not mean inflexibility. It does not forbid introduction of improved accounting techniques. However, if adoption of such a technique results in inflating or deflating the figures of profit as compared to the previous period, a note to that effect should be given in the financial statements.

4. **Materiality:** According to this convention the accountant should attach importance to material details and ignore insignificant details. This is because otherwise accounting will be unnecessarily overburdened with minute details. The question what constitutes a material detail, is left to the discretion of the accountant. Moreover, an item may be material for one purpose while immaterial for another. For example, while sending each debtor "a statement of his account", complete details upto paise have to be given. However, when a statement of outstanding debtors is prepared for sending to top management, figures may be rounded to the nearest ten or hundred. The Companies Act also permits ignoring of 'paise' while preparing financial statements. Similarly, for tax purposes, the income has to be rounded to nearest ten.

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

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Thus, the term 'materiality' is a subjective term. The accountant should regard an item as material if there is reason to believe that knowledge of it would influence the decision of the informed investor. According to Kohler, "materiality means the characteristic attaching to a statement, fact or item whereby its disclosure or method of giving it expression would be likely to influence the judgement of a reasonable person."

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

Check Your Progress

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

2.4 ACCOUNTING PRINCIPLES

Accounting practices follow certain guidelines. The rules that govern how accountants measure progress and communicate financial information fall under the heading "Generally Accepted Accounting Principles" (GAAP). GAAP comprises of conventions, rules and procedures that constitute accepted accounting practices at any given time. They are like the law or rules for conducting behaviour in a way acceptable to majority of the people. They may readily be defined as rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. They are a body of doctrines commonly associated with the theory and procedures of accounting, serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist.

It should be noted that GAAP differ from country to country because of the legislative requirements of each country, local accounting practices, customs, usage and business environment peculiar to each country. Each country has set up its own professional accounting body/regulatory authority to frame, implement and regulate the application of the GAAPs in the country. For example, in USA the Financial Accounting Standard Board (FASB) set up in 1973 makes major pronouncements called Statements of Financial Accounting Standards (SFAS) from time to time. Similarly, in

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

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UK the Accounting Standard Board set up in 1990 issues financial reporting standards. The Board has replaced the Accounting Standards Committee which was responsible for issuing Statements of Standard Account Practices (SSAPs) earlier from time to time. In India, the Accounting Standard Board set up by the Institute of Chartered Accountants of India issues the accounting standards to be observed by all business entities. However, the Ministry of Corporate Affairs (MCA) has also notified presently 40 Indian Accounting Standards (Ind AS), as a step towards convergence of International Financial Reporting Standards (IFRS) in India. It may be noted that Ind AS would be applicable to various classes of entities as may be prescribed by the relevant authorities such as Ministry of Corporate Affairs for the companies governed under the Companies Act, 2013 from the notified date(s). The existing Accounting Standards (AS) would continue to apply to entities other than those to which Ind AS would apply. In case of differences between the two standards i.e. AS issued by the Institute of Chartered Accountants of India and Ind AS notified by the Ministry of Corporate Affairs, Government of India, the Institute of Chartered Accountants of India would harmonise their differences. This, in some cases, has already been done e.g. withdrawal of AS 6: Depreciation Accounting and replacement of AS 10: Fixed Assets by AS 10: Property, Plant and *Equipment*.

2.5 ACCOUNTING STANDARDS

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

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

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

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

International Accounting Standards Committee and IAS/IFRS

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

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

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

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

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

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

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

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

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

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

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

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

(*a*) International Financial Reporting Standards;

(*b*) International Accounting Standards, and

(*c*) Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

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

Scope of IFRS The scope of IFRS is as under.

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

Explanations:

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

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

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

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

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

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

IFRS Around the World

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

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

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

IFRS Main Financial Statements

Types : The IFRS financial statements include the following.

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

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

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

- Understandability
- Relevance
- Reliability
- Comparability

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

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

NOTES

IAS 1. Presentation of Financial Statements.

IAS 2. Inventories.

IAS 7. Cash Flow Statements.

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

IAS 10. Events after the Balance Sheet Date.

IAS 11. Construction Contracts.

IAS 12. Income Taxes.

IAS 16. Property, Plant and Equipment.

IAS 17. Leases.

IAS 18. Revenue.

IAS 19. Employee Benefits.

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

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

IAS 23. Borrowing Costs

IAS 24. Related Party Disclosures.

IAS 26. Accounting and Reporting by Retirement Benefit Plans.

IAS 27. Consolidated and Separate Financial Statements.

IAS 28. Investments in Associates.

IAS 29. Financial Reporting in Hyperinflationary Economies.

IAS 31. Interests in Joint Ventures.

IAS 32. Financial Instruments: Presentation

IAS 33. Earnings per share.

IAS 34. Interim Financial Reporting.

IAS 36. Impairment of Assets.

IAS 37. Provisions, Contingent Liabilities and Contingent Assets.

IAS 38. Intangible Assets.

IAS 39. Financial Instruments: Recognition and Measurement.

IAS 40. Investment Property.

IAS 41. Agriculture.

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

NOTES

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

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

SIC 7 Introduction of the Euro

SIC 10 Government Assistance - No Specific Relation to Operating Activities

SIC 12 Consolidation - Special-Purpose Entities

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

SIC 15 Operating Leases - Incentives

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

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

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

SIC 29 Service Concession Arrangements: Disclosures

SIC 31 Revenue - Barter Transactions lnvolving Advertising Services

SIC 32 Intangible Assets - Web Site Costs

IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities

IFR1C 2 Members' Shares in Co-operative Entities and Similar Liabilities

IFRIC 4 Determining Whether an Arrangement contains a Lease

IFRIC 5 Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds.

IFRIC 6 Liabililies arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment

IFRIC 7 Applying the Restatement Approach under IAS 29, Financial Reporting in Hyperinflationary Economies

IFRIC 8 Scopc of IFRS 2

IFRIC 9 Reassessment of Embedded Derivatives

IFRIC 10 Interim Financial Reporting and Impairment

IFRIC 11 IFRS 2: Group and Treasury Share Transactions

IFRIC 12 Service Concession Arrangements

IFRIC 13 Customer Loyalty Programmes

IFRIC 14 IAS 19 - The Limit on a Defined Benefit Asset, Minimum Funding Requirements, and their Interaction

IFRIC 15 Agreements for the Construction of Real Estate

IFRIC 16 Hedges of a Net Investment in a Foreign Operation

2.5.1 Introduction to Accounting Standards Issued by ICAI

In order to bring uniformity in terminology, approach and presentation of accounting results, the Institute of Chartered Accountants of India established on 22nd April, 1977, an Accounting Standards Board (ASB). The main function of the ASB is to formulate accounting standards so that such standards will be established by the Council of the Institute of Chartered Accountants. While formulating the accounting standards, the ASB will give due consideration to the International Accounting Standards and try to integrate them to the extent possible. It will also take into consideration the applicable laws, customs, usages and the business environments prevailing in India.

Preface to The Statements of Accounting Standards

The following are the specific features of the Preface to the Statements of Accounting Standards issued by the Council of the Institute of Chartered Accountants of India.

1. Formation of the Accounting Standards Board

(1) The Institute of Chartered Accountant of India (ICAI), recognising the need to harmonise the diverse accounting policies and practices in use in India, constituted the Accounting Standards Board (ASB) on 21st April, 1977.

(2) The composition of the ASB is fairly broad-based and ensures participation of all interest-groups in the standard-setting process. Apart from the elected members of the Council of the ICAI nominated on the ASB, the following are represented on the ASB:

(*i*) Nominee of the Central Government representing the Department of Company Affairs on the Council of the ICAI.

(*ii*) Nominee of the Central Government representing the Office of the Comptroller and Auditor General of India on the Council of the ICAI.

(*iii*) Nominee of the Central Government representing the Central Board of Direct Taxes on the Council of the ICAI.

(*iv*) Representative of the Institute of Cost Accountants of India.

(*v*) Representative of the Institute of Company Secretaries of India.

(*vi*) Representatives of Industry Associations (one from Associated Chambers of Commerce and Industry (ASSOCHAM), one from Confederation of Indian Industry (CII) and one from Federation of Indian Chambers of Commerce and Industry (FICCI).

(*vii*) Representative of Reserve Bank of India.

(*viii*) Representative of Securities and Exchange Board of India.

(*ix*) Representative of Controller General of Accounts.

(*x*) Representative of Central Board of Excise and Customs.

(*xi*) Representatives of Academic Institutions (one from Universities and one from Indian Institutes of Management)

(*xii*) Representive of Financial Institutions.

(*xiii*) Eminent professionals co-opted by the ICAI (they may be in practice or in industry, government, education, etc.)

(*xiv*) Chairman of the Research Committee and the Chairman of the Expert Advisory Committee of the ICAI, if they are not otherwise members of the Accounting Standards Board.

(*xv*) Representative(s) of any other body, as considered appropriate by the ICAI.

2. Objectives and Functions of the Accounting Standards Board

The following are the objectives of the Accounting Standards Board:

(*i*) To conceive of and suggest areas in which Accounting Standards need to be developed.

(*ii*) To formulate Accounting Standards with a view to assisting the Council of the ICAI in evolving and establishing Accounting Standards in India.

(*iii*) To examine how far the relevant International Accounting Standard/ International Financial Reporting Standard can be adapted while formulating the Accounting Standard and to adapt the same.

(*iv*) To review, at regular intervals, the Accounting Standards from the point of view of acceptance or changed conditions, and, if necessary, revise the same.

(*v*) To provide, from time to time, interpretations and guidance on Accounting Standards.

(*vi*) To carry out such other functions relating to Accounting Standards.

The Accounting Standards are issued under the authority of the Council of the ICAI. The ASB has also been entrusted with the responsibility of propagating the Accounting Standards and of persuading the concerned parties to adopt them in the preparation and presentation of financial statements. The ASB will provide interpretations and guidance on issues arising from Accounting Standards. The ASB will also review the Accounting Standards at periodical intervals and, if necessary, revise the same.

3. General Purpose Financial Statements

(1) For discharging its functions, the ASB will keep in view the purpose and limitations of financial statements and the attest function of the auditors. The ASB will enumerate and describe the basic concept to which accounting principles should be oriented and state the accounting principles to which the practices and procedures should conform.

(2) The ASB will clarify the terms commonly used in financial statements and suggest improvements in the terminology wherever necessary. The ASB will examine the various current alternative practices in vogue and endeavour to eliminate or reduce alternatives within the bounds of rationality.

(3) Accounting Standards are designed to apply to the general purpose financial statements and other financial reporting, which are subject to the attest function of the members of the ICAI. Accounting Standards apply in respect of any enterprise (whether organised in corporate, cooperative or other forms) engaged in commercial, industrial or business activities, irrespective of whether it is profit-oriented or it is established for charitable or religious purposes. Accounting

Standards will not, however, apply to enterprises only carrying on the activities which are not of commercial, industrial or business nature, (*e.g.*, an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise is considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature.

(4) The term 'General Purpose Financial Statements' includes balance sheet, statement of profit and loss, a cash flow statement (wherever applicable) and statements and explanatory notes which form part thereof, issued for the use of various stakeholders, governments and their agencies and the public. References to financial statements in the Preface and in the standards issued from time to time will be construed to refer to General Purpose Financial Statements.

(5) Responsibility for the preparation of financial statements and for adequate disclosure is that of the management of the enterprise. The auditor's responsibility is to form his opinion and report on such financial statements.

4. Scope of Accounting Standards

(1) Efforts will be made to issue Accounting Standards which are in conformity with the provisions of the applicable laws, customs, usages and business environment in India. However, if a particular Accounting Standard is found to be not in conformity with law, the provisions of the said law will prevail and the financial statements should be prepared in conformity with such law.

(2) The Accounting Standards by their very nature cannot and do not override the local regulations which govern the preparation and presentation of financial statements in the country. However, the ICAI will determine the extent of disclosure to be made in financial statements and the auditor's report thereon. Such disclosure may be by way of appropriate notes explaining the treatment of particular items. Such explanatory notes will be only in the nature of clarification and therefore need not be treated as adverse comments on the related financial statements.

(3) The Accounting Standards are intended to apply only to items which are material. Any limitations with regard to the applicability of a specific Accounting Standard will be made clear by the ICAI from time to time. The date from which a particular Standard will come into effect, as well as the class of enterprises to which it will apply, will also be specified

by the ICAI. However, no standard will have retroactive application unless otherwise stated.

5. Procedure for Issuing an Accounting Standard

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Broadly, the following procedure is adopted for formulating Accounting Standards:

(1) The ASB determines the broad areas in which Accounting Standards need to be formulated and the priority in regard to the selection thereof.

(2) In the preparation of Accounting Standards, the ASB will be assisted by Study Groups constituted to consider specific subjects. In the formation of Study Groups, provision will be made for wide participation by the members of the Institute and others.

(3) The draft of the proposed standard will normally include the following:

(*a*) Objective of the Standard
(*b*) Scope of the Standard
(*c*) Definitions of the terms used in the Standard
(*d*) Recognition and measurements principles, wherever applicable
(*e*) Presentation and disclosure requirements.

(4) The ASB will consider the preliminary draft prepared by the Study Group and if any revision of the draft is required on the basis of deliberations, the ASB will make the same or refer the same to the Study Group.

(5) The ASB will circulate the draft of the Accounting Standard to the Council members of the ICAI and the following specified bodies for their comments:

(*i*) Department of Company Affairs (DCA)
(*ii*) Comptroller and Auditor General of India (C&AG)
(*iii*) Central Board of Direct Taxes (CBDT)
(*iv*) The Institute of Cost Accountants of India (ICAI)
(*v*) The Institute of Company Secretaries of India (ICSI)
(*vi*) Associated Chambers of Commerce and Industry (ASSOCHAM), Confederation of Indian Industry (CII) and Federation of Indian Chambers of Commerce and Industry (FICCI)
(*vii*) Reserve Bank of India (RBI)
(*viii*) Securities and Exchange Board of India (SEBI)
(*ix*) Standing Conference of Public Enterprises (SCOPE)
(*x*) Indian Banks' Association (IBA)
(*xi*) Any other body considered relevant by the ASB keeping in view the nature of the Accounting Standard.

(6) The ASB will hold a meeting with the representatives of specified bodies to ascertain their views on the draft of the proposed Accounting Standard. On the basis of comments received and discussion with the

representatives of specified bodies, the ASB will finalise the Exposure Draft of the proposed Accounting Standard.

(7) The Exposure Draft of the proposed Standard will be issued for comments by the members of the Institute and the public. The Exposure Draft will specifically be sent to specified bodies (as listed above), stock exchanges, and other interest groups, as appropriate.

(8) After taking into consideration the comments received, the draft of the proposed Standard will be finalised by the *ASB* and submitted to the Council of the *ICAI*.

(9) 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*.

(10) For a substantive revision of an Accounting Standard, the procedure followed for formulation of a new Accounting Standard, as detailed above, will be followed.

(11) Subsequent to issuance of an Accounting Standard, some aspect(s) may require revision which are not substantive in nature. For this purpose, the *ICAI* may make limited revision to an Accounting Standard. The procedure followed for the limited revision will substantially be the same as that to be followed for formulation of an Accounting Standard, ensuring that sufficient opportunity is given to various interest groups and general public to react to the proposal for limited revision.

6. Compliance with the Accounting Standards

(1) The Accounting Standards will be mandatory from the respective date(s) mentioned in the Accounting Standard(s). The mandatory status of an Accounting Standard implies that while discharging their attest functions, it will be the duty of the members of the Institute to examine whether the Accounting Standard is complied within the presentation of financial statements covered by their audit. In the event of any deviation from the Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviation.

(2) Ensuring compliance with the Accounting Standards while preparing the financial statements is the responsibility of the management of the enterprise. Statutes governing certain enterprises require of the enterprises that the financial statements should be prepared in compliance with the Accounting Standards, *e.g.*, the Companies Act, 2013 (section 129), and the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000.

(3) Financial Statements cannot be described as complying with the Accounting Standards unless they comply with all the requirements of each applicable standard.

NOTES

Issue of Accounting Standards In all 32 accounting standards have been issued out of which 1 has been withdrawn while 3 are only recommendatory. The applicable of these standards is dependent on the size—Level I/II/III company. The following table lists out the Accounting Standards and their applicability.

Accounting Standards

No.	*Title*	*Mandatory from accounting period beginning on or after*	*Applicability level of enterprise*
AS 1	Disclosure of Accounting Policies	1-4-1991	I, II, III
AS 2 (Revised)	Valuation of lnventories	1-4-1999	I, II, III
AS 3 (Revised)	Cash Flow Statements	1-4-2001	I
AS 4 (Revised)	Contingencies and Events occurring after Balance Sheet Date	1-4-1995	I, II, III
AS 5 (Revised)	Net Profit or Loss Prior Period and Extraordinary Items and Changes in Accounting Policies	1-4-1996	I, II, III
AS 6 (Revised)	Depreciation Accounting withdrawn w.e.f. 1st April 2017	1-4-1995	I, II, III
AS 7 (Revised)	Accounting for Construction Contracts	1-4-2003	I, II, III
AS 8	Accounting for Research and	1-4-1991	Withdrawn
	Developments (withdrawn w.e.f. 1-4-2003)	1-4-1991	I, II, III
AS 9	Revenue Recognition	1-4-1991	I, II, III
AS 10	Property, Plant & Equipment (changed from Accounting for Fixed Assets)	1-4-1991	I, II, III
AS 11 (Revised 2003)	Accounting for the Effect of Changes in Foreign Exchange Rates	1-4-2004	I, II, III
AS 12	Accounting for Government Grants	1-4-1995	I, II, III
AS 13	Accounting for Investments*	1-4-1995	I, II, III
AS 14	Accounting for Amalgamations*	1-4-1994	I, II, III
AS 15 (Revised 2005)	Employee Benefits	7-12-2006	I, II, III
AS 16	Borrowing Costs	1-4-2000	I. II, III
AS 17	Segment Reporting	1-4-2001	II, II, III (with modifications)
AS 18	Related Party Disclosures	1-4-2001	
AS 19	Leases	1-4-2001	
AS 20	Earnings Per Share	1-4-2001	
AS 21	Consolidated Financial Statements*	1-4-2001	
AS 22	Accounting for Taxes on Income	1-4-2001	I, II, III
AS 23	Accounting for Investments in Associates	1-4-2002	I
AS 24	Discounting Operations	1-4-2004	I
AS 25	Interim Financial Reporting	1-4-2004	I
AS 26	Intangible Assets	1-4-2003	I, II, III
AS 27	Financial Reporting of Interests in Joint		

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No.	Title	Mandatory from accounting period beginning on or after	Applicability level of enterprise
	Ventures	1-4-2002	I. II, III (with clarifications)
AS 28	Impairment of Assets	1 -4-2004	I, II. III (with modifications)
AS 29	Provisions, Contingent Liabilities and Contingent Assets*	1-4-2004	I
AS 30	Financial Instruments: Recognition and Measurement (recommendatory w.e.f. 1-4-2009)		
AS 31	Financial Instruments: Presentation (recommendatory w.e.f. 1-4 2009)		
AS 32	Financial Instruments: Disclosures (recommendatory w.e.f. 1-4-2009)		

Level I Company Enterprises, which fall in any one or more of the following categories, at any time during the accounting period, are classified as Level I enterprises.

(*i*) Enterprises whose equity or debt securities are listed whether in India or outside India.

(*ii*) Enterprises, which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(*iii*) Banks including co-operative banks.

(*iv*) Financial Institutions

(*v*) Enterprises carrying on insurance business

(*vi*) All commercial, industrial and business reporting enterprises, whose turnover (excluding other income) exceeds ₹ 50 crore in the immediately preceding accounting year.

(*vii*) All commercial, industrial and business reporting enterprises having borrowings, (including public deposits), in excess of ₹ 10 crore at any time during the immediately preceding accounting year.

(*viii*) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

Level II Company Enterprises, which are, not Level I enterprises but fall in any one or more of the following categories are classified as Level II enterprises:

(*i*) All commercial, industrial and business reporting enterprises, whose turnover (excluding other income) for the immediately preceding accounting year exceeds ₹ 40 lakh, but does not exceed ₹ 50 crore. Turnover does not include 'other income'.

(*ii*) All commercial, industrial and business reporting enterprises having borrowing, (including public deposits), in excess of ₹ one crore but not in excess of ₹ 10 crore at any time during the immediately preceding accounting year.

(*iii*) Holding and subsidiary enterprises of any one of the above.

Level III Company Enterprises, which are not covered under Level I and Level II are considered as Level III enterprises.

Applicability

Level II and Level III enterprises are considered as SMEs.

Level I enterprises are required to comply fully with all the accounting standards.

No relaxation is given to Level II and Level III enterprises in respect of recognition and measurement principles. Relaxations are provided with regard to disclosure requirements. Accordingly, Level II and Level III enterprises are fully exempted from certain accounting standards, which mainly lay down disclosure requirements. In respect of certain other accounting standards, which lay down recognition, measurement and disclosure requirements, relaxations from certain disclosure requirements have been given.

In the following pages we are giving brief details of Accounting Standards issued by ICAI.

Check Your Progress

3. Define accounting principles.
4. What are accounting standards?

2.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. According to the going concern concept it is assumed that the business will continue for a fairly long time to come. There is neither the intention nor the necessity to liquidate the particular business venture in the foreseeable future. On account of this concept, the accountant while valuing the assets does not take into account forced sale value of assets.
2. The convention of conservatism has become the target of serious criticism these days especially on the ground that it goes against the convention of full disclosure. It encourages the accountant to create secret reserves (e.g., by creating excess provision for bad and doubtful debts, depreciation etc.), and the financial statements do not depict a true and fair view of the state of affairs of the business.
3. Accounting principles are basically the rules that govern current accounting practices and are used as references to determine application of appropriate treatment of complex transactions.
4. Accounting standards are rules according to which accounting statements have to be prepared. They can be termed as statements

of code of practice of the regulatory accounting bodies that are to be observed in the preparation and presentation of financial statements.

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2.7 SUMMARY

- The term 'concepts' includes those basic assumptions or conditions upon which the science of accounting is based.
- In accounting business is considered to be a separate entity from the proprietor(s). It may appear to be ludicrous that one person can sell goods to himself but this concept is extremely helpful in keeping business affairs strictly free from the effect of private affairs of the proprietor(s).
- According to the going concern concept it is assumed that the business will continue for a fairly long time to come. There is neither the intention nor the necessity to liquidate the particular business venture in the foreseeable future.
- Accounting records only monetary transactions. Events or transactions which cannot be expressed in money do not find place in the books of accounts though they may be very useful for the business.
- The cost concept is closely related to going concern concept. According to this concept:
  - o an asset is ordinarily entered in the accounting records at the price paid to acquire it, and
  - o this cost is the basis for all subsequent accounting for the assets.
- In the initial stages of accounting, certain anticipated profits which were recorded, did not materialise. This resulted in less acceptability of accounting figures by the end-users.
- The convention of conservatism has become the target of serious criticism these days especially on the ground that it goes against the convention of full disclosure. It encourages the accountant to create secret reserves (e.g., by creating excess provision for bad and doubtful debts, depreciation etc.), and the financial statements do not depict a true and fair view of the state of affairs of the business.
- The rules that govern how accountants measure progress and communicate financial information fall under the heading "Generally Accepted Accounting Principles" (GAAP). GAAP comprises of conventions, rules and procedures that constitute accepted accounting practices at any given time.
- In simple words, accounting standards are rules according to which accounting statements have to be prepared. They can be termed as statements of code of practice of the regulatory accounting bodies

that are to be observed in the preparation and presentation of financial statements.

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2.8 KEY WORDS

- **Accounting Concepts:** Basic assumptions or conditions upon which the science of accounting is based
- **Accounting Conventions:** Customs and traditions which guide the accountants while preparing the accounting statements.
- **Accounting Principles:** Rules of action or conduct adopted by the accountants universally while recording accounting transactions

2.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What is the current status of IAS/IFRS and interpretations?
2. Differentiate between accounting principles and standards.
3. State the objectives of accounting standard board.

Long Answer Questions

1. Explain any three of the following accounting concepts:
   (i) Money measurement concept
   (ii) Business entity concept
   (iii) Going concern concept
   (iv) Realisation concept
   (v) Cost concept.
2. Analyse the various accounting conventions.
3. Describe the procedure for issuing an accounting standard.

2.10 FURTHER READINGS

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

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

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

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

UNIT 3 JOURNALISING TRANSACTIONS

NOTES

Structure

3.0 Introduction
3.1 Objectives
3.2 Journal
  3.2.1 Rules of Debit and Credit
  3.2.2 Compound Journal Entry
  3.2.3 Opening Entry
3.3 Sub-Division of Journals
  3.3.1 Cash Journal or Book
  3.3.2 Petty Cash Book
  3.3.3 Purchases Journal
  3.3.4 Sales Returns Journal
  3.3.5 Purchases Returns Journal
3.4 Voucher System
3.5 Answers to Check Your Progress Questions
3.6 Summary
3.7 Key Words
3.8 Self Assessment Questions and Exercises
3.9 Further Readings

3.0 INTRODUCTION

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

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

3.1 OBJECTIVES

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

- Identify the stages of the accounting cycle
- Appreciate the role of Journal in recording business transactions
- Understand the rules of debit and credit applicable to different types of business transactions
- Describe the various categories of accounts
- Pass appropriate entries for recording transactions in the Journal

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3.2 JOURNAL

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

JOURNAL

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

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

3.2.1 Rules of Debit and Credit

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

(*i*) Transactions relating to persons.

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

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

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

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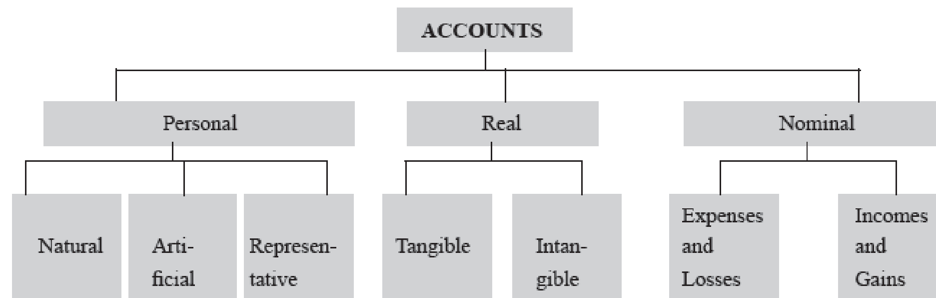
(*i*) Each person with whom it deals.

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

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

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



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

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

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

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

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

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

The rule is:

- Debit the Receiver
- Credit the Giver

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

Real accounts Real accounts may be of the following types:

1. *Tangible real accounts* Tangible Real Accounts are those which relate to such things which can be touched, felt, measured etc. Examples of such accounts are cash account, building account, furniture account, stock account, etc. It should be noted that bank account is a personal account; since it represents the account of the banking company—an artificial person.

2. *Intangible real accounts* These accounts represent such things which cannot be touched. Of course, they can be measured in terms of money. For example, patents account, goodwill account, etc.

The rule is:

- Debit What Comes In
- Credit What Goes Out

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

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

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

The rule is:

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

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

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

Illustration 3.1. From the following transactions find out the nature of account and also state which account should be debited and which account should be credited.

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

Solution:

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

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

NOTES

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

Illustration 3.2. Ram starts a business with capital of ₹20,000 on January 1, 2011.

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

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

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

JOURNAL

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

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

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

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

JOURNAL

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

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

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

NOTES

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

JOURNAL

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

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

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

JOURNAL

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

Classification of Goods Account The term goods include articles purchased by the business for resale. Goods purchased by the business may be returned back to the supplier. Similarly, goods sold by the business to its customers can also be returned by the customers back to the business due to certain reasons. In business, it is desired that a separate record be kept of all sale, purchase and return of goods. Hence, Goods Accounts can be classified into the following categories:

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

(*ii*) *Sales Account* The account is meant for recording of selling of goods. The goods "go out" on selling of goods, and therefore, on sale of goods, the Sales Account is credited.

(*iii*) *Purchases Returns Account* The account is meant for recording return of goods purchased. The goods "go out" on returning of goods to the suppliers and, therefore, the account should be credited on returning goods purchased.

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

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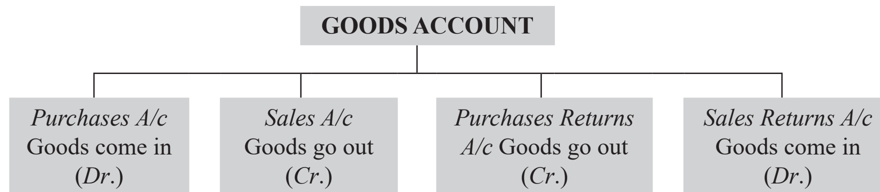
The above classification of Goods Account can be shown in the form of the following chart:



3.2.2 Compound Journal Entry

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

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

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

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

This has been explained in the following illustration:

Illustration 3.3. Pass a compound journal entry in each of the following cases:

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

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

Solution:

JOURNAL

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

NOTES

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

Notes:

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

3.2.3 Opening Entry

In case of a running business, the assets and liabilities appearing in the previous year's balance sheet will have to be brought forward to the current year. This is done by means of a journal entry which is termed as "Opening Entry". All Assets Accounts are debited while all Liabilities Accounts are credited. The excess of assets over liabilities is the proprietor's capital and is credited to his Capital Account. This will be clear with the help of the following illustration:

Illustration 3.4. Pass the Opening Entry on January 1, 2016 on the basis of the following information taken from the business of Mr. Sunil:

		₹
(*i*)	Cash in Hand	2,000
(*ii*)	Sundry Debtors	6,000
(*iii*)	Stock of Goods	4,000

(*iv*) Plant 5,000

(*v*) Land and Buildings 10,000

(*vi*) Sundry Creditors 10,000

NOTES

Solution:

JOURNAL

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

Debit Balances on Jan. 1, 2016:

1. Jan. 01 Cash in hand ₹8,000

Cash at Bank ₹25,000

Stock of Goods ₹20,000

Furniture ₹2,000

Building ₹10,000

Sundry Debtors:

Vijay ₹2,000

Anil ₹1,000

Madhu ₹2,000

Credit Balances on Jan. 1, 2016:

Sundry Creditors

Anand ₹5,000

Loan from Bablu ₹10,000

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

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

NOTES

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

Solution:

JOURNAL

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

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

NOTES

Check Your Progress

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

3.3 SUB-DIVISION OF JOURNALS

Let us study the different types of Journals.

NOTES

1. General Journal

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

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

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

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

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

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

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

2. Special Journal

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

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

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

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

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

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

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

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

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

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

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

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

3.3.1 Cash Journal or Book

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

(*i*) The number of cash transactions is quite large in every business. The business has to pay for salaries, rent, lighting, insurance, purchase of goods and it has to receive cash for sales of goods and capital assets.

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

NOTES

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

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

(*i*) Simple Cash Book

(*ii*) Two-Columnar Cash Book

(*iii*) Three-Columnar Cash Book

(*iv*) Multi-Columnar Cash Book

(*v*) Cash Receipts Book

(*vi*) Cash Payments Book

(i) Simple (Single)-Columnar Cash Book

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

Dr. SIMPLE CASH BOOK *Cr.*

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

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

Illustration 3.5. Record the following transactions in the Cash Book and post them in the ledger:

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

Solution:

NOTES

Dr. CASH BOOK Cr.

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

Ledger

Dr. INTEREST ACCOUNT Cr.

	4	By Cash A/c	3,000

SALES ACCOUNT

	5	By Cash A/c	8,000

RENT ACCOUNT

To Cash A/c	2,000	1	

PURCHASES ACCOUNT

To Cash A/c	4,000	2	

SALARIES ACCOUNT

To Cash A/c	2,000	3	

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

(ii) Two (Double)-Columnar Cash Book

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

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

NOTES

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

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

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

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

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

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

Illustration 3.6. Record the following transactions in the Cash Book and post them in the ledger:

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

Solution:

Dr. CASH BOOK *Cr.*

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

Ledger

MAHESH

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

SURESH

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

MUKESH

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

DISCOUNT ALLOWED ACCOUNT

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

DISCOUNT RECEIVED ACCOUNT

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

Notes:

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

(iii) Three-Columnar Cash Book

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

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

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

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

The proforma of such a Cash Book is as follows:

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

NOTES

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

Illustration 3.7.

Jan. 01 Opening Balance : Cash ₹3,000
Bank ₹4,000

Jan. 04 Rent paid by cheque ₹2,000

Jan. 06 Received on account of cash sales ₹3,000.

Jan. 08 Paid to Mehta Bros. by cheque ₹2,000 and earned ₹200 as cash discount.

Jan. 10 Received from Suresh by cheque ₹2,000 and allowed him ₹100 as cash discount.

Jan. 12 Cash sales ₹20,000.

Jan. 20 Cash purchases ₹15,000.

Jan. 31 Salaries paid ₹5,000.

Solution:

CASH BOOK

Dt.	*Particulars*	*L.F*	*Dis-count (₹)*	*Cash (₹)*	*Bank (₹)*	*Dt.*	*Particulars*	*L.F.*	*Dis-count (₹)*	*Cash (₹)*	*Bank (₹)*
Jan.						Jan.					
1	To Balance b/d			3,000	4,000	6	By Rent A/c				2,000
6	To Sales A/c			3,000		8	By Mehta Bros.		200		2,000
10	To Suresh		100		2,000	20	By Purch. A/c			15,000	
12	To Sales A/c			20,000		31	By Salaries A/c			5,000	
						31	By Balance c/d			6,000	2,000
			100	26,000	6,000				200	26,000	6,000
	To Balance b/d			6,000	2,000						

Ledger

Dr. SALES ACCOUNT *Cr.*

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

SURESH

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

RENT ACCOUNT

Jan. 4	To Bank A/c		2,000		

NOTES

MEHTA BROS

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

PURCHASES ACCOUNT

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

SALARIES ACCOUNT

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

DISCOUNT ALLOWED ACCOUNT

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

DISCOUNT RECEIVED ACCOUNT

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

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

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

NOTES

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

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

CASH BOOK (RECEIPTS SIDE)

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

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

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

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

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

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

CASH BOOK (CASH COLUMN ONLY)

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

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

NOTES

(*I*) A cheque received by a business and sent to the Bank for collection may be dishonoured on presentation for payment. In such a case, the party from whom the cheque was received should be debited while the account of the Bank should be credited. For example, if a cheque received from, *'A'* for ₹10,000 on January 10, is dishonoured by his bankers on presentation for payment on January 14, entries in the Cash Book will appear as follows:

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

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

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

(a) On receipt of cheque

Cash A/c Dr.

To Customer

(b) On endorsement of cheque

Creditor Dr.

To Cash

(c) On dishonour of the cheque

Customer Dr.

To Creditor

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

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

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

Creditor Dr.

To Bank

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

Bank Dr.

To Creditor

NOTES

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

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

Illustration 3.8. Enter the following transactions in the appropriate type of the cash books, and post the same to the relevant ledger accounts:

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

NOTES

Solution:

Dr. CASH BOOK Cr.

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

Ledger

Dr. CAPITAL ACCOUNT Cr.

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

BUILDING ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
July 4	To Bank	5,000			

PURCHASES ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
July 15	To Bank	800			
July 25	To Cash	1,000			

FREIGHT ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
July 28	To Cash	50			

ELECTRICITY ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
July 31	To Cash	90			

SALES ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
			July 20	By Cash	1,200
			July 26	By Bank	1,500

FURNITURE ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
July 10	To Bank	1,000			

NOTES

INSURANCE PREMIUM ACCOUNT

July 27	To Bank	100			

DRAWINGS ACCOUNT

July 30	To Bank	500			

DISCOUNT ACCOUNT

July 31	To Sundries	35	July 31	By Sundries	20

Notes:

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

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

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

Cash Receipts and Payments Journal

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

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

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

3.3.2 Petty Cash Book

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

the beginning of every month/quarter to meet petty expenses. At the end of the month/quarter, the Petty Cashier submits a statement of account of the expenses incurred by him during the month/quarter and gets a fresh advance.

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

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

Illustration 3.9. Enter the following transactions in the Petty Cash Book (maintained on Imprest system) for the month of January, 2015.

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

NOTES

Solution:

PETTY CASH BOOK

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

Note: Voucher numbers, Ledger Folio numbers are imaginary.

NOTES

Postings from the Petty Cash Book Postings in the Ledger from the Petty Cash Book is done at the end of the period, *i.e.,* month or quarter as the case may be. There are two alternative ways of making postings from the Petty Cash Book.

1. *Petty Cash Book maintained as a Memorandum Book only* In such a case, the total of the various expenses from the Petty Cash Book is debited, to the concerned accounts at the end of the period and credit is given to the Cash Account with the actual expenditure incurred. The amount advanced by the Chief Cashier to the Petty Cashier is recorded by him as a memorandum by way of a note in the Cash Book itself. This method is usually not followed.

2. *Where Petty Cash Book is taken as a part of the Double Entry System* This method is quite popular. The recording is done regarding the petty cash transactions on the basis of the following entries:

(i) When money is advanced to the Petty Cashier:

Petty Cash Account Dr.

To Cash Account

(The Petty Cash Account is debited with the actual amount of money advanced)

(ii) On submission of accounts by the Petty Cashier:

Expenses Accounts Dr.

To Petty Cash Account

(Each expense is to be debited separately with the expenditure incurred during the period as shown by the Petty Cash Book.)

Thus, in the Ledger, there is a Petty Cash Account as well as separate Expenses Accounts for each of the expenses.

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

Dr. PETTY CASH ACCOUNT *Cr.*

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

STATIONERY ACCOUNT

July 31	To Petty Cash A/c	61			

NOTES

POSTAL CHARGES ACCOUNT

July 31	To Petty Cash A/c	71				

CARTAGE ACCOUNT

July 31	To Petty Cash A/c	2				

CLEANING ACCOUNT

July 31	To Petty Cash A/c	8				

MISCELLANEOUS expenses ACCOUNT

July 31	To Petty Cash A/c	27				

3.3.3 Purchases Journal

The Purchases Journal is meant for recording credit purchases of goods. It is also known as the Purchases or Bought Day Book. It has columns for date of purchase, invoice number, name of the party, ledger folio and the amount of purchases. It should be noted that the book records only purchase of goods on credit. Purchases of items other than goods on credit is recorded in the General Journal. Similarly, cash purchases are recorded in the Cash Book.

Posting The posting is done in the Personal Accounts daily from the Purchases Book. At the end of a week/month, the total of the Purchases Book is debited to the Purchases Account in the ledger.

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

Illustration 3.10. Record the following transactions in the Purchases Journal and post them in the Ledger.

2016			
Jan. 01	Purchased from Ram & Co. on credit:		
		30 Heater rods	@ ₹10
		20 Philips Bulbs	@ ₹20
Jan. 04	Purchased from Shyam & Co. on credit:		
		40 Heater rods	@ ₹10
		20 E.C.E. Bulbs	@ ₹15
Jan. 08	Purchased from Bajaj & Co. on credit:		
		20 Electric Elements	@ ₹40
		3 Electric Mixers	@ ₹100
Jan. 24	Purchased from K.C. & Co. on credit:		
		30 Electric Plugs	@ ₹20
		40 Table Fans	@ ₹200

Solution:

NOTES

PURCHASES JOURNAL

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

Ledger

RAM & CO. (*Folio 4*)

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

SHYAM & CO. (*Folio 8*)

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

BAJAJ & CO. (*Folio 12*)

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

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

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

PURCHASES ACCOUNT (*Folio 14*)

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

Notes:

(i) Folio Nos. are all imaginary.

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

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

Sales Journal

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

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

NOTES

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

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

Illustration 3.11. Record the following transactions in the Sales Day Book and post them into the ledger.

2015

Jan. 01 Sold to Mukesh & Co.:
- 10 Heater Rods @ ₹ 20
- 10 Lamp Shades @ ₹ 30

Jan. 10 Sold to Suresh & Brothers:
- 10 Table Fans @ ₹ 250
- 20 Philips Tubelights @ ₹ 30

Jan. 25 Sold to Ramesh & Co.:
- 10 Electric Switches @ ₹ 50
- 20 E.C.E. Tubelights @ ₹ 30

Solution:

SALES JOURNAL

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

Ledger

MUKESH & CO. (*Folio 4*)

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

NOTES

SURESH & BROTHERS *(Folio 6)*

Jan. 10	To Sales	3,100			

RAMESH & CO. (*Folio 8*)

Jan. 25	To Sales	1,100			

SALES ACCOUNT *(Folio 10)*

			Jan. 31	By Sundries	4,700

Notes:

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

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

3.3.4 Sales Returns Journal

The Journal is meant for recording return of goods sold on credit. The goods which are sold for cash, if returned, are either exchanged for new goods or the parties are paid in respect of them depending upon the circumstances. In case the goods returned are not immediately exchanged for the other goods or not paid for in cash, they are recorded in a memorandum book only. Thus, goods sold for cash and returned do not find a place in the Sales Returns Journal. They are recorded in the Cash Book in case cash is paid for them or no entry will be passed in case they have been recorded in a memorandum book only. A proforma of Sales Returns Journal is as under:

SALES RETURNS JOURNAL

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

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

Credit Note The customer who returns the goods, gets credit for the value of the goods returned. A Credit Note is sent to him intimating that his account has been credited with the value of the goods returned. The Note is prepared in duplicate. Its Proforma is as under:

NOTES

MAHESHWARI BROTHERS

3, Strand Road, Kolkata

No. 202 Date Jan. 10, 2016

To

Ram & Co.,

21, Shri Ram Road, Delhi.

Dear Sir,

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

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

For Maheshwari Brothers

Sunil

Manager

3.3.5 Purchases Returns Journal

The book is meant for recording return of goods purchased on credit. The goods purchased for cash and returned are not recorded in this book. They are recorded in a memorandum book only. On receipt of cash in respect of the goods returned, the entry will be passed through cash book. In case, the goods are exchanged for other goods of the same value, no entry will be required. The entry in the memorandum book will be cancelled on getting cash or goods for goods returned. A proforma of the Purchases Returns Journal is given below:

PURCHASES RETURNS JOURNAL

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

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

Debit Note When the goods are returned to the supplier, a debit note is sent to him indicating that this account has been debited with the amount mentioned in the Debit Note. Its proforma is given as under:

NOTES

MAHESHWARI BROTHERS

3, Strand Road Kolkata

No. 301 Date Jan. 12, 2014

To

Shyam & Co.

3, Clive Road, Kolkata.

Dear Sir.

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

4 Electric Rods @ ₹30 ₹120

For Maheshwari Brothers

Sunil

Manager

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

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

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

3.4 VOUCHER SYSTEM

In a small organisation, it is possible for the proprietor to supervise personally all important matters. However, in case of large organisations, delegation of authority is required and therefore, it is necessary to have a proper internal check system for prevention of errors and frauds in recording the transactions and receiving or making final cash payments. The chances of frauds in case of cash payments are all the more. It is almost impossible for the disbursing official to have all information regarding the goods and services in respect of which he is required to make payments. This is because even in case of organisations of moderate size, the responsibility for issuing purchase orders, inspecting commodities received, verifying contractual and arithmetical details of invoices is divided among the employees of the various departments. The disbursing official should have, therefore, assurance of all concerned officials before making payments that the terms of the contract have been complied with and he is paying the exact amount of obligation. This is possible only when all the activities mentioned above are properly coordinated and linked with ultimate issuance of cheques to the creditors. One of the most effective system employed for this purpose is termed as Voucher System.

Voucher System may, therefore, be defined as ‘‘a plan and method of procedure for the verification, recording and payment of all items (other than items to be paid petty cash) which require the disbursement of cash.’’ As a matter of fact, it is mainly a plan of internal check for all cash disbursement items. There are three basic requirements of Voucher System:

NOTES

(a) A voucher is to be prepared for each item of expenditure.

(b) No payment shall be made without a properly verified and authorised voucher.

(c) Development of a proper and efficient system for determining the amount to be paid on each day. This helps the disbursing official in determining the amount to be paid and the management is conveniently and continuously forecasting the amount of the cash required to meet maturing obligations.

The following documents are used in the Voucher System:

1. **Vouchers** In general terms, a voucher means a documentary evidence in support of a business transaction. It is a documentary evidence by which the accuracy of an entry made in the books of account can be substantiated. It may be a receipt, a counterfoil of a receipt book, an invoice or even correspondence with the concerned parties. The term 'Voucher' has a narrower meaning when applied to the Voucher System. It is a special form on which is recorded pertinent data about a liability and the particulars of its payments.

Vouchers are generally prepared by the accounting department on the basis of invoices or returns that serves as the evidence of expenditure. This is done after the following comparisons and verifications have been completed and noted on the invoices:

(*i*) Comparison with the copy of Purchase Order to verify the quantities, prices and terms.

(*ii*) Comparison with the Goods Received Returns to determine the receipt of items recorded in the invoices.

(*iii*) Verification of the arithmetical accuracy of the Invoices.

After making the above verifications and comparisons, the invoices or other supporting evidence is attached to the voucher and is presented to the concerned official for his final approval.

2. **Voucher Register** The Voucher Register is a columnar journal giving the details about the Voucher Nos., and different items of expenses in respect of which payments have to be made. A Proforma of a Voucher Register is given below.

VOUCHER REGISTER

Date	*Payee*	*Voucher No*	*Paid*		*Credit*			*Debit*			
			Date	*Cheque No.*	*Voucher Payable*	*Purch-ases*	*Wages*	*Salaries*	*Office*	*Selling Expenses*	*Sundries Expenses*
01-5-11	Mohan	501	1-5-11	430	250	250					
08-5-11	Kishan	502	–	–	300	300					
15-5-11	David	503	20-5-11	431	500	–	500				
				1,050	550	500					

The vouchers are recorded in a numerical sequence. The credit is given to the accounts payable while debit is given to the account or accounts to be charged for expenditure. On making payment, the date of payment and the number of cheques are inserted in the appropriate columns in the Voucher Register. The objective of such a recording is to provide ready information about determining the amount of individual unpaid vouchers. The total outstanding liability on account of vouchers unpaid at a particular date can be found out by adding up the individual amount of the unpaid vouchers as shown in the Voucher Register.

3. **Unpaid Voucher File** After the vouchers have been prepared and recorded in the Voucher Register, they are filed in an Unpaid Voucher File. They remain there till they are paid. The amount due on each voucher represents the credit balance of an account payable. Each voucher in itself is comparable to an individual account in a Creditors Ledger. Hence, no separate Creditors Ledger is necessary.

4. **Cheque Register** The payment of a voucher is recorded in Cheque Register, the proforma of which is given below:

CHEQUE REGISTER

Date	*No. Cheque*	*Payee*	*No. Voucher*	*Accounts Payable Dr.*	*Discount Cr.*	*Bank Cr.*
May 5	430	Mohan	501	250	10	240
May 15	431	David	503	500	5	495
				750	15	735

The Cheque Register is a modified form of Cash Payment Journal and it is so called because it is a complete record of all cheques issued. It is customary to record all cheques in a Cheque Register in the order of their sequence to avoid mistake in their recording.

When a Voucher is to be paid, it is removed from the Unpaid Voucher File. On issue of a cheque, the data, the number of cheque and amount are listed on the back of the voucher. This helps in recording the payments in the Cheque Register. The paid vouchers and the supporting documents are cancelled through a cancelling stamp to prevent their accidental or intentional reuse.

5. **Paid Voucher File** After payments, the vouchers are generally filed in numerical sequence in Paid Voucher File. They are then readily available for examination by employees or independent auditors who may require information about a specific expenditure. The paid vouchers are finally destroyed in accordance with the firm's policy concerning the retention of records.

6. **Vouchers Payable Account** Vouchers Payable Account is similar to Total Creditors Account. It is credited with the total amount payable on account of different vouchers and is debited with the amount of payments made. The balance of the Vouchers Payable Account should agree with the total of the Unpaid Vouchers File and also with the sum of unpaid vouchers as shown in the Voucher Register. A proforma of a Vouchers Payable Account is given below:

VOUCHERS PAYABLE ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2016			2016		
May 31	To Cheque-Register	735	May 31	By Voucher Register	1,050
	To Discount	15			
	To Balance c/d	300			
		1,050			1,050

Advantages of the Voucher System

The Voucher System offers the following advantages:

(*i*) *Safeguards cash disbursements* The Voucher System provides for a systematic plan for the verification and approval of all invoices, bills and other items requiring disbursement of cash. Thus, it safeguards all cash disbursements.

(*ii*) *Reduces book-keeping work* The Voucher System considerably reduces the book-keeping work. The voucher itself works as an account of the creditor and total amount due to the creditors can be found out with the help of the Unpaid Vouchers File.

(*iii*) *Recording of all current liabilities* The Voucher System provides for the immediate recording of all current liabilities. It is generally found that the firms which do not use the Voucher System fail to record bills for items of services and expenses till such time they are actually paid. As a matter of fact, it is desirable to show all liabilities in the books of the business from the time they are incurred.

(*iv*) *Strengthening of internal check system* The placing of responsibilities for verification and approvals strengthens the system of internal check.

(*v*) *Planning future cash requirements* The Voucher System provides continuous information for planning the future cash requirements. This enables the management to make the maximum use of cash resources. Invoices in respect of which cash discounts are allowed can be paid within the discount period. Other invoices can be paid in accordance with the credit items. This helps in minimising cost and maintaining a favourable credit standard. Moreover, seasonal borrowings for working capital can also be planned more effectively resulting in saving in interest cost.

Limitations of the Voucher System

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The Voucher System has the following limitations:

(*i*) *Unsuitable for small concerns* The Voucher System is neither suitable nor necessary for small business enterprises, particularly those with high degree of proprietary supervision and control.

(*ii*) *Proper personnel and finances required* The Voucher System requires sufficient personnel as well as finances for its successful operation. It will be a cumbersome exercise especially for an enterprise which is not well organised. If an enterprise which uses the voucher system does not have sufficient cash and is not in a position to pay the approved vouchers according to schedule, it may develop an unwieldy file of approved unpaid vouchers.

(*iii*) *Fails to provide overall position of a creditor's account* The system does not provide for giving an overall position of a creditor's account.

(*iv*) *Difficulties in case of partial payments, returns, etc.* The system proves as a hindrance rather than as a help in case of concerns which have many returns of goods and other corrections after approving and recording of purchase invoices. Such concerns have to make partial payments of approved vouchers. In some cases, they have to defer payment also.

From the above, it may be concluded that the Voucher System is suitable only for an enterprise which is well equipped both in respect of personnel and finances. It is not suitable for small concerns. Moreover, suitable modifications may have also to be made in the operation of the system as to meet the specific needs of a particular enterprise.

Check Your Progress

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

3.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The two types of real accounts are:
    - Tangible real account
    - Intangible real account

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

3.6 SUMMARY

- The Journal records all daily transactions of a business into the order in which they occur. A Journal may, therefore, be defined as a book containing a chronological record of transactions. It is the book in which the transactions are recorded first of all under the double entry system. Thus, Journal is the book of original record.
- The transactions in the Journal are recorded on the basis of the rules of debit and credit. For this purpose business transactions have been classified into three categories:
- (i) Transactions relating to persons.
- (ii) Transactions relating to properties and assets.
- (iii) Transactions relating to incomes and expenses.
- Personal accounts include the accounts of persons with whom the business deals.
- Nominal accounts are opened in the books to simply explain the nature of the transactions. They do not really exist. For example, in a business, salary is paid to the manager, rent is paid to the landlord, commission is paid to the salesman—cash goes out of the business and it is something real; while salary, rent or commission as such do not exist.
- Sometimes there are a number of transactions on the same date relating to one particular account or of one particular nature. Such transactions may be recorded by means of a single journal entry instead of passing several journal entries. Such entry regarding recording a number of transactions is termed as a "Compound Journal Entry".
- In case of a running business, the assets and liabilities appearing in the previous year's balance sheet will have to be brought forward to

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the current year. This is done by means of a journal entry which is termed as “Opening Entry”. All Assets Accounts are debited while all Liabilities Accounts are credited.

- Voucher System may be defined as ‘‘a plan and method of procedure for the verification, recording and payment of all items (other than items to be paid petty cash) which require the disbursement of cash.’’ As a matter of fact, it is mainly a plan of internal check for all cash disbursement items.

3.7 KEY WORDS

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

3.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State the stages of accounting cycle.
2. What are the rules of debit and credit?
3. What are the different categories of personal accounts?
4. State the limitations of the voucher system.

Long Answer Questions

1. Analyse the documents used in the voucher system.
2. Explain the operation of cash receipts and payments journal.
3. Explain the different rules for journalising the transaction with appropriate illustrations.
4. Briefly explain the difference between:
   (i) Personal and Impersonal Accounts.
   (ii) Real Accounts and Nominal Accounts

3.9 FURTHER READINGS

NOTES

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

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

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BLOCK - II

BANKING THEORY AND PRACTICE

UNIT 4 LEDGER POSTING AND TRIAL BALANCE

Structure

4.0 Introduction
4.1 Objectives
4.2 Ledger
  4.2.1 Relationship between Journal and Ledger
  4.2.2 Rules Regarding Posting
4.3 Trial Balance
4.4 Final Accounts of Sole Proprietorship and Firms
  4.4.1 Trading Account
  4.4.2 Profit and Loss Account
  4.4.3 Balance Sheet
4.5 Answers to Check Your Progress Questions
4.6 Summary
4.7 Key Words
4.8 Self Assessment Questions and Exercises
4.9 Further Readings

4.0 INTRODUCTION

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

4.1 OBJECTIVES

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

- Appreciate the role of ledger in recording business transactions
- Understand the meaning and rules regarding posting
- Describe the meaning and the objects of preparing a trial balance
- Make posting and prepare a trial balance
- Analyse the meaning and objectives of sole proprietorship and firms

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4.2 LEDGER

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

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

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

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

Posting

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

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

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

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

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

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

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

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

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

4.2.1 Relationship between Journal and Ledger

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

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

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

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

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

4.2.2 Rules Regarding Posting

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

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

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

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

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

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

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

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

Dr. SALARIES ACCOUNT *Cr.*

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

Dr. CASH ACCOUNT *Cr.*

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

Use of the words "To" and "By"

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

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

Illustration 4.1. Journalize the following transactions and post them into the Ledger:

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

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

Solution:

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JOURNAL

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

Ledger

CASH ACCOUNT

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

CAPITAL ACCOUNT

Particulars	₹	Particulars	₹	
		By Cash A/c	10,000	5

FURNITURE ACCOUNT

	Particulars	₹	Particulars	₹
2	To Cash A/c	4,000		

PURCHASES ACCOUNT

	Particulars	₹	Particulars	₹
3	To Mohan	2,000		

MOHAN

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

Balancing of an Account

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

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This will be clear with the help of the following illustration.

Illustration 4.2. Journalize the following transactions, post them in the Ledger and balance the accounts on 31st January.

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

Solution:

JOURNAL

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

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Ledger

Dr. CASH ACCOUNT *Cr.*

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

Dr. CAPITAL ACCOUNT *Cr.*

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

PURCHASES ACCOUNT

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

MOHAN

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

SURESH

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

SALES ACCOUNT

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

It is to be noted that the balance of an account is always known by the side which is greater. For example, in the above illustration, the debit side of the Cash Account is greater than the credit side by ₹12,000. It will be, therefore, said that Cash Account is showing a debit balance of ₹12,000. Similarly, the credit side of the Capital Account is greater than debit side by ₹10,000. It will be, therefore, said that the Capital Account is showing a credit balance of ₹10,000.

NOTES

Check Your Progress

1. What are the two forms of ledger?
2. When is the ledger folio column in the journal used?

4.3 TRIAL BALANCE

In case the various debit balances and the credit balances of the different accounts are taken down in a statement, the statement so prepared is termed as a Trial Balance. In other words, Trial Balance is a statement containing the various ledger balances on a particular date. For example, with the balances of the ledger accounts prepared in Illustration 4.9 (of the previous unit), the Trial Balance can be prepared as follows:

TRIAL BALANCE
as on 31st January

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

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

Objects of Preparing a Trial Balance

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

Balance Sheet. The Trial Balance represents all transactions relating to different accounts in a summarised form for a particular period. In case the Trial Balance is not prepared, it will be almost impossible to prepare the financial statements as stated above to know the profit or loss made by the business during a particular period or its financial position on a particular date.

3. *Summarised ledger* It has already been stated that a Trial Balance contains the ledger balances on a particular date. Thus, the entire ledger is summarised in the form of a Trial Balance. The position of a particular account can be judged simply by looking at the Trial Balance. The Ledger may be seen only when details regarding the accounts are required.

Methods of Preparation of a Trial Balance

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

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

Illustration 4.3. Prepare (*a*) ledger accounts and (*b*) the trial balance according to (*i*) Total method (*ii*) Balance method and (*iii*) Total and balance method on the basis of transactions.

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Solution:

(*a*) **Preparation of Ledger Accounts**

Dr. CASH ACCOUNT Cr.

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

INTEREST ACCOUNT

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

BANK ACCOUNT

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

STOCK ACCOUNT

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

Dr. FURNITURE ACCOUNT *Cr.*

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

BUILDING ACCOUNT

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

VIJAY

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

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ANIL

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

MADHU

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

ANAND

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

CAPITAL ACCOUNT

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

Dr. BABU'S LOAN ACCOUNT *Cr.*

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

PURCHASES ACCOUNT

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

DISCOUNT ACCOUNT

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

BHARAT

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

NOTES

PLANT ACCOUNT

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

INTEREST ON LOAN ACCOUNT

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

Dr. MUKESH *Cr.*

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

SALES ACCOUNT

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

Dr. RAHIM *Cr.*

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

BAD DEBTS ACCOUNT

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

SALARY ACCOUNT

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

DRAWINGS ACCOUNT

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

NOTES

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

TRIAL BALANCE

(as on 31st January, 2016)

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

(*ii*) Balance Method

TRIAL BALANCE

(as on 31st January, 2016)

Particulars	*Debit* (₹)	*Credit* (₹)
Cash Account	580	
Interest		200
Bank Account	25,000	
Stock Account	20,000	
Furniture Account	2,000	
Building Account	10,000	
Anil	1,000	
Madhu	2,000	
Capital Account		55,000
Babu's Loan Account		10,000
Purchases Account	8,800	
Discount Account		380
Bharat		5,000
Plant Account	5,300	
Interest on Loan Account	500	
Mukesh		5,000
Sales Account		2,100

Bad Debts Account	300	
Salary Account	2,000	
Drawings Account	200	
	77,680	77,680

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(*iii*) Total and Balance Method

TRIAL BALANCE

(as on 31st January, 2016)

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

4.4 FINAL ACCOUNTS OF SOLE PROPRIETORSHIP AND FIRMS

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

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

Characteristics of Final Accounts

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

Objectives of Final Accounts

The following are the main objectives of final accounts:

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

4.4.1 Trading Account

Trading Account gives the overall result of trading, *i.e.*, purchasing and selling of goods. In other words, it explains whether purchasing of goods and selling them has proved to be profitable for the business or not. It takes into account

on the one hand the cost of goods sold and on the other the value for which they have been sold away. In case the sales value is higher than the cost of goods sold, there will be a profit, while in a reverse case, there will be a loss. The profit disclosed by the Trading Account is termed as Gross Profit, similarly the loss disclosed by the Trading Account is termed as Gross Loss.

This will be clear with the help of the following illustration:

Illustration 4.4. The following figures have been taken from the Trial Balance of a trader:

	₹
Purchases	30,000
Purchases Returns	5,000
Sales	40,000
Sales Returns	5,000

Calculate the amount of profit or loss made by the trader.

Solution:

The profit or loss made by the trader can be found out by comparing the cost of goods sold with sales value. This has been done as follows:

Particulars	*Amount* ₹	*Amount* ₹
Sales	40,000	
Less Sales Returns	5,000	35,000
Purchases	30,000	
Less Purchases Returns	5,000	25,000
Gross Profit		10,000

Opening and Closing Stocks

In Illustration 4.4, we have presumed that all goods purchased have been sold away by the trader. However, it does not normally happen. At the end of the accounting year, a trader may be left with certain unsold goods. Such stock of goods with a trader unsold at the end of the accounting period is termed as Closing Stock. Such a stock will become the opening stock for the next period. For example, if a trader has with himself goods amounting to ₹5,000 unsold at the end of the year 2017, this stock of ₹5,000 will be termed as his Closing Stock. For the year 2017, this stock of ₹5,000 will be termed as his Opening Stock. While calculating the amount of profit or loss on account of trading, a trader will have to take such Opening and Closing Stocks into consideration. This will be clear with the help of the following illustration.

Illustration 4.5. Taking the figures given in Illustration 7.1, calculate the amount of Gross Profit if stock of ₹5,000 is left at the end of the accounting period.

Solution:

In case all goods purchased have not been sold away, goods of ₹5,000 are still left with the trader. Stock of such goods is termed as Closing Stock. Thus, cost of goods sold will be calculated as follows:

COST OF GOODS SOLD = NET PURCHASES – CLOSING STOCK
= ₹25,000 – 5,000 = ₹20,000

The Gross Profit now can be computed as follows:

GROSS PROFIT= NET SALES – COST OF GOODS SOLD
= ₹35,000 – 20,000 = ₹15,000

Illustration 4.6. From the following data calculate the profit made by a trader in 2017.

	₹
Stock of goods on 1.1.2017	10,000
Purchases during the year	40,000
Purchases Returns during the year	3,000
Sales during the year	60,000
Sales returns during the year	10,000
Stock of goods on 31.12.2017	15,000

Solution:

Particulars	*Amount* ₹	*Amount* ₹
Sales	60,000	
Less: Sales Returns	10,000	50,000
Cost of goods sold:		
Opening Stock	10,000	
Add: Net Purchases (₹40,000 – 5,000)	35,000	
	45,000	
Less: Closing Stock	15,000	30,000
Gross Profit		20,000

Expenses on Purchases etc.

In the Illustrations given above, we have presumed that the trader has not incurred any expenses for purchase of goods and bringing them to his shop for sale. However, a trader has to incur various types of expenses for purchasing of goods as well as for bringing them to his shop for sale. Such expenses may include brokerage or commission paid to agents for purchase of goods, cartage or carriage charges for bringing the goods to the trader's shop, wages paid to coolies for transportation of goods etc. All such expenses increase the cost of the goods sold and hence they have also to be included in the cost of purchasing the goods. In other words, cost of goods sold will be calculated as follows:

COST OF GOODS SOLD = OPENING STOCK + NET PURCHASES + EXPENSES ON PURCHASING OF GOODS – CLOSING STOCK

Cost of goods sold calculated as above will then be compared with the net sales to find out the amount of profit or loss made by the business. This will be clear with the following Illustrations.

Illustration 4.7. Calculate the amount of the profit made by the trader with the help of data given in Illustration 7.3, if the wages, carriage charges etc. incurred for bringing the goods to the trader's shop amount to ₹5,000.

Solution:

Particulars	*Amount* ₹
Net Sales	50,000
Less: Cost of goods sold (30,000 + 5,000)	35,000
Gross Profit	15,000

The term 'merchandise' is also used for the term 'goods'.

Thus:

COST OF GOODS	=	**COST OF MERCHANDISE**
COST OF GOODS PURCHASED	=	**COST OF MERCHANDISE PURCHASED**
COST OF GOODS SOLD	=	**COST OF MERCHANDISE SOLD**

Illustration 4.8. Find out the cost of merchandise purchased, cost of merchandise sold, cost of merchandise unsold and Gross Profit from the following transactions:

	₹
Purchases (3,000 articles)	25,000
Freight	1,000
Local Taxes	1,000
Salaries	2,500
Shop Rent	500
Godown Rent	500
Electrical Charges	600
Municipal Taxes	200
Stationery	250
Furniture (estimated life 5 years)	12,000
Sales (2,700 articles)	32,000

Solution:

Particulars	*Amount* ₹
Cost of Merchandise purchased	
This consists of:	
Purchases	25,000
Freight	1,000
Local Taxes	1,000
	27,000
Cost of Merchandise sold	
Cost of 3,000 units of merchandise purchased	27,000
Cost of one unit of merchandise	9
Cost of 2,700 units of merchandise sold	24,300

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Gross Profit	
Sales of 2,700 units of merchandise	32,000
Less: Cost of merchandise sold	24,300
	7,700
Cost of Merchandise unsold	
300 units @ ₹9 per unit	2,700

All other expenses including annual depreciation of furniture (amounting in all to ₹6,950) will be considered for computing the Net Profit of the business. The concept of Net Profit has been explained later in the chapter.

Equation for Preparing Trading Account

On the basis of the Illustrations given in the preceding pages, the following equation can be derived for preparing Trading Account:

Gross Profit = Sales – Cost of Goods Sold

Cost of Goods Sold = Opening Stock + Purchases + Direct Expenses – Closing Stock

Therefore, Gross Profit = Sales – (Opening Stock + Purchases + Direct Expenses – Closing Stock)

Or **Gross Profit = (Sales + Closing Stock) – (Opening Stock + Purchases + Direct Expenses)**

The term "Direct Expenses" include those expenses which have been incurred in purchasing the goods, bringing them to the business premises and making them fit for sale. Examples of such expenses are carriage charges, octroi, import duty, expenses for seasoning the goods, etc.

The Trading Account can be prepared in the following form on the basis of equation given above.

TRADING ACCOUNT

Dr. *for the period ending ...* *Cr.*

Particulars		*Amount* ₹	*Particulars*		*Amount* ₹
To Opening Stock		......	By Sales	......	
To Purchases	......		*Less:* Returns	......	......
Less: Returns	......	......	By Closing Stock		......
To Direct Expenses		......	By Gross Loss*		......
To Gross Profit*		......			......
		......			......

*Only one figure will be there.

Illustration 4.9. Prepare the Trading Account of Mr. Ramesh for the year ending 31st December, 2017 from the data as follows:

	₹		₹
Purchases	10,000	Wages	4,000
Purchases Returns	2,000	Carriage Charges	2,000
Sales	20,000	Stock on 1.1.2017	4,000
Sales Returns	5,000	Stock on 31.12.2017	6,000

Solution:

TRADING ACCOUNT

Dr. *for the year ending 31-12-2017* *Cr.*

Particulars		₹	*Particulars*		₹
To Opening Stock		4,000	By Sales	20,000	
To Purchases	10,000		*Less:* Sales		
Less: Returns	2,000	8,000	Returns	5,000	15,000
To Wages		4,000	By Closing Stock		6,000
To Carriage Charges		2,000			
To Gross Profit		3,000			
		21,000			21,000

Important Points Regarding Trading Account

1. **Stock** The term 'Stock' includes goods lying unsold on a particular date. The Stock may be of two types:

(i) Opening Stock (ii) Closing Stock

The term 'Opening Stock' means goods lying unsold with the businessman in the beginning of the accounting year. This is shown on the debit side of the Trading Account.

The term 'Closing Stock' includes goods lying unsold with the businessman at the end of the accounting year. It should be noted that stock at the end of the accounting year is taken after the books of accounts have been closed. The following journal entry is passed in the Journal Proper to record the amount of closing stock:

Closing Stock Account Dr.

To Trading Account

The amount of closing stock is shown on the credit side of the Trading Account and as an asset in the Balance Sheet. This has been explained later. The Closing Stock at the end of the accounting period will become the Opening Stock for the next year. The Opening Stock is, therefore, shown on the debit side of the Trial Balance.

The following equations can be derived for computation of stocks:

Opening Stock = Cost of Goods Sold + Closing Stock – Cost of Purchases

Closing Stock = Opening stock + Cost of purchases – Cost of Goods Sold

Taking the figures from Illustration 11.6 the two stocks can be computed as under:

Opening Stock = Cost of Goods Sold + Closing stock – Cost of purchases

= 12,000 + 6,000 – 14,000 = ₹4,000

Closing Stock = Opening stock + Cost of purchases – Cost of Goods Sold

= 4,000 + 14,000 – 12,000 = ₹6,000

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Valuation of Closing Stock: The closing stock is valued on the basis of "cost or market price whichever is less" principle. It is, therefore, very necessary that the cost of the goods lying unsold should be carefully determined. The market value of such goods will also be found out on the Balance Sheet date. The closing stock will be valued at the lower of the two values. For example, if the goods lying unsold at the end of the accounting period amount to ₹11,000, while their market price on the Balance Sheet date amounts to ₹10,000, the closing stock will be valued at ₹10,000. This valuation is done because of the accounting convention of conservatism, according to which expected losses are to be taken into account but not expected profits.

2. **Purchases:** The term "Purchases" includes both cash and credit purchases of goods. The term "goods", as already explained in an earlier chapter, means items purchased for resale. Assets purchased for permanent use in the business such as purchase of plant, furniture, etc., are not included in the purchase of goods. Similarly, purchase of articles such as stationery meant for using in the business will also not be included in the item of purchases. In case a proprietor has himself used certain goods for his personal purposes, the value of such goods at cost will be deducted from the purchases and included in the drawings of the proprietor. The journal entry in such a case would be as follows:

Drawings Account Dr.

To Purchases Account

Similarly, in case certain goods are given by way of free samples, etc., the value of such goods should be charged to advertisement account and deducted from purchases. The journal entry in such a case would be as follows:

Advertisement Account Dr.

To Purchases Account

The amount of purchases will be the net purchases made by the proprietor. The term 'net purchases' means total purchases of goods made by the businessman less the goods that he has returned back to the suppliers. In other words, purchases will be taken to the Trading Account after deducting purchases returns from the gross purchases made during the accounting period.

3. **Sales:** The term 'Sales' includes both cash and credit sales. Gross sales will be shown in the inner column of the Trading Account out of which "sales returns" will be deducted. The net sales will then be shown in the outer column

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of the Trading Account. Proper care should be taken in recording sale of those goods which have been sold at the end of the financial year but have not yet been delivered. The sales value of such goods should be included in the sales, but care should be taken that they are not included in the closing stock at the end of the accounting period.

Sales have to be recorded at net realisable value excluding sales tax, i.e., Sales excluding Sales Tax – Cost incurred necessarily to make the sale. For example, an item can be sold for ₹50 plus sales tax at 10% after getting it repaired at a cost of ₹5. The sales should be recorded at net relisable value, i.e., ₹45.

Sales of assets like plant and machinery, land and building or such other assets which were purchased for using in the business, and not for sale, should not be included in the figure of 'sales' to be taken to the Trading Account.

4. **Wages:** The amount of wages is taken as a direct expense and, therefore, is debited to the Trading Account. Difficulty arises in those cases when the Trial Balance includes a single amount for "wages and salaries". In such a case, the amount is taken to the Trading Account. However, if the Trial Balance shows "salaries and wages" the amount is taken to the Profit and Loss Account. In actual practice such difficulties do not arise because the businessman knows for which purpose he has incurred the expenditure by way of wages or salaries. However, in an examination problem, it will be useful for the students to follow the principle given above, i.e., "wages and salaries" to be charged to Trading Account while "wages and salaries" to be charged to the Profit and Loss Account. Wages paid for purchase of an asset for long-term use in the business, i.e., wages paid for plant and machinery or wages paid for construction of a building should not be charged to the Wages Account. They should be charged to the concerned Asset Account.

5. **Customs and Import Duty:** In case the goods have been imported from outside the country, customs and import duty may have to be paid. The amount of such duty should be charged to the Trading Account.

6. **Freight, Carriage and Cartage:** Freight, Carriage and Cartage are taken as direct expenses incurred on purchasing of the goods. They are, therefore, taken to the debit side of the Trading Account. The terms "Freight In", "Cartage In" and "Carriage In" have also the same meaning. However, "Cartage Out", "Freight Out" and "Carriage Out" are taken to be the expenses incurred on selling the goods. They are, therefore, charged to the Profit and Loss Account. The term "Inward" is also used for the term "IN". Similarly, the term "Outward" is also used for the term "Out". In other words, "Carriage" or "Carriage Inward" or "Cariage In" are used as synonymous terms. Similarly, "Carriage Out" or "Carriage Outward" are also synonymous terms. The same is true for other expenses like Freight or Cartage.

7. **Royalty:** Royalty is the amount paid to the owner for using his rights. For example, the royalty is paid by a "Lessee" of a coalmine to its owner for taking out the coal from the coalmine. Similarly, royalty is paid to the owner of a patent for using his right. It is generally taken as a direct expense and, therefore, is charged to the Trading Account. However, where royalty is based on sales, for example, in case of the book publishing trade, it may be charged to the Profit and Loss Account.

8. **Gas, Electricity, Water, Fuel, etc.** All these expenses are direct expenses and, therefore, they are charged to the Trading Account.

9. **Packing Materials:** Packing Materials used for packing the goods purchased for bringing them to the shop or convert them into a saleable state are direct expenses and, therefore, they are charged to the Trading Account. However, packing expenses incurred for making the product look attractive or packing expenses incurred after the product has been sold away are charged to the Profit and Loss Account.

Closing Entries

Closing Entries are entries passed at the end of the accounting year to close different accounts. These entries are passed to close the accounts relating to incomes, expenses, gains and losses. In other words, these entries are passed to close the different accounts which pertain to Trading and Profit and Loss Account. The accounts relating to assets and liabilities are not closed but they are carried forward to the next year. Hence, no closing entries are to be passed regarding those accounts which relate to the Balance Sheet.

The principle of passing closing entry is very simple. In case an account shows a debit balance, it has to be credited in order to close it. For example, if the Purchases Account is to be closed, the Purchases Account will have to be credited so that it may be closed because it has a debit balance. The Trading Account will have to be debited.

The closing entries are passed in the Journal Proper. The different closing entries to be passed by the accountant for preparing a Trading Account are being explained below:

(i) Trading Account Dr.

To Stock Account (Opening)

To Purchases Account

To Sales Returns Account

To Carriage Account

To Customs Duty Account

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(ii) Sales Account Dr.
Purchases Returns Account Dr.
Stock Account (Closing) Dr.
To Trading Account

In case the total of the credit side of the Trading Account is greater than the total of the debit side of the Trading Account, the difference is known as Gross Profit. In a reverse case it will be a Gross Loss. Gross Profit or Gross Loss disclosed by the Trading Account is transferred to the Profit and Loss Account.

Importance of the Trading Account

Trading Account provides the following information to a businessman regarding his business:

1. Gross Profit disclosed by the Trading Account tells him the upper limit within which he should keep the operating expenses of the business besides saving something for himself. The cost of purchasing and the price at which he can sell the goods are governed largely by market factors over which he has no control. He can control only his operating expenses. For example, if the cost of purchasing an article is ₹10 and it can be sold in the market at ₹15 per unit, the gross margin available on each article is ₹5. In case a businessman proposes to sell 1,000 units of that article in a year, his gross profit or gross margin will be ₹5,000. His other expenses should therefore be less than ₹5,000 so that he can also save something for himself.
2. He can calculate his Gross Profit Ratio1 and compare his performance year after year. A fall in the Gross Profit Ratio means increase in the cost of purchasing the goods or decrease in the selling price of the goods or both. In order to maintain at least same figure of gross profit in absolute terms, he will have to push up the sales or make all out efforts to obtain goods at cheaper prices. Thus, he can prevent at least fall in the figure of his gross profit if he cannot bring any increase in it.
3. Comparison of stock figures of one period from another will help him in preventing unnecessary lock-up of funds in inventories.
4. In case of new products, the businessman can easily fix up the selling price of the products by adding to the cost of purchases, the percentage gross profit that he would like to maintain. For example, if the trader has been so far maintaining a rate of gross profit of 20% on sales and he introduces a new product in the market having a cost of ₹100, he should fix the selling price at ₹125 in order to maintain the same rate of gross profit (i.e., 20% on sales).

1. Gross Profit ÷ Sales × 100

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4.4.2 Profit and Loss Account

The Trading Account simply tells about the gross profit or loss made by a businessman on purchasing and selling of goods. It does not take into account the other operating expenses incurred by him during the course of running the business. For example, he has to maintain an office for getting orders and executing them, taking policy decisions and implementing them. All such expenses are charged to the Profit and Loss Account. Besides this, a businessman may have other sources of income. For example, he may receive rent from some of his business properties. He may have invested surplus funds of the business in some securities. He might be getting interest or dividends from such investments. In order to ascertain the true profit or loss which the business has made during a particular period, it is necessary that all such expenses and incomes should be considered. Profit and Loss Account considers all such expenses and incomes and gives the net profit made or loss suffered by a business during a particular period. It is generally prepared in the following form:

PROFIT AND LOSS ACCOUNT

Dr. *for the year ending.....* *Cr.*

Particulars	₹	*Particulars*	₹
To Gross Loss b/d*	....	By Gross Profit b/d*	....
To Salaries	....	By Discount received	....
To Rent	....	By Net Loss transferred	
To Commission	....	to Capital A/c*	....
To Advertisements	....		
To Bad Debts	....		
To Discount	....		
To Net Profit Transferred			
to Capital Account*	....		
	....		....

* Only one figure of profit or loss will appear.

Important Points Regarding Profit and Loss Account

1. **Gross Profit or Gross Loss** The figure of gross profit or gross loss is brought down from the Trading Account. Of course, there will be only one figure, *i.e.,* either of gross profit or gross loss.
2. **Salaries** Salaries payable to the employees for the services rendered by them in running the business being of indirect nature are charged to the Profit and Loss Account. In case of a partnership firm, salaries may be allowed to the partners. Such salaries will also be charged to the Profit and Loss Account.
3. **Salaries *less* Tax** In case of employees earning salaries beyond a certain limit, the employer has to deduct at source income tax from the salaries of such employees. In such a case, the amount of gross

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salaries should be charged to the Profit and Loss Account, while the tax deducted by the employer will be shown as a liability in the Balance Sheet of the business till it is deposited with the Tax Authorities. For example, if salaries paid are ₹2,400 after deducting income tax of ₹600, the amount of salaries to be charged to the Profit and Loss Account will be a sum of ₹3,000. The amount of tax-deducted at source by the employer, *i.e.*, ₹600 will be shown as a liability in the Balance Sheet.

4. **Salaries after deducting Provident Fund Contribution etc.** In order to provide for old age of the employees, employers contribute a certain percentage of salaries of the employees to the Provident Fund. The employee is also required generally to contribute an equivalent amount. The share of the employee's contribution to Provident Fund is deducted from the salary due to him and the net amount is paid to him. The amount of salaries to be charged to the Profit and Loss Account will be the gross salary payable to the employee, *i.e.*, including the employee's contribution to the Provident Fund. The contribution by the employer will also be charged as an expense to the Profit and Loss Account. Both employer's and employee's contributions to the Provident Fund will also be shown as liability in the Balance Sheet under the heading "Employees Provident Fund".
5. **Interest** Interest on loans whether short-term or long-term is an expense of an indirect nature and, therefore, is charged to the Profit and Loss Account. However, interest on loans advanced by a firm to third-parties is an item of income and, therefore, will be credited to the Profit and Loss Account.
6. **Commission** Commission may be both an item of income as well as an item of expense. Commission on business brought by agents is an item of expense while commission earned by the business for giving business to others is an item of income. Commission to agents is, therefore, debited to the Profit and Loss Account while commission received is credited to the Profit and Loss Account.
7. **Trade Expenses** Trade expenses are expenses of a miscellaneous nature. They are of small amount and varied in nature and, therefore, it is not considered worthwhile to open separate accounts for each of such types of expenses. The terms "Sundry Expenses", "Miscellaneous Expenses" or "Petty Expenses" have also the same meaning. They are charged to the Profit and Loss Account.
8. **Printing and Stationery** This item of expense includes expenses on printing of bills, invoices, registers, files, letter heads, ink, pencil, paper and other items of stationery, etc. It is of an indirect nature and, therefore, charged to the Profit and Loss Account.

9. **Advertisements** Advertisement expenses are incurred for attracting the customers to the shop and, therefore, they are taken as selling expenses. They are debited to the Profit and Loss Account. However, advertisement expenses incurred for purchasing of goods should be charged to the Trading Account, while an advertisement expense incurred for purchase of a capital asset (*e.g.*, cost of insertion in a newspaper for purchase of car) should be taken as a capital expenditure and debited to the concerned asset account. Similarly, advertisement expenditure incurred for sale of a capital asset should be deducted out of the sale proceeds of the asset concerned.
10. **Bad Debts** Bad Debts denotes, the amount lost from debtors to whom the goods were sold on credit. It is a loss and, therefore, should be debited to the Profit and Loss Account.
11. **Depreciation** Depreciation denotes decrease in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accident. For example, a motor car purchased gets depreciated on account of its constant use. A property purchased on lease for ₹12,000 for a period of 12 years will depreciate at the rate of ₹1,000 per year. On account of new inventions, old assets become obsolete and they have to be replaced. Mines etc. get exhausted after the minerals are completely taken out of them. An asset may meet an accident and may lose its value. It is necessary that depreciation on account of all these factors is charged to the Profit and Loss Account to ascertain the true profit or loss made by the business.
12. **Discount** It is a reduction from a list price, quoted price or invoice price. Discount may be of three types:
    (*a*) *Trade Discount* It is a reduction from the list price. It is a reduction granted by a supplier from the list price of goods or services.
    (*b*) *Quantity Discount* It is similar to trade discount with the difference that it is given in case of purchasing of goods in bulk quantity.
    (*c*) *Cash Discount* It is a reduction granted by a supplier from the invoice price in consideration of immediate payment or payment within a stipulated period.

Thus, quantity discount is similar to trade discount. However, cash discount is different from trade discount.

Distinction between trade discount and cash discount can be put as follows:

(*a*) *Meaning* A trade discount is a reduction granted by the supplier from the list price on total amount of sales, while a cash discount is a reduction for prompt payment or payment within a stipulated time period.

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(*b*) *Objective* The objective of trade discount is to promote sales, while the objective of cash discount is quick collection of payment.

(*c*) *Time* Trade discount is allowed at the time of purchasing of goods, while cash discount is allowed at the time of making payment.

(*d*) *Disclosure* Trade discount is shown as reduction in the invoice itself, while cash discount is not shown in the invoice. Moreover, trade discount account is not opened in the ledger, while cash discount account is opened in the ledger.

(*e*) *Variation* Trade discount may vary with the quantity of goods purchased, while cash discount may vary with time period within which payment is received.

13. **Manager's Commissions** The manager of a firm may be given a certain percentage of net profit. This percentage of commission may be before or after charging of such commission. The computation of commission can be understood with the following example.

Example:

Net Profit before charging commision: ₹10,000.

Manager's Commission 10% of Net Profit before charging his commission.

The Manager's Commission can be computed as under:

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

However, if the manager's commission is 10% of Net profit after charging his commission, the amount of commission will be computed as follows:

$$= ₹10,000 \times \frac{10}{100} \quad ₹909$$

This can be verified as under:

Net Profit before charging commission	=	₹10,000
Less: Manager's Commission	=	₹909
Net Profit after charging commission	=	9,091

Thus, manager' commission of ₹909 is 10% of firm's net profits after charging commisson.

Accounting (Closing) Entries for Preparing Profit and Loss Account

The following journal entries will be passed in the Journal Proper for preparing the Profit and Loss Account.

(*i*) For transfer of items of expenses, losses, etc., appearing on the debit side of the Trial Balance

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Profit and Loss Account Dr.

To Salaries

To Rent

To Commission

To Advertisements

To Bad Debts

To Discount

To Printing and Stationery

(*ii*) For transfer of items of incomes, gains, etc., appearing on the credit side of the Trial Balance

Interest Account Dr.

Dividends Account Dr.

Discount Account Dr.

To Profit and Loss Account

(*iii*) For transfer of net profit or net loss:

In case the total of the credit side of the Profit and Loss Account is greater than the debit side of the Profit and Loss Account, the difference is termed as Net Profit. In a reverse case, it will be termed as Net Loss. The amount of Net Profit or Net Loss shown by the Profit and Loss Account will be transferred to Capital Account in case of sole proprietary firm. In case of a partnership firm, the amount of net profit or net loss will be transferred to the Partners' Capital Accounts in the agreed ratio. In the absence of any agreement, the partners will share profits and losses equally.

For transfer of Profit

Profit and Loss Account Dr.

To Capital Account(s)

For transfer of Net Loss

Capital Account(s) Dr.

To Profit and Loss Account

Illustration 4.10. From the following balances, taken from the Trial Balance of Shri Suresh, prepare a Trading and Profit and Loss Account for the year ending 31st Dec., 2017:

Particulars	*Dr.* ₹	*Cr.* ₹
Stock on 1.1.2017	2,000	
Purchases and Sales	20,000	30,000
Returns	2,000	1,000
Carriage	1,000	
Cartage	1,000	
Rent	1,000	
Interest Received		2,000
Salaries	2,000	
General Expenses	1,000	
Discount		500
Insurance	500	

The Closing Stock on 31st December, 2017 is ₹5,000.

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Solution:

TRADING AND PROFIT AND LOSS ACCOUNT

Dr. *for the year ending 31st December, 2017* *Cr.*

Particulars		₹	*Particulars*		₹
To Opening Stock		2,000	By Sales	30,000	
To Purchases	20,000		*Less:* Returns	2,000	28,000
Less: Returns	1,000	19,000	By Closing Stock		5,000
To Carriage		1,000			
To Cartage		1,000			
To Gross Profit c/d		10,000			
		33,000			33,000
To Rent		1,000	By Gross Profit b/d		10,000
To Salaries		2,000	By Interest		2,000
To General Expenses		1,000	By Discount		500
To Discount		1,000			
To Insurance		500			
To Net Profit taken to Capital Account		8,000			
		12,500			12,500

Importance of Profit and Loss Account

The Profit and Loss Account provides information regarding the following matters:

(*i*) **Ascertainment of net profit (or loss)** It provides information about the net profit or net loss earned or suffered by the business during a particular period. Thus, it is an index of the profitability or otherwise of the business.

(*ii*) **Comparative study** The Profit figure disclosed by the Profit and Loss Account for a particular period can be compared with that of the other period. Thus, it helps in ascertaining whether the business is being run efficiently or not.

(*iii*) **Controlling expenses** An analysis of the various expenses included in the Profit and Loss Account and their comparison with the expenses of the previous period or periods helps in taking steps for effective control of the various expenses.

(*iv*) **Providing for contingencies** Allocation of profit among the different periods or setting aside a part of the profit for future contingencies can be done.

(*v*) **Prospective planning** On the basis for profit figures of the current and the previous period estimates about the profit in the year to come can be made. These projections will help the business in planning the future course of action.

4.4.3 Balance Sheet

Having prepared the Trading and Profit and Loss Account, a businessman will like to know the financial position of his business. For this purpose,

he prepares a statement of his assets and liabilities as on a particular date. Such a statement is termed as "Balance Sheet". Thus, Balance Sheet is not an account but only a statement containing the assets and liabilities of a business on a particular date. It is, as a matter of fact, a classified summary of the various remaining accounts after accounts relating to Incomes and Expenses have been closed by transfer to Manufacturing, Trading and Profit and Loss Account.

Balance Sheet has two sides. On the left hand side, the "liabilities" of the business are shown while on the right hand side the assets of the business appear. These two terms have been explained later in the unit.

It will be useful here to quote definitions of the Balance Sheet given by some prominent writers. According to Palmer, "The Balance Sheet is a statement at a given date showing on one side the trader's property and possessions and on the other side his liabilities." According to Freeman, "A Balance Sheet is an itemised list of the assets, liabilities and proprietorship of the business of an individual at a certain date." The definition given by the American Institute of Certified Public Accountants makes the meaning of Balance Sheet more clear. According to it, Balance Sheet is "a list of balances of the asset and liability accounts. This list depicts the position of assets and liabilities of a specific business at a specific point of time."

Proforma of Balance Sheet and Principle of Marshalling

Marshalling There is no prescribed form of Balance Sheet for a sole proprietary and partnership firm.[2] However, the principle of marshalling is applied while arranging the assets and liabilities in the balance sheet of a firm. Marshalling refers to arrangement of assets and liabilities in the balance sheet in any of the following order:

1. Liquidity Order 2. Permanency Order

1. **Liquidity Order** In case a concern adopts liquidity order, the assets which are more readily convertible into cash come first and those which cannot be so readily converted come next and so on. Similarly, those liabilities which are payable first come first, and those payable later, come next and so on. A proforma of Balance Sheet according to liquidity order is given below:

BALANCE SHEET

as on ....

Liabilities	₹	*Assets*		₹
Bank Overdraft	....	Cash in Hand		....
Outstanding Expenses	....	Cash at Bank		....
Bills Payable	....	Prepaid Expenses		....
Sundry Creditors	....	Bills Receivable		....
Long-term Loans	....	Sundry Debtors		....
Capital	....	Closing Stock:		
		Raw Materials	....	

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

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Liabilities	₹	*Assets*		₹
		Work-in-Progress	....	
		Finished Goods	....	....
		Plant and Machinery		....
		Furniture		....
		Building		....
		Land		....
		Goodwill		....
	....			....

2. **Permanency Order** In case of permanency order, assets which are more permanent come first, less permanent come next and so on. Similarly, liabilities which are more permanent come first, less permanent come next and so on. In other words, an asset which will be sold in the last or a liability which will be paid in the last come first and that order is followed both for all assets and liabilities. In case a balance sheet is to be prepared according to permanency order, arrangement of assets and liabilities will be reversed than what has been shown above in case of liquidity order.

Distinction between Profit & Loss Account and Balance Sheet

The points of distinction between Profit & Loss Account and Balance Sheet are as under:

(*i*) A profit and loss account shows the profit or loss made by the business during a particular period. While a balance sheet shows the financial position of the business on a particular date.

(*ii*) A profit and loss account incorporates those items which are of a revenue nature while a balance sheet incorporates those items which are of a capital nature.

(*iii*) Of course, both profit and loss account and the balance sheet are prepared from the Trial Balance. However, the accounts transferred to the profit and loss account are finally closed while the accounts transferred to the balance sheet represent those accounts whose balances are to be carried forward to the next year.

Difference between Trial Balance and Balance Sheet

The difference between trial balance and balance sheet can be put as under:

(*a*) **Meaning** A trial balance is a statement containing various ledger balances on a particular date while a balance sheet is a statement of various assets and liabilities of the business on a particular date.

(*b*) **Objective** The objective of preparation of a trial balance is to check the arithmetical accuracy of the books of account of the business, while the objective of preparation of a balance sheet is to ascertain the financial position of the business.

(*c*) **Items covered** A trial balance contains all items relating to incomes, expenses, assets and liabilities while a balance sheet incorporates only assets and liabilities.

(*d*) **Preparation** A trial balance is prepared before preparation of a balance sheet. In other words, the preparation of a trial balance is independent of the preparation of a balance sheet. While a balance sheet is prepared not only on the basis of trial balance but also of any additional information which may not have been incorporated in the trial balance.

(*e*) **Use** A trial balance is meant only for internal use while a balance is prepared both for internal as well as external use.

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Important Points Regarding Balance Sheet

1. **Liabilities** The term "Liabilities" denotes claims against the assets of a firm, whether those of owners of the business or of the creditors. As a matter of fact, the term "Equity" is more appropriate than the term "Liabilities". This is supported by the definition given by American Accounting Association. According to this Association, Liabilities are "claims of the creditors against the enterprise arising out of past activities that are to be satisfied by the disbursement or utilisation of corporate resources". While the term "Equity" stands both for owners equity (owners claims) as well as the outsiders equity (outsiders claims). However, for the sake of convenience, we are using the term "Liabilities" for the purposes of this book.

Liabilities can be classified into two categories:

(*i*) Current Liabilities (*ii*) Long-Term or Fixed Liabilities.

Current liabilities The term "Current Liabilities" is used for such liabilities which are payable within a year from the date of the Balance Sheet either out of existing current assets or by creation of new current liabilities. The broad categories of current liabilities are as follows:

(*a*) Accounts Payable, *i.e.*, bills payable and trade creditors.

(*b*) Outstanding Expenses, *i.e.,* expenses for which services have been received by the business but for which payments have not been made.

(*c*) Bank Overdraft.

(*d*) Short-term Loans, *i.e.*, loans from Bank which are payable within one year from the date of the Balance Sheet.

(*e*) Advance payments received by the business for the services to be rendered or goods to be supplied in future.

Fixed liabilities All liabilities other than Current Liabilities come within this category. In other words, these are the liabilities which do not become due for payment in one year and which do not require current assets for their payment.

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2. **Assets** The term ''Assets'' denotes the resources acquired by the business from the funds made available either by the owners of the business or others. It thus includes all rights or properties which a business owns. Cash, investments, bills receivable, debtors, stock of raw materials, work-in-progress and finished goods, land, buildings, machinery, trademarks, patent rights, etc., are some examples of assets.

Assets may be classified into the following categories:

(*a*) **Current assets** Current Assets are those assets which are acquired with the intention of converting them into cash during the normal business operations of the enterprise. According to Grady, ''the term Current Assets is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realised in cash or sold during the normal operating cycle of the business.'' Thus, the term "Current Assets" includes cash and bank balances, stocks of raw materials, work-in-progress and finished goods, debtors, bills receivable, short-term investments, prepaid expenses, etc.

(*b*) **Liquid assets** Liquid Assets are those assets which are immediately convertible into cash without much loss. Liquid Assets are a part of current asset. In computing liquid assets, stock of raw materials, work-in-progress and finished goods and prepaid expenses are excluded while all other current assets are taken.

(*c*) **Fixed assets** Fixed assets are those assets which are acquired for relatively long periods for carrying on the business of the enterprise. They are not meant for resale. Land and building, machinery, furniture are some of the examples of Fixed Assets. Sometimes, the term "Block Capital" is also used for them.

(*d*) **Intangible assets** Intangible Assets are those assets which cannot be seen and touched. Goodwill, patents, trademarks, etc., are some examples of Intangible Assets.

(*e*) **Fictitious assets** There are assets not represented by tangible possession or property. Examples of such assets are formation expenses incurred for establishing a business such as registration charge paid to the Registrar of joint stock companies for getting a company incorporated, discount on issue of shares, debit balance in the Profit and Loss Account when shown on the assets side in case of a joint stock company etc.

Valuation of Assets The following requirements of various accounting standards (ASs) should be kept in mind while valuing assets.

(*i*) The cost of a fixed asset should comprise its purchase price and any attributable costs of bringing the asset to its working condition for its intended use. (AS 10)

(*ii*) Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. (AS 10)

(*iii*) The direct costs incurred in developing the patents should be capitalised, and written off over their legal term of validity or over their working life, whichever is shorter. (AS 10)

(*iv*) Amount paid for knowhow for the plants, lay-out and designs of building and/or design of the machiery should be capitalised under the relevant asset heads, such as buildings, plants and machinery, etc., (AS 10)

(*v*) If the recoverable amount of an asset is less than its carrying amount, *i.e.*, it has become an impaired asset, the carrying amount of the asset should be reduced to its recoverable amount. That reduction is an impairment loss. Impairment loss should be recognised as an expense in the statement of profit and loss immediately, unless the asset is carried at revalued amount in accordance with another Accounting Standard (see Accounting Standard (AS) 10, Accounting for Fixed Assets), in which case any impairment loss of a revalued asset should be treated as a revaluation decrease under that Accounting Standard. (AS 28)

(*vi*) The current assets are meant for converting into cash during the normal operating cycle of business, hence, they are valued on the principle of ''cost or market price whichever is less''.

(*vii*) Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicates that the fundamental accounting assumption of going concern (*i.e.*, the continuance of existence or substratum of the enterprise) is not appropriate. (AS 4)

Treatment of Adjustments

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

Check Your Progress

3. How is the determination of profit and loss done?
4. State the objectives of final accounts.

4.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Ledger can be kept in any of the following forms:
    - Bound ledger
    - Loose-leaf ledger
2. The Ledger Folio (L.F.) column in the Journal is used at the time when debits and credits are posted to the Ledger. The page number of the Ledger on which the posting has been done is mentioned in the L.F. column of the Journal.
3. The determination of profit and loss is done by preparing a Trading and Profit and Loss Account.
4. The following are the main objectives of final accounts:
    - To determine gross profit and net profit of the business
    - To present the true financial position of the business

4.6 SUMMARY

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

    (i) Bound Ledger (ii) Loose-leaf Ledger.
- The term "Posting" means transferring the debit and credit items from the Journal to their respective accounts in the Ledger. It should be noted that the exact names of accounts used in the Journal should be carried to the Ledger.
- The Ledger Folio (L.F.) column in the Journal is used at the time when debits and credits are posted to the Ledger. The page number of the Ledger on which the posting has been done is mentioned in the L.F. column of the Journal.
- Both Journal and Ledger are the most important books used under Double Entry System of book-keeping.
- In business, there may be several transactions relating to one particular account. In Journal, these transactions appear on different pages in a chronological order while they appear in a classified form under that particular account in the Ledger.
- In case the various debit balances and the credit balances of the different accounts are taken down in a statement, the statement so prepared is termed as a Trial Balance.

- The Trading and Profit and Loss Account is a final summary of such accounts which affect the profit or loss position of the business. In other words, the account contains the items of Incomes and Expenses relating to a particular period. The account is prepared in two parts: (i) Trading Account, and (ii) Profit and Loss Account.
- Closing Entries are entries passed at the end of the accounting year to close different accounts. These entries are passed to close the accounts relating to incomes, expenses, gains and losses.
- The Trading Account simply tells about the gross profit or loss made by a businessman on purchasing and selling of goods. It does not take into account the other operating expenses incurred by him during the course of running the business.

4.7 KEY WORDS

- **Ledger:** A book containing different accounts of an entity.
- **Posting:** Transferring the debit and credit items from the Journal to the respective accounts in the Ledger.
- **Trial Balance:** A statement containing the various ledger balances on a particular date.

4.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State the methods of preparation of trial balance.
2. State the characteristics of final accounts.
3. What is the equation for preparing trading account?
4. State the importance of profit and loss account.

Long Answer Questions

1. Analyse the opening and closing of stocks with the help of illustrations.
2. Describe the important points regarding trading account.
3. Explain the rules regarding posting of transactions into the Ledger.
4. What is a trial balance? Explain its objectives.

4.9 FURTHER READINGS

NOTES

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

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UNIT 5 BANK RECONCILIATION STATEMENT

NOTES

Structure

5.0 Introduction
5.1 Objectives
5.2 Meaning, Importance and Procedure of Reconciliation
5.3 Bills of Exchange and the Treatment Thereof
5.4 Account Current
5.5 Average Due Date
5.6 Consignment
5.7 Joint Venture Accounts
5.8 Answers to Check Your Progress Questions
5.9 Summary
5.10 Key Words
5.11 Self Assessment Questions and Exercises
5.12 Further Readings

5.0 INTRODUCTION

All transactions relating to the bank—deposits or withdrawals—are recorded by the firm in the bank column maintained on each side of the cash book. The deposit of money into the bank account is recorded on the debit side of the cash book in the bank column, while the withdrawal of money is recorded on the credit side in the bank column of the cash book. The bank also maintains the firm's account in its books.

The Pass Book or the Bank Statement is submitted by the bank to the customer for his information and verification.

5.1 OBJECTIVES

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

- Explain the meaning and objectives of preparing a Bank Reconciliation Statement
- Prepare a Bank Reconciliation Statement
- Describe the treatment of bills of exchange
- Analyse the concept of account current
- Prepare consignment and joint venture accounts

5.2 MEANING, IMPORTANCE AND PROCEDURE OF RECONCILIATION

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A Bank Reconciliation Statement is a statement reconciling the balance as shown by the bank pass book and the balance as shown by the cash book. The objective of preparing such a statement is to know the causes of difference between the two balances and pass necessary correcting or adjusting entries in the books of the firm. It should be noted that every variation or difference does not require an adjusting or correcting entry. Some reasons for difference are automatically adjusted. For example, a cheque that has been sent for collection, but not yet collected, causes a difference between the balance as shown by the bank pass book and the balance as shown by the cash book, but no adjusting entry is required in the cash book for such a difference because, the bank will credit the firm's account as soon as the cheque is collected. This is only a question of time. However, if the cheque sent for collection to the bank has been returned by the bank on account of it being dishonoured, the firm should pass an adjusting entry for return of this cheque if it has not already been passed. Similarly, the firm has also to pass in its books the entries for bank charges or direct payments received by the bank on behalf of the firm.

Importance of Bank Reconciliation Statement

The importance of Bank Reconciliation Statement can be judged on the basis of the following facts:

(*i*) It highlights the causes of difference between the bank balance as per cash book and the bank balance as per pass book. Necessary adjustments or corrections can therefore be carried out at the earliest.

(*ii*) It reduces the chances of fraud by the staff handling cash . It may be possible that the cashier may not deposit the money in the bank in time though he might have passed the entry in the bank column of the cash book. The Bank Reconciliation Statement will project such discrepancies.

(*iii*) There is a moral check on the staff of the organisation to keep the cash records always up-to-date.

Technique or Procedure of Preparing Bank Reconciliation Statement

A Bank Reconciliation Statement is prepared usually at the end of a period, *i.e.*, a quarter, a half year or a year, as may be found convenient and necessary by the firm, taking into account the number of transactions involved. The following are the steps to be taken for preparing a Bank Reconciliation Statement.

(*i*) The cash book should be completed and the balance as per the bank column on a particular date should be arrived at for the period for which the Bank Reconciliation Statement has to be prepared.

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(*ii*) The Bank should be requested to complete and send to the firm the bank pass book upto the date on which the reconciliation statement is to be prepared.

(*iii*) The balance as shown by either the cash book or the bank pass book should be taken as the base. This, as a matter of fact, is the starting point for determining the balance as shown by the other book after making suitable adjustments taking into account the causes of difference.

(*iv*) The effect of that particular cause of difference should be studied on the balance shown by the other book.

(*v*) In case the cause has resulted in an increase in the balance shown by the other book, the amount of such an increase should be added to the balance shown in the former book which has been taken as the base.

(*vi*) In case the cause has resulted in a decrease in the balance shown by the other book, the amount of such a decrease should be deducted from the balance shown in the former book which has been taken as the base.

In case the book shows an adverse balance (*i.e.*, an overdraft) the amount of the overdraft should be transferred to minus column. The Recociliation Statement should then be prepared on the above basis assuming a favourable balance.

The above technique will be clear with the help of the illustrations given in the following pages.

Where Causes of Differences are Given

Illustration 5.1. From the following particulars, prepare a Bank Reconciliation Statement as on 31st December, 2017.

(*i*) Balance as per Cash Book ₹5,800.

(*ii*) Cheques issued but not presented for payment ₹2,000.

(*iii*) Cheques sent for collection but not collected up to 31st December, 2010 ₹1,500.

(*iv*) The Bank had wrongly debited the account of the firm by ₹200 which was rectified by them after 31st December.

Balance as per Pass Book is ₹6,100.

Solution:

There is a difference of ₹300 between the balance as shown by the cash book and the balance as shown by the bank pass book. A reconciliation statement can be prepared to reconcile on the following basis the balances shown by the two books:

(*i*) The balance as shown by the cash book will be taken as the starting point.

(*ii*) The cheques issued but not presented for payment have not been recorded in the bank pass book. The balance as per pass book has to be found out. The Bank has not yet passed the entry for the payment of these cheques since they have not been presented for payment. The balance, therefore, in the pass book should be more. The amount of ₹2,000 should, therefore, be added to the balance as shown by the cash book.

(*iii*) Cheques sent for collection but not yet collected must have been entered in the cash book but must not have been credited by the Bank to the firm's account since they have not yet been collected. The balance in pass book should, therefore, be less as compared to the cash book. The amount of ₹1,500 should, therefore, be deducted out of the balance as shown by the cash book.

(*iv*) The Bank has wrongly debited the firm's account. This must have resulted in reducing balance as per the bank pass book. The amount should, therefore, be deducted out of the balance shown as per the cash book.

The Bank Reconciliation Statement will now appear as follows:

BANK RECONCILIATION STATEMENT

	Particulars	(+) ₹	(–) ₹
(*i*)	Balance as per cash book	5,800	
(*ii*)	*Add:* Cheques issued but not presented for payment	2,000	
(*iii*)	*Less*: Cheques sent for collection but not yet collected		1,500
(*iv*)	*Less:* Amount wrongly debited by the Bank		200
		7,800	1,700
	Balance as per Bank Pass Book	6,100	

5.3 BILLS OF EXCHANGE AND THE TREATMENT THEREOF

There are certain documents which are freely used in commercial transactions and monetary dealings. They are transferable by delivery and confer a good title on any one who takes them *bona fide* and for value. Such documents are termed as Negotiable Instruments. Bills of Exchange, Promissory Notes and Cheques are all Negotiable Instruments. These Instruments can be made "payable to order" or "payable to bearer." In the former case, they are known as "order instruments" while in the latter case they are known as "bearer instruments." In case of an order instrument the payment is to be made either to the person named in the instrument or according to his order. In case of a bearer instrument, the payment is to be made to the person who is its bearer. The provisions of the Negotiable Instruments Act, 1881 apply to them. We shall be discussing here only those legal provisions of the Act which shall

enable the students to have a clear understanding of the accounting aspect of these instruments[1].

Bills of Exchange: Fundamental Concepts

Promissory Note

Definition Section 4 of the Negotiable Instruments Act defines a Promissory Note as "an instrument in writing (*not being a bank note and a currency note*) containing an unconditional undertaking signed by the maker, to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument."

Essentials The following are essential features of a Promissory Note:

1. *There are two parties* The Promissor is termed as the Maker and the Promissee is called as the Payee. The former is the "Debtor" while the latter is the "Creditor".
2. *It is an instrument in writing* More verbal promise will not amount to a Promissory Note.
3. *The promise to pay should be unconditional* A promissory note should go without any condition attached to it. For example, *A* promises to pay a sum of money on the marriage of a particular person will not amount to a Promissory Note.
4. *The promise should be to pay money to another person* If a person promises to supply goods, it shall not be a Promissory Note.
5. *The amount should be certain* If interest is also to be paid, the rate of interest should be given.
6. The payee must also be certain, either by name or by designation.
7. A Promissory Note can be made payable to the bearer. However, a bearer Promissory Note cannot be drawn by private individuals. It can be drawn only by the Reserve Bank of India, as per the provisions of Section 31 of the Reserve Bank of India Act. The objective is to protect Government's monopoly of issuing currency notes.
8. Bank notes and currency notes, though similar to promissory notes in every respect, have been expressly excluded. They are considered as money and not merely securities for money. A currency note is a note issued by the Government containing a promise to pay to the bearer a certain sum of money on demand. A 'bank note' is a promissory note issued by a bank for payment of money to the bearer on demand. The banks now cannot issue such notes which are payable to the bearer on

[1] For a detailed study of legal provision please refer to Sec IV: "*A Manual of Business Laws*" (6th edition) by Dr. S.N. Maheshwari and Dr. S.K. Maheshwari, and published by Himalaya Publishing House.

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demand on account of Section 31 of the Reserve Bank of India Act. Only the Reserve Bank of India is now authorised to issue such notes.

Specimen of a Promissory Note[2]

₹10,000

Delhi
Jan. 4, 2016

On demand,[2] I promise to pay Kaushal or order the sum of Ten thousand rupees, value received.

(Stamp)
sd/-
Ramesh

Ramesh is the Maker and Kaushal is the Payee.

Bill of Exchange

Definition Section 5 of the Negotiable Instruments Act defines a Bill of Exchange as "an instrument in writing containing an unconditional order, signed by the maker, directing a certain person, to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument."

Essentials The essentials of a Bill of Exchange are similar to those of a Promissory Note except that:

1. In case of a Bill of Exchange, there are three parties, the "Maker" is termed as the "Drawer". He is the creditor. The person liable to pay the money is called as the "Drawee". The person entitled to get the money is termed as the "Payee". It should be noted that drawer himself can also be the payee. There are only two parties in case of a Promissory Note.
2. In case of a Bill of Exchange, the drawer being the creditor, orders the drawee to pay a certain sum of money; while in case of a Promissory Note, the drawer, being the debtor, himself, he promises to pay a certain sum of money.
3. A Time Bill of Exchange (*i.e.*, a B/E payable after some time) can be made payable to the bearer, while the Promissory Note cannot be made payable to the bearer by person other than the Reserve Bank of India or the Central Government.

Classification of Bills of Exchange

Bills of Exchange can be classified as follows:

1. *Time and demand bills* When payment of a Bill of Exchange is to be made after a particular period of time, the bill is termed as a 'Time Bill'. In such a case, date of maturity is always calculated by adding three

[2] In case of time promissory notes, the words 'on demand' will be instituted by words "..... months or ...... days after date or after sight."

days of grace. Such bills requires the "Acceptance" of the drawee. It is generally given by writing across the face of the instrument as shown above:

In case of 'Demand Bill', payment is to be made on demand. Neither the acceptance of the drawee is necessary nor any days of grace are allowed in this case

Accepted
R. Mohan
1.1.2017

In case of 'Demand Bill', payment is to be made on demand. Neither the acceptance of the drawee is necessary nor any days of grace are allowed in this case.

2. *Trade and accommodation Bills* Where a Bill of Exchange has been drawn and accepted for a genuine trade transaction, it is termed as a 'Trade Bill'. For example, *A* sells goods worth ₹10,000 to *B*. He draws a Bill of Exchange on *B* for the said amount and the same is accepted by *B*. This is a Trade Bill. Where a Bill of Exchange is drawn and accepted for providing funds to a friend in need, it is termed as an Accommodation Bill. For example *C* may be in want of money. He may approach his friends *A* and *B*, who instead of lending the money directly to him, propose to draw an "Accommodation Bill" for ₹10,000 payable three months after, in his favour. *C* promises to reimburse *B* (the acceptor before the period of three months is up). *C* can get this bill discounted from his bankers. Thus, his needs of funds will be met.
3. *Inland and foreign bills* A Bill is termed as an Inland Bill, if
   (*a*) it is drawn in India on a person residing in India whether payable in or outside India, or
   (*b*) it is drawn in India on a person residing outside India but payable in India.

   A Bill which is not an Inland Bill is a Foreign Bill.

A Foreign Bill is generally drawn up in triplicate and each copy is sent by separate post, so that at least one copy reaches the concerned party. Of course, when payment is made on one copy, the other two copies become inoperative.

Cheque

Definition Section 6 defines a cheque as 'A bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form'.

Essentials A cheque is similar to a bill of exchange with three additional qualifications:

1. It is always drawn on a specified banker.
2. It is always payable on demand.
3. It includes the electronic image of a truncated cheque and also a cheque in the electronic form. The two terms: 'A truncated cheque' and 'A cheque in the electronic form' having been defined under the Act as under:
   (*i*) 'A truncated cheque' means a cheque which is truncated during the course of a clearing cycle, either by the clearing house or by the bank whether paying or receiving payment, immediately on generation of an electronic image for transmission, substituting the further physical movement of the cheque in writing.
   (*ii*) 'A cheque in the electronic form' means a cheque which contains the exact mirror image of a paper cheque, and is generated, written and signed in a secure system ensuring the minimum safety standards with the use of digital signature (with or without biometrics signature) and asymmetric crypto system.

Thus, all cheques are bills of exchange but all bills of exchange are not cheques.

Recording of Bill of Exchange in the Books of Account

Bills of Exchange and Promissory Notes, being Negotiable Instruments, are freely transferable. The transfer is made by endorsement and delivery in case of order instrument in case of non-payment of the bill, or promissory note can recover the money from all previous endorsers or the payee or the maker of the instrument. Moreover, the title of a holder-in due course remains good though the title of the transferrer may be defective. On account of these two important reasons, *i.e.*, negotiability and liability of the endorsers, a bill of exchange or a promissory note is considered to be an excellent security by the bankers. They are generally willing to advance money to a holder of bill of exchange or promissory note at commercial rate of discount. Thus, a person who receives a bill of exchange or promissory note has the following alternatives with him:

(*i*) He can keep the bill of exchange or promissory note with himself till the date of maturity.

(*ii*) He can pass it to one of his creditors.

(*iii*) He can get it discounted from his bank.

In the following pages, we are explaining the accounting entries to be made in the books of the receiver of a bill of Exchange or a Promissory Note

(*i.e.*, the Creditor or the Drawer or the Promisee in case or a Promissory Note) and the Acceptor (*i.e.*, the Debtor, or the Drawee, or the Maker in case of a Promissory Note). For the former it is a Bill Receivable (the term is also used for a promissory note received) and for the latter, it is a Bill Payable (the term is also used for a promissory note given).

1. When a Bill of Exchange is Kept till the Date of Maturity

In case, the receiver of a bill of exchange keeps the Bill of Exchange till the date of maturity with him, the following accounting entries will be passed in the books of the receiver of the Bill of Exchange (*i.e.*, the Drawer) and the Drawee of the Bill of Exchange.

In the Books of the Drawer:

(*i*) On selling goods on credit to the Drawee

Drawee Dr.
To Sales A/c

(*ii*) On receipt of Bill of Exchange duly accepted by the Drawee

Bill Receivable A/c Dr.
To Drawee

(*iii*) On receiving payment on maturity of the Bill

Cash A/c Dr.
To Bills Receivable Account

In the Books of the Drawee:

(*i*) On purchasing goods on credit from the Drawer

Purchases A/c Dr.
To Drawer

(*ii*) On acceptance of the Bill of Exchange in favour of Drawer

Drawer Dr.
To Bills Payable Account

(*iii*) On payment of the Bill on maturity

Bill Payable Account Dr.
To Cash

2. When the Bill of Exchange is Endorsed in Favour of a Creditor

In case the drawer of the Bill of Exchange endorses the Bill of Exchange received in favour of a creditor and the Bill is met on maturity, the following journal entries will be passed in the books of the Drawer as well as the Drawee of the Bill of Exchange.

Books of the Drawer

The entries regarding selling of goods and receiving of the Bills of Exchange will be the same, as explained before. However, the following entry will be passed when the Bill of Exchange is endorsed in favour of a Creditor.

Creditor A/c Dr.

To Bills Receivable A/c

On the date of maturity, when the Bill is met, no entry is required in the books of the Drawer. This is because in his books, the Bills Receivable Account has already been closed and he has no liability, if the bill is met on maturity.

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Books of the Drawee

The Drawee is not at all concerned with the endorsement of the Bill by the Drawer to a third-party. Accounting entries in his books will therefore be the same as explained before.

3. When Bill of Exchange is Discounted with a Bank

The Drawer of a Bill of Exchange may get the Bill of Exchange discounted from his bankers. In such a case, the following journal entries will be passed in the books of the Drawer and the Drawee.

Books of the Drawer

The entries regarding selling of goods and receipt of Bill of Exchange will be the same as explained before. However, the following entry will be passed in the books of the drawer when he gets the Bill of Exchange discounted from his bankers.

Bank Account Dr.

Discount Account Dr.

To Bills Receivable Account

Books of the Drawee

The entries in the books of the Drawee will remain the same as explained before. He is not at all concerned whether he keeps the Bill with him or he gets it discounted from his bankers.

4. Dishonour of a Bill of Exchange

A Bill of Exchange is to be presented on maturity for payment. In case, the acceptor of the Bill refuses to make payment of the Bill on the date of maturity, it is said that the Bill of Exchange has been dishonoured. In order to get an authenticate proof of the fact that the Bill of Exchange was really presented for payment and was dishonoured, the Drawer (or holder) may get the Bill of Exchange noted and protested. The Notary Officer appointed by the Government for this purpose issues a certificate to this effect. He charges some fee for this work which is termed as "Noting Charges".

The entries for dishonour of the bill in the books of the Drawer (or holder) and the acceptor will be as follows:

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Books of the Drawer

(*i*) If the Bill is kept by the Drawer (or the holder) with himself till the date of maturity:

On dishonour of the Bill

Drawee/Acceptor Dr.
To Bills Receivable A/c
To Cash A/c

(The account of the drawee or acceptor will be debited with the amount of the bill plus noting charges. The Bills Receivable Account will be credited with the amount of the Bill while Cash Account will be credited with the amount of the noting charges incurred.)

(*ii*) If the Bill is discounted with a banker and is dishonoured:

On dishonour of the Bill

Drawee/Acceptor Dr.
To Bank

(The account of the acceptor will be debited not only with the amount of the Bill but also with the amount of Noting Charges which the Bank might have paid. The account of the bank will be credited with the total amount.)

(*iii*) If the Bill is endorsed by the Drawer in favour of a Creditor and it is dishonoured:

On dishonour:

Drawee/Acceptor Dr.
To Creditors A/c

(The account of the drawee will be debited with the amount of the Bill as well as the amount of Noting Charges which the creditor might have incurred. The creditor will be given credit with the total amount.)

Books of the Acceptor

The acceptor will pass the following entry irrespective of the fact whether the Bill of Exchange is with the Drawer himself or it has been endorsed or discounted by him. He is concerned only with the Drawer and therefore, he is going to give him credit with the amount of the Bill plus any noting charges that might have been incurred either by him or by any other person who happens to be holder of the Bill of exchange.

Bills Payable A/c Dr.
Noting Charges Dr.
To Drawer

5. Renewal of a Bill

The acceptor of the Bill may not be in a position to meet the Bill on the date of maturity. However, he may accept to meet the bill in case, he is given some time by the drawer for making payment of the Bill. He may, therefore, request the Drawer to cancel the old Bill and draw a new Bill on him.The Drawer may charge some interest for the delayed payment at mutually agreed rate of

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interest. The amount of interest may be paid in cash or it may be included in the amount of the new Bill. The following journal entries will be passed in the books of the Drawer and the Drawee on renewal of a Bill of Exchange. Books of the Drawer

(*i*) Cancellation of the old Bill

Drawee's Personal A/c Dr.

To Bills Receivable A/c

(The entry is the same as for dishonour of a Bill of Exchange, except there will be no need for getting the Bill noted and protested, since the Drawee himself has requested for cancellation of the Bill.)

(*ii*) On receipt of amount of Interest in cash

Cash A/c Dr.

To Interest

(The interest will be charged for the delay in payment *i.e.*, the date by which the payment would be made as per the new Bill and the date by which payment should have been made as per the old Bill of Exchange.)

(*iii*) In case, the interest is not payable in cash

Drawee's Personal A/c Dr.

To Interest A/c

(*iv*) For receipt of the new Bill

Bills Receivable A/c Dr.

To Drawee's Personal A/c

(The amount will include the amount of interest also if it is not paid in cash.)

Books of the Drawee

(*i*) On cancellation of the old Bill:

Bills Payable A/c Dr.

To Drawer's Personal A/c

(The entry is similar to dishonour of the bill except that there will be no necessity for getting the bill noted and protested and, therefore, there will be no charge for Noting Charges.)

(*ii*) When Interest is paid in cash:

Interest A/c Dr.

To Cash A/c

(*iii*) In case the interest is not paid in cash:

Interest A/c Dr.

To Drawer's Personal A/c

(*iv*) On acceptance of the new Bill:

Drawer's Personal A/c Dr.

To Bills Payable A/c

(The amount may include the amount of interest if it has not been paid in cash.)

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6. Retiring of a Bill under Rebate

The acceptor of a Bill may be in a position to meet the Bill before maturity. He may, therefore, approach the acceptor to make the payment of the Bill before the due date of the Bill. In such a case, usually, the Drawer gives some rebate to the Drawer for early payment of the Bill. The following are the journal entries to be passed in the books of the Drawer as well as the acceptor.

Retiring of a Bill of Exchange which is with the Drawer

Books of the Drawer

On receipt of payment of the Bill

Cash A/c Dr.

Rebate A/c Dr.

To Bills Receivable A/c

(Rebate is a loss to the Drawer and, therefore, it is debited.)

Books of the Drawee

Bills Payable A/c Dr.

To Cash A/c

To Rebate A/c

(Rebate is a gain to Drawee and, therefore, it has been credited.)

Retiring of Bill of an Exchange Discounted or Endorsed by the Drawer

In case the acceptor requests the drawer to accept retirement of a bill which has been endorsed or discounted by the drawer, the drawer will have to request the bank or the creditor (endorsee) to return the bill back to him. He will then get the payment from the drawee and allow him rebate for pre-payment. Similarly, the bank or the creditor may also allow some rebate to the drawer on account of his making pre-payment to the bank or the creditor, as the case may be. The accounting entries will be as follows:

In the Books of the Drawer

On return of the bill from bank/creditor

Bills Receivable A/c Dr.

To Bank/Creditor

On receiving payment from the drawee:

Cash A/c Dr.

Rebate Allowed A/c Dr.

To Bills Receivable A/c

On making payment to the Bank/Creditor:

Bank/Creditor A/c Dr.

To Cash A/c

To Rebate A/c

In the Books of the Drawee

The Drawee is concerned only with the Drawer. Hence, on payment of the bill under rebate, the entry will be the same as if the bill was with the Drawer, *i.e.*,

Bills Payable A/c Dr.
To Cash A/c
To Rebate A/c

The journal entries given in the preceding pages both in the Book of the Drawer of the Bill as well as the Acceptor of the Bill can be summarised as follows:

BOOKS OF THE DRAWER OF THE BILL

Sl. No.	*Transaction*	*Debit*	*Credit*
1.	On Selling of goods	Purchaser's A/c	Sales A/c
2.	On receipt of the Bill from the purchaser	Bill Receivable A/c	Purchaser's A/c
3.	Disposal of the Bill:		
	(*a*) When the Bill is kept by the receiver till the date of maturity.	No entry	No entry
	(*b*) When the Bill is discounted with a banker.	Bank A/c Discount A/c	Bills Receivable A/c
	(*c*) When the Bill is endorsed in favour of a creditor.	Creditor's A/c	Bills Receivable A/c
4.	On maturity, if the Bill is honoured:		
	(*a*) If the Bill is kept by the receiver till the date of maturity.	Cash A/c	Bills Receivable A/c
	(*b*) If the Bill was discounted with the banker by the receiver.	No entry	No entry
	(*c*) If the Bill was endorsed in favour of a creditor.	No entry	No entry
5.	On maturity of the Bill, if dishonoured:		
	(*a*) If it is with the Drawer and he incurs Noting Charges.	Drawee's/Purchaser's A/c (Amount of the Bill + Noting charges)	Bills Receivable A/c (amount of the Bill) + Cash A/c (Noting Charges)
	(*b*) If the Bill was discounted and thereafter is now in the hands of the banker and noting charges are incurred	Drawee's A/c (with the amount of the Bill and Noting Charges)	Bank A/c (with the amount of the Bill and Noting Charges)
	(*c*) If the Bill was transferred to a Creditor and thereafter it is now in his hands and he incurs Noting Charges.	Drawee's A/c (with the amount of Bill and Noting Charges)	Creditor's A/c (with the amount of the Bill and Noting Charges)
6.	Renewal of the Bill:		
	(*i*) The entries will be similar to dishonour of the Bill except that there will be no expense by way of noting charges.		
	(*ii*) For interest paid in cash	Cash A/c	Interest A/c
	(*iii*) If interest not paid in cash	Drawee's A/c	Interest A/c
	(*iv*) For receipts of new bill	Bills Receivable A/c	Drawee's A/c
7.	Retirement of the Bill		
	(*i*) When the Bill is with the Drawer	Cash A/c, Rebate A/c	Bills Receivable A/c
	(*ii*) In case the Bill is with the Bank or with a creditor		
	(*a*) On return of Bill from bank/creditor	Bills Receivable A/c	Bank/Creditor's A/c
	(*b*) On receiving payment from the drawee	Cash A/c Rebate Allowed A/c	Bills Receivable A/c
	(*c*) On making payment to bank/creditor	Bank/Creditor A/c Rebate Received A/c	Cash A/c

ENTRIES IN THE BOOKS OF THE DRAWEE OR ACCEPTOR OF THE BILL

Sl. No.	*Transaction*	*Debit*	*Credit*
1.	On purchases of goods	Purchases A/c	Seller's or the Drawer's A/c
2.	On acceptance of the Bill	Drawer's A/c	Bills Payable A/c
3.	On payment of the Bill	Bills Payable A/c	Cash A/c
4.	On dishonour of Bill and he has to bear the Noting Charges	Bills Payable A/c Noting Charges A/c	Drawer's A/c (amount of Bill plus Noting Charges)
5.	Renewal of the Bill		
	(*i*) Entry will be similar to dishonour of a Bill except there will be Noting Charges	Bills Payable A/c	Drawer's A/c
	(*ii*) (*a*) For interest paid in cash	Interest A/c	Cash a/c
	(*b*) For interest not paid in cash	Interest A/c	Drawer's A/c
	(*c*) For accepting new Bill	Drawer A/c	Bills Payable A/c
6.	On retirement of Bill	Bills Payable A/c	Cash A/c, Rebate A/c

Notes:

1. No entry is passed in the Acceptor's books for discounting or endorsing of bill of exchange by the Drawer/Receiver of the bill.
2. If the Drawee has transferred or got discounted the bill of exchange and the Bill is dishonoured, the Drawee will credit the account of the Drawer only and not any other account.

The comprehensive illustration given in the following pages will make clear to the readers the entries to be passed in the books of the Drawer as well as the Drawee of a bill of exchange.

Illustration 5.2. *A* sold goods to *B* for ₹5,000. *B* accepted two bills of ₹2,500 each for 2 months. *A* endorsed one bill to *C* for ₹2,600, on due date both the bills were met.

Pass journal entries in the books of *A* and *B*.

Solution:

BOOKS OF *A*

Date	*Particulars*		*L.F.*	*Dr.* ₹	*Cr.* ₹
	B	Dr.		5,000	
	To Sales A/c				5,000
	(Being sale of goods to *B*)				
	Bills Receivable A/c	Dr.		5,000	
	To *B*				5,000
	(Being to Bills Receivable of ₹2,500 each received from *B*)				
	C	Dr.		2,600	
	To Bills Receivable A/c				2,500
	To Discount A/c				100
	(Being one Bill Receivable endorsed to *C*)				
	Bank A/c	Dr.		2,500	
	To Bills Receivable A/c				2,500
	(Being payment received of another Bill Receivable)				

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BOOKS OF *B*

Date	Particulars			Dr. ₹	Cr. ₹
	Purchase A/c To *A* (Being goods purchased from *A*)	Dr.		5,000	 5,000
	A To Bills Payable A/c (Being two acceptances of ₹2,500 each given to *A*)	Dr.		5,000	 5,000
	Bills Payable A/c To Bank (Being acceptance met on maturity)	Dr.		5,000	 5,000

Accommodation Bill

In general, bills are drawn and accepted for the sake of acknowledging a debt which has arisen due to genuine business transactions between a creditor and a debtor. Any bill drawn and accepted for the above purpose is known as trade bill. Apart from the above-said trade bill, an individual may accept a bill drawn by another person in consultation with him for the sake of helping the other person in creating the funds by discounting the bill and the amount may be used either by one person or by both. These types of bills are drawn and accepted purely for the purpose of accommodating another person and such bills are called accommodation bills.

In such cases, the discount loss will be borne by the parties to the bill in the same proportion in which they have shared the proceeds of the bill. The accounting treatment is exactly similar to a trade bill.

Illustration 5.3

On 1st March 1998 Kaul approached his friend Wadekar for a loan ₹ 2,000 and latter being unable to find the money accepted a two months bill for the amount. Kaul discounted the bill with his banker on 3rd March 1998 at 12% p.a. On the due date of the bill Kaul sent the necessary amount to Wadekar to enable him to meet the bill. Show the journal entries in the books of Kaul and Wadekar.

Books of Kaul Journal

Date	Particulars		Dr.	Cr.
1998 March 1	Bills Receivable A/c To Wadekar (Being the bill received on accommodation)	Dr.	₹ 2,000	₹ 2,000
March 3	Bank A/c Discount A/c To Bills Receivable (Being the bill discounted)	Dr. Dr.	1,960 40	 2,000
May 4	Wadekar To Bank (Being the amount due paid)	Dr.	2,000	 2,000

Wadekar Account

Date	Particulars	₹	Date	Particulars	₹
1998 May 4	To Bank A/c	2,000	1998 March 1	By Bills Receivable A/c	2,000
		2,000			2,000

Books of Wadekar Journal

Date	Particulars		₹	₹
1998 March 1	Kaul A/c To Bills Payable (Being the bill accepted for accommodation)	Dr.	2,000	2,000
May 4	Bank A/c To Kaul (Being the amount due from Kaul received)	Dr.	2,000	2,000
May 4	Bills Payable A/c To Bank (Being the bill honoured)	Dr.	2,000	2,000

Kaul Account

Date	Particulars	₹	Date	Particulars	₹
1998 March 1	To Bill Payable A/c	2,000	1998 May 4	By Bills Receivable A/c	2,000
		2,000			2,000

Check Your Progress

1. What is a promissory note?
2. What is a truncated cheque?

5.4 ACCOUNT CURRENT

In case there are several transactions between two parties, it will be necessary to take into account the question of interest besides ensuring the correctness of amount due by one party to the other. It will be appropriate in such a case that each party should send a Statement of Account to the other party instead of settling each transaction individually. Such a statement when rendered in the form of an account by one party to another, duly setting out in chronological order the details of the transactions together with interest, is termed as an Account Current. The main heading of the account is preceded by the name of the party to whom it is rendered and is succeeded by the name of the party sending the statement. For example, if *A* sends an account current to *B*, the heading of the account current will be:

B in account current with *A*

In case the account current is being sent by *B* to *A*, the heading of the account current will be:

A in account current with *B*

Account current is sent by one person to another in case of the following types of relationship:

(a) Principal and Agent, (b) Consignor and Consignee, (c) Supplier of goods and Customer, and (d) Co-venturers.

Computation of Interest

Interest is usually calculated on the basis of number of days. Thus, computation of interest involves:

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(1) Calculation of days.

(2) Calculation of the amount of interest.

(1) Calculation of days   The following points should be kept in mind while calculating the number of days.

(i) There are three methods for calculating the number of days:

(a) *Forward method*   The method is most common. The number of days is calculated from the due date of the transaction to the date of settlement.

(b) *Backward or epoque method*   In case of this method the number of days is counted from the opening date (the date of commencement) of the account current to the due date of the transaction.

(c) *Daily balance method*   The method is used by banks. Days are calculated from the due date of a transaction to the due date of the next transaction.

(ii) The effective date of the transaction should be considered for calculating the number of days irrespective of the method followed. For example, if, as per terms of trade, some credit period is allowed, any interest is to be charged only with effect from the date after the expiry of such a period. Similarly, when bills of exchange are received or issued, the due date of the bill (including 3 days of grace) will be the effective date for this purpose.

(iii) The date of the transaction should be excluded while calculating the number of days. For example, if days are to be calculated from 5th January, 1999 (the date of transaction) to 31st January, 1999 (settlement date), the number of days will be taken as 26, the day of 5th January will be excluded.

(iv) In case some balance has been brought forward from the previous period, the first day of the new period will also be considered. For example, if there has been a opening balance on 1st March and when the settlement date is considered 30th June, the number of days will be counted as follows:

March 31 + April 30 + May 31 + June 30 = 122

However, if a new transaction takes place on 1st March, the day of 1st March will not be included for calculating the number of days.

(2) Calculation of amount of interest   There are four methods for charging interest:

(i) *Calculating interest on each item*   In case of this method interest is calculated on each item separately. The days are calculated from the date of the transaction to the settlement date and interest is charged for the number of days so calculated at a agreed rate of interest.

Illustration 5.4 The following are a series of transactions between *A* and *B* for the three months ending on 31st March 2015. Calculate the amount of interest to be payable by one party to the other @ 10% p.a.

	Books of A	₹
Jan. 1	Opening balance (*Dr.*)	5,000
Jan. 10	Sold goods to *B*	10,000
Jan. 15	Cash received from *B*	10,000
Feb. 15	Sold goods to *B*	10,000
March 1	Cash received from *B*	5,000

Solution

B* in Account Current with *A

Date	*Particulars*	₹	*Date*	*Particulars*	₹
Jan. 1	To Balance b/d	5,000	Jan. 15	By Cash	10,000
Jan. 10	To Sales	10,000	March 1	By Cash	5,000
Feb. 15	To Sales	10,000	March 31	By Balance c/d	10,217
March 31	(To Interest (*see Working Note*	217			
		25,217			25,217

Working Note:

Computation of Interest

Debit Items	₹	*Credit Items*	₹
(i) 5,000 × (90/365) × (10/100)	123	(i) 10,000 × (75/365) × (10/100)	206
(ii) 10,000 × (80/365) × (10/100)	220	(ii) 5,000 × (30/365) × (10/100)	41
(iii) 10,000 × (44/365) × (10/100)	121		

Total Interest to be charged to *B* = (123 + 220 + 121) – (206 + 41) = ₹ 217

(ii) *Product method* This is a modification of the first method. In place of making separate calculations, the amount involved in each transaction is multiplied by the number of days (or months) from its date to the date of settlement. Interest is calculated on the balance of the products for one day (or month) and is put on the side the sum of the products is more. However, if the rates of interest are different for debits and credits, interest for debits and credits will have to be calculated separately.

Red Ink Interest

Sometimes, the due date of a transaction falls after the closing date of the account current. For example, an account current is prepared for the quarter ending 31st March, 2015. *A* receives a bill of exchange from *B* for ₹ 10,000 on 15th March due one month after date. The due date of the transaction is, therefore, 18th April, 2015, i.e., 18 days after the closing date of the account current. *A* on 31st March is entitled to get interest from *B* for 18 days instead of allowing interest to him for this transaction. In the statement to be rendered by *A* to *B*, the product of 1,80,000 will be subtracted from the total of the products of other items. In order to differentiate it from other products, the products of such an amount is entered in **red ink**. This is the reason why such a product is known as "red ink interest" product.

(iii) *Epoque method* This method is the reverse of the first two methods. Interest is computed from the opening date of the account current to the date of each transaction. Thus, no interest is charged on the opening balance while interest for the whole period will be charged on the closing balance.

Interest is calculated at the agreed rate on the balance of the products for one day (or month) and entered on the side which has smaller product. In case rates of interest are different for debits and credits, interest for each side will have to be calculated separately.

(iv) *Periodical balance method* The method is usually followed in banks. The balance is struck after each transaction and is multiplied by the number of days up to the next transaction. Interest is charged for one day on the difference of the products. In case the rates of interest are different for debits and credits interest will be calculated for the debits of the products and the credits of the products separately. The difference of the two amounts will be the amount of interest chargeable to or receivable from the party concerned.

Illustration 5.5 From, the following particulars prepare a current account, as sent by Mr. Ram to Mr. Siva as on 31st October, 2014 by means of product method charging interest @ 5% p.a.

2014	*Particulars*	₹
1st July	Balance due from Siva	750
15th August	Sold goods to Siva	1250
20th August	Goods returned by Siva	200
22nd Sep	Siva paid by cheque	800
15th Oct	Received cash from Siva	500

Solution

Siva in Account Current with Ram

Dr. *as on 31st Oct, 2014* *Cr.*

Date	*Particulars*	₹	*Days*	*Product (₹)*	*Date*	*Particulars*	₹	*Days*	*Product (₹)*
01.07.14	To Bal. b/d	750	123	92,250	20.08.14	By Sales Returns	200	72	14,400
15.8.14	To Sales	1,250	77	96,250	22.09.14	By Bank	800	39	31,200
31.10.14	To Interest	18.48			15.10.14	By Cash	500	16	8,000
						By Balance of Products			1,34,900
					31.10.14	By Bal. c/d	518.18		
		2018.48		1,88,500			2018.48		1,88.500

$$\text{Interest} = ₹\,1,34,900 \times \frac{5}{100} \times \frac{1}{365} = ₹18.48$$

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Illustration 5.6 Roshan has a current account with partnership firm. It has debit balance of ₹ 75,000 as on 01-07-2017. He has further deposited the following amounts:

Date	*Amount (₹)*
14-07-2017	1,38,000
18-08-2017	22,000

He withdrew the following amounts:

Date	*Amount (₹)*
29-07-2017	97,000
09-09-2017	11,000

Show Roshan's Account in the ledger of the firm. Interest is to be calculated at 10% on debit balance and 8% on credit balance. You are required to prepare current account as on 30th September, 2017.

Roshan's Current Account with Partnership Firm

(as on 30.9.2017)

Date	*Particulars*	*Dr* (₹)	*Cr* (₹)	*Balance* (₹)	*Dr. or .Cr*	*Days*	*.Dr Product* (₹)	*.Cr Product* (₹)
01.07.17	To Bal b/d	75,000		75,000	*.Dr*	13	9,75,000	
14.07.17	By Cash A/c		1,38,000	63,000	*.Cr*	15		9,45,000
29.07.17	To Self	97,000		34,000	*.Dr*	20	6,80,000	
18.08.17	By Cash A/c		22,000	12,000	*.Dr*	22	2,64,000	
09.09.17	To Self	11,000		23,000	*.Dr*	22	5,06,000	
30.09.17	To Interest A/c	457		23,457	*.Dr*			
30.09.17	By Bal. c/d		23,457					
		1,83,457	1,83,457				24,25,000	9,45,000

Interest Calculation:

On ₹ 24,25,000 × 10% × 1/365 = ₹ 664

On ₹ 9,45,000 × 8% × 1/365 = ₹ 207

Net interest to be debited = ₹ 457

Note: The above current account has been prepared by means of product of balances method.

5.5 AVERAGE DUE DATE

Average Due Date may be defined as the mean or equated date on which one payment may be made in lieu of several payments due on different dates without loss of interest to either party. For example, *A*, a businessman, may have a series of transactions involving receipts and payments of money due on different dates with *B*, another businessman. They may decide to settle their accounts on a particular date, after taking into account the amount of

interest which may have become due by one party to another. There are two alternatives available in such a case:

(a) Interest may be calculated separately for each transaction, or

(b) A mean date may be determined and the interest may be calculated from such mean date to the date of actual settlement on the total amount due by one party to another.

Alternative (b) is preferable since it will reduce a lot of clerical work. The mean date so calculated is termed as the Average Due Date.

Utility of Average Due Date

Average due date is useful in the following types of accounting problems:

1. Problems relating to settlement of accounts involving a series of bills of exchange due on different dates.
2. Problems relating to calculation of interest of partners' drawings made on different dates.
3. Problems involving piecemeal realisation of assets during the partnership dissolution.
4. Problems involving settlement of accounts where money advanced is to be received in a number of instalments due on different dates.

Types of Problems

Broadly, the problems relating to computation of the Average Due Date can be put into two categories:

(i) Calculation of Average Due Date when the amount is lent in a number of instalments and repayment is made in one instalment.

(ii) Calculation of Average Due Date when the amount is lent in one instalment and repayment is made in a number of instalments.

Each of these types of problems has been exhaustively explained in the following pages.

(i) Where the amount is lent in a number of instalments The calculation of the Average Due Date in this case can be done by taking the following steps:

1. A certain convenient basic date (or zero date) is taken as a starting point. This is usually the date of one of the transactions and preferably the due date of the first transaction.
2. In respect of each transaction, the number of days (or months) filling in between the basic date and date of the transaction is ascertained.
3. The amount of the transaction is multiplied by the number of days (or months) ascertained by step 2 above.

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4. Both the products as ascertained by step 3 above as well as the amounts are added up.
5. The total of the products is divided by the sum total of the amount.
6. The result is the number of days (or months) by which the Average Due Date is distant from the chosen date. In other words, the basic date + number of days (or months), calculated in this way, will give Average Due Date.

In case some amounts have been paid out and some have been received, the products for the two should be added up separately. The difference between the two totals of the products should then be divided by the difference in the sum total of the amounts of Debit and Credit. However, it should be noted that the basic date for both groups of transactions should be the same.

Calculation of interest The computation of the Average Due Date simplifies interest calculations. The amount of interest can be calculated from the Average Due Date to the date of settlement instead of making separate calculation for interest for each transaction. This will be clear with the help of the following illustration:

Illustration 5.7 Sunil is a partner in Sunil & Sharad Co. His drawings from the business during the year 2014 are as follows:

Month	₹	*Month*	₹
Jan. 31	150	Jul. 31	250
Feb. 28	100	Aug. 31	150
Mar. 31	160	Sep. 30	120
Apr. 30	200	Oct. 31	100
May. 31	140	Nov. 30	180
June 30	70	Dec. 31	300

You are required to calculate the Average Due Date and the amount of interest @ 10% p.a. payable by Sunil for his transactions, taking

(a) Jan. 1 as the basic date,

(b) Dec. 31 as the basic date.

Solution

Month	*Dec. 31 being used as basic date*			*Jan. 1 being used as basic date*	
	₹ Amount	*.Months before 31st Dec*	*Product*	*Months after 1st .Jan*	*Product*
2014					
Jan. 31	150	11	1,650	1	150
Feb. 28	100	10	1,000	2	200
Mar. 31	160	9	1,440	3	480
Apr. 30	200	8	1,600	4	800
May 31	140	7	980	5	700
June 30	70	6	420	6	420

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Month	Dec. 31 being used as basic date			Jan. 1 being used as basic date	
	₹ Amount	.Months before 31st Dec	Product	Months after 1st .Jan	Product
July 31	250	5	1,250	7	1,750
Aug. 31	150	4	600	8	1,200
Sep. 30	120	3	360	9	1,080
Oct. 31	100	2	200	10	1,000
Nov. 30	180	1	180	11	1,980
Dec. 31	300	0	0	12	3,600
	1,920		9,680		13,360

Average Due Date when December 31 is taken as the basic date = 9,680/1,920 = 5 months (approx.) prior to 31st December.

Hence, the Average Due Date is 31st July.

Average Due Date when January 1st is taken as the basic date = 13,360/1,920 = 7 months (approx.) subsequent to January 1.

Hence, the Average Due Date is 31st July.

In case Sunil had paid the amount of ₹ 1,920 to the firm on the Average Due Date, i.e., 31st July, there would have been no loss of interest to either party. Since the accounts are being settled not on 31st July but on 31st December, Sunil is liable to pay to the firm interest for 5 months. The amount comes to $\left(1,920 \times \frac{10}{100} \times \frac{5}{12}\right) = ₹\ 80.$ = ₹ 80.

(ii) Where the amount is lent in a single instalment In this case, where the amount is lent in one single instalment while the repayment is made in a number of equal instalments, the average due date can be calculated by taking the following steps:

1. The number of days (months or years) from the date of lending money to the date of each repayment should be calculated.
2. The total of such days (months or years) should be found out.
3. The total calculated as per step 2 above should be divided by the number of instalments payable for repayment of the amount.
4. The result as per step 3 above will be the number of days (months or years) by which the Average Due Date is away from the date on which the loan was given.

The above steps for calculation of the Average Due Date can be put in the form of the following formula:

$$ADD = D + \frac{SDP}{N}$$

where ADD = Average Due Date

D = Date of lending

SDP = Sum of Days (months or years) from the date of lending to the date of repayment of each instalment.

N = Number of instalments.

5.6 CONSIGNMENT

NOTES

The increasing size of the market is making more and more difficult for the manufacturer or wholesaler to come in direct contact with customers living at far off distances. This has made imperative for him to enter into an agreement with a reliable local trader who can sell goods on his behalf and at his (Principal) risk for an agreed amount of commission. Such a despatch of goods from one person to another person at a different place for the purpose of warehousing and ultimate sale is termed as consignment. Goods so sent are termed as 'Goods sent on Consignment', the sender is called "Consignor" and the recipient is called "Consignee".

For example if *A* of Mumbai sends 100 radio sets to *B* of Delhi to sell on his (*A*'s) behalf and at his (*A*'s) risk, the transaction between *A* and *B* is a consignment transaction. *A* is the 'consignor' and *B* is the 'consignee'.

It should be noted that in the above example, *A* continues to be the owner of the goods. *B* is simply an agent of *A*. He has not purchased the goods. He has agreed to sell the goods of *A* to the best of his ability and capacity. He will, therefore, be responsible to *A* for payment only when he has sold away the goods. Of course, he will be reimbursed by *A* for any expenses incurred by him in obtaining and selling the goods besides remuneration for selling the goods as per the agreed terms.

The main features of a consignment transaction can now therefore be put as follows:

(*i*) Consignment of goods is not a sale. It is mere transfer of possession of goods.

(*ii*) The consignee sells goods at the risk of the consignor. He is not responsible for any loss or destruction of goods.

(*iii*) The sale proceeds belong to the consignor and the consignee merely gets commission and expenses that he might have incurred.

(*iv*) The relationship between consignor and consignee is that of a Principal and an Agent.

Sale and consignment

The difference between sale and consignment can be put as follows:

(*a*) *Transfer of ownership* In case of sale, the ownership of the goods is transferred from the seller to the buyer. While in case of consignment, goods remain the property of the consignor till they are sold by the consignee.

(*b*) *Return of goods* Goods once sold cannot be returned unless they are defective and the seller agrees to take them back. While in case of consignment unsold goods remain lying with consignee or returned back to the consignor.

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(*c*) *Nature of relationship* The relationship between the seller and the buyer, if the goods are sold on credit, is that of debtor and creditor. While in case of consignment, the relationship between the consignor and the consignee is that of a principal and an agent.

(*d*) *Transfer of risk* In case of sale, the risk also passes with the transfer of ownership. In other words, once the goods are sold, the buyer will bear the loss even if the goods are still in the possession of the seller. In case of consignment the ownership does not pass to the consignee and therefore the risk remains with the consignor in the event of goods being lost or destroyed.

Important Terms

1. **Proforma invoice** It is a statement prepared by the consignor stating quantity, quality and price of goods. It is sent with goods despatched to consignee.

A proforma invoice is different from Invoice.

Invoice implies that a sale has taken place. It is a statement describing the goods despatched to the buyer and showing the total amount due by him to the seller. A proforma invoice is simply a statement of information in the form of invoice to apprise the party, who has not bought the goods but shall be having their possession, or dealing with them, of certain essential particulars of the goods. Such an invoice in sent by the intending seller to his agent or the intending buyer before the sale actually takes place. It does not show that the person to whom it is sent is indebted to the sender.

2. **Account sales** It is a periodical statement rendered by the Consignee to the Consignor containing details of goods received, sales made, expenses incurred, commission charged, remittances made and balance due by him to the consignor. The following is a specimen of an Account Sales.

Account Sales of 50 transistors ex S.S. San Pedro received and sold on account of Robbins & Sons, Chicago by:

M/S CHIMAN LAL DESAI & CO. MUMBAI

Particulars		₹	₹
40 transistors at ₹1,200 per transistor		48,000.00	
10 transistors at ₹1,100 per transistor		11,000.00	59,000.00
Less: Charges:			
Dock Dues	700		
Customs Duty	2,000		
Freight	1,300		
Godown Rent	500	4,500.00	
Commission at 5 per cent		2,950.00	7,450.00
			51,550.00
Less: Draft accepted			20,000.00
Balance due, Bank draft enclosed			31,550.00

E & O.E. For Messrs Chiman Lal Desai & Co.

(Sd) Ashoka Kumar

Mumbai, the 15th Jan. 2012 Manager

3. **Commission** It is the remuneration payable to the consignee for sale made by him. This can be simple, overriding and del-credere.

Simple commission is calculated as per terms laid down by the consignor. Usually this is a fixed percentage on total sales.

In order to give further incentive, sometimes an extra commission termed as over-riding commission is allowed to consignee, in case the sales exceed a specified amount. It is also calculated on total sales.

Where the consignee agrees to meet any loss which the consignor may suffer by reason of bad debts, one more extra commission, known as del-credere commission, is given to consignee. This is also normally calculated on total sales.

Illustration 5.8. Gopi Cycles (P) Ltd., Hyderabad, sent 2,000 dynamos costing ₹50 each for sale on consignment basis to Ramoo of Vijaywada, subject to the following terms:

(*i*) Normal selling price per dynamo ₹60;

(*ii*) Consignee's commission to be calculated as under:

(*a*) 5 per cent on normal selling price;

(*b*) 1 per cent additional commission if selling price is more than normal price; and

(*c*) ½ per cent del-credere commission on total sales for guaranteeing collection of credit sales.

Ramoo reported sales as follows:

	₹
Cash Sales:	
500 dynamos at ₹60 each	30,000
200 dynamos at ₹75 each	15,000
Credit Sales:	
400 dynamos at ₹75 each	30,000
400 dynamos at ₹80 each	32,000
Total	1,07,000

Ascertain the commission due to consignee.

Solution:

STATEMENT OF COMMISSION DUE TO CONSIGNEE

	₹
Normal (or Simple) Commission: 1,500 × 60 × 5/100	4,500
Additional (or Overriding) Commission: 77,000 × 1/100	770
Del-credere Commission: 1,07,000 × ½/100	535
	5,805

4. **Direct expenses** These are expenses which are incurred for placing the goods in a saleable condition. All expenses till the goods reach the godown of the consignee come in this category. These expenses are of a non-recurring nature and increase the value of goods. Examples of such expenses are freight, carriage, insurance, loading and unloading charges etc.

5. **Indirect expenses** These are expenses incurred after the goods reach the consignee's godown. They are of a recurring nature and do not increase the value of goods. Examples of such expenses are godown rent, storage charges, advertisement expenses, salaries of salesmen, etc.

The distinction between direct and indirect expenses is of special importance at the time of the valuation of the unsold stock. Direct expenses form a part of the cost and, therefore, a proportion of such expenses is included in the cost of stock, while the indirect expenses do not form part of the cost and, therefore, excluded while valuing the unsold stock. This has been explained in detail later.

6. **Advance** The consignor may ask the consignee to deposit some money with him to be kept by him as security in respect of the goods sent by him on consignment. It is usually a certain percentage of the value of goods sent on consignment. For example, if the value of goods sent on consignment is to be ₹50,000, and the consignee is asked to deposit (say) 10 per cent of the value of goods to be sent, the amount of advance will be ₹5,000. This covers to certain extent the risk of the consignor. The amount is adjusted against the amount due from consignee when the accounts are finally settled. However, the consignor may like to keep with himself a certain percentage of value of the goods lying with the consignee. In such a case advance will be adjusted only to the extent of the proportionate goods sold.

Example. Goods of ₹50,000 are sent on consignment to *A* who sells away 50 per cent of the goods for ₹40,000. Consignor required that 10 per cent of the value of the goods should be kept as an advance with him. *A*'s expenses and commission amount to ₹5,000. The amount to be sent by *A* will be calculated as follows:

	₹	₹
Sales Value of the goods		40,000
Less : Commission and Expenses	5,000	
Advance deposited 10 per cent of ₹25,000	2,500	7,500
Amount to be sent by *A*		32,500

Thus, 10 per cent of the value stock lying with the consignee i.e., ₹2,500 out of initial advance of ₹5,000 will still remain as advance with the consignor till these goods are finally sold.

Accounting Records

A proper record of all transactions relating to a particular consignment is necessary for ascertaining Net Profit or Net Loss on each separate

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consignment. To attain this objective the consignor usually maintains three accounts:

(1) Consignment Account.

(2) Consignee's Account.

(3) Goods Sent on Consignment Account.

Consignment Account is a Nominal Account. It is in fact a special Trading and Profit & Loss Account and, therefore, its balance shows the Profit or Loss made on a particular consignment.

Consignee's Account is a Personal Account and, therefore, in case the Consignee has not remitted the balance due by him in full, he will be a debtor, whereas if he has remitted more than the balance due by him, he will be a creditor.

Goods sent on Consignment Account is a Real Account. It is closed up by transferring its balance to Purchases Account (sometimes it is also transferred to the credit side of Trading Account).

The above accounts are maintained in respect of each of the consignments. For example, if goods have been sent on Consignment to Mumbai, Kolkata and Chennai, Consignment Account, Consignee's Account and Goods sent on Consignment Account will be maintained in respect of each of these consignments.

Pricing of Goods Sent on Consignment

Goods can be consigned to the consignee either (*i*) at cost or (*ii*) at invoice price.

At cost In case of this method the goods are charged to the consignment at cost price to the consignor. The proforma invoice is also prepared at this price. For example if the goods costing ₹10,000 are purchased by *A* and 80 per cent of such goods are sent by him on consignment to Mumbai, proforma invoice will show the value of goods as ₹8,000 and the Consignment to Mumbai account will also be charged with this price. The consignee may be given the direction regarding the price at which he should sell the goods.

At invoice price In case of this method the goods are charged to the consignment at a price higher than cost. The proforma invoice also shows the value of goods at such higher price. The excess of invoice price over the actual cost, represents the profit which the consignor intends to make on the goods consigned. For example, if in the above case the goods are consigned at a profit of 25 per cent on cost (or 20 per cent on invoice price), the consignment account will be charged with ₹10,000 (*i.e.,* ₹8,000 + ₹2,000) for the value of goods sent on consignment. However, in order to find out the profit, at the end of the accounting period, the consignment account will be given credit with the excess price so charged. In this case, the credit to the consignment account will be of ₹2,000. Thus, in fact, consignment account

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has been charged only with the cost (*i.e.,* ₹10,000 – ₹2,000) of the goods sent on consignment as has been done in the first case. Suitable adjustment for profit element included in the stock with the consignee has also to be made.

The following are the advantages of invoicing goods to consignee at a price higher than the cost:

(*i*) The consignor can keep secret from the consignee the profit that he is making on the goods sold, thus reducing the possibility of bringing more competition in the field.

(*ii*) The consignee can be directed to sell the goods at the invoice price only. Thus, he is prevented from charging different prices from different customers.

(*iii*) Control over stock with the consignee becomes slightly easier. The value of stock with the consignee at any time will be the difference between the value of goods sent on consignment and the sales made by him.

The accounting entries to be recorded in the books of the consignor in both the cases are being explained in the following pages.

Book of Consignor

JOURNAL ENTRIES

	Transaction	*Debit*	*Credit*
(1)	When Security is asked	Bank or Cash or B/E.	Consignee's A/c.
(2)	When goods are sent:	Consignment A/c.	Good sent on Consignment A/c.
	(*a*) at cost.		(with cost price)
	(*b*) at Invoice Price.	(*i*) Consignment A/c.	Goods sent on Consignment A/c. (at invoice price)
	In order to bring down the goods sent on consignment to cost, an adjustment entry will be necessary.	(ii) Goods sent on Consignment A/c. (with the difference between invoice price and cost price)	Consignment A/c.
(3)	For expenses incurred by the consignor.	Consignment A/c.	Cash A/c.
(4)	When goods are received by the consignee.	No entry	
(5)	When Account Sales is received from the consignee:		
	(*a*) for sales made by Consignee.	Consignee's A/c.	Consignment A/c.
	(*b*) for expenses incurred by Consignee.	Consignment A/c.	Consignee's A/c.
	(*c*) for commission.	Consignment A/c.	Consignee's A/c.
(6)	If bad debts incur and consignee is a del-credere agent.	No entry	
(7)	When bad debts take place and consignee is not a del-credere agent.	Consignment A/c.	Consignee's A/c. (because he was debited with total sales)
	Transaction	Debit	Credit
(8)	For stock in the hands of the consignee:	Stock on Consignment A/c. (with cost price)	Consignment A/c.
	(*a*) If the goods were sent at cost.		
	(*b*) If the goods were sent in invoice price.	(*i*) Stock on Consignment A/c. (with invoice price)	Consignment A/c.

	Transaction	*Debit*	*Credit*
	In order to write-off the unrealised profit on stock an adjusting entry will be necessary.	(*ii*) Consignment A/c. (with the difference between invoice price of stock and cost price)	Stock Reserve A/c.
	The balance of Stock Reserve A/c will be carried to the *B/S* and will be deducted from the value of stock on consignment.		
	In the following period, the consignment stock of last period will be transferred to the debit side of the consignment account. The stock reserve on such stock will be transferred to the credit side of that account.		
(9)	For settlement of accounts with the consignee		
	(*i*) If the consignee owes money he will pay it in cash or send B/E etc.	Bank/Cash or B/E.	Consignee's A/c.
	(*ii*) If the consignor owes money to the consignee, he will pay him in cash or send B/E.	Consignee's A/c.	Cash or B/E A/c.
	(in case accounts are not settled the balance of Consignee's Account will be carried forward).		
(10)	If the B/E received from the consignee is discounted.	Bank A/c Discount A/c.	B/E A/c.
(11)	The discount A/c is closed by transferring it to P & L A/c.	P & L A/c.	Discount A/c.
(12)	The consignment account will be closed by transferring the balance (*i.e.,* Profit or Loss) to P & L A/c.		
	(*a*) In case of profit.	Consignment A/c.	P & L A/c.
	(*b*) In case of a large number of consignment accounts, a separate 'Profit & Loss on Consignment A/c' can be opened. Profit or Loss on each individual Consignment A/c will be transferred to this account and ultimately the balance of this account will be transferred to P & L A/c.	For loss a reverse entry will be passed	
(13)	Goods sent on Consignment A/c will be closed by transferring its balance to Purchases or Trading A/c.	Goods sent on Consignment A/c.	Purchases A/c or Trading A/c.
(14)	"Consignment Stock A/c" will appear as an asset in the Balance Sheet.		

Illustration 5.9. On 1st April, 2016, Aditya Mills Ltd., Delhi, consigns 500 pieces of shirting costing ₹5,000 to Birla Stores, Mumbai. The consignee is entitled to 5% selling commission and 1% del-credere commission.

Following expenses were incurred by the consignor:

	₹
Carriage	200
Insurance	100
Freight	150

Aditya Mills Ltd. draws a Bill of Exchange for ₹2,000 on Birla Stores, Mumbai, which was duly accepted by them. It is discounted for ₹1,950.

NOTES

On 31st May, 2016, Birla Stores send the Account Sales which shows that they have sold goods for ₹7,500 and paid expenses amounting to ₹150. Stock in Consignee's hands on 31st May, 2016 is valued at ₹1,500.

Birla Stores enclose a sight draft with the Account Sales, for the net amount due to Aditya Mills Ltd. Give journal entries and ledger accounts in the books of the consignor.

Solution:

JOURNAL

Date	Particulars		Dr. (₹)	Cr. (₹)
2016	Consignment to Mumbai A/c	Dr.	5,000.00	
April	To Goods Sent on Consignment A/c			5,000.00
	(500 pieces of shirting consigned to Birla Stores, Mumbai)			
	Consignment to Mumbai A/c	Dr.	450.00	
	To Cash A/c			450.00
	(Expenses incurred: Carriage ₹200, Insurance ₹100, and Freight ₹150)			
	Bills Receivable A/c	Dr.	2,000.00	
	To Birla Stores, Mumbai A/c			2,000.00
	(Bills of exchange received from Birla Stores, Mumbai)			
	Bank A/c	Dr.	1,950.00	
	Discount A/c	Dr.	50.00	
	To Bills Receivable A/c			2,000.00
	(Bills Receivable discounted for ₹1,950)			
	Consignment to Mumbai A/c	Dr.	150.00	
	To Birla Stores A/c			150.00
	(Expenses incurred by the consignee in connection with consignment)			
	Consignment to Mumbai A/c	Dr.	450.00	
	To Birla Stores, Mumbai A/c			450.00
	(Commission due to Birla Stores, Mumbai being ordinary @ 5% and del-credere @ 1% on ₹7,500)			
	Birla Stores Ltd. A/c	Dr.	7,500.00	
	To Consignment to Mumbai A/c			7,500.00
	(Being sales made)			
	Stock on Consignment A/c	Dr.	1,500.00	
	To Consignment to Mumbai A/c			1,500.00
	(Stock with consignee)			
Dec. 31	Goods Sent on Consignment A/c	Dr.	5,000.00	
	To Trading A/c			5,000.00
	(Being transfer of goods sent on consignment to Trading A/c)			
	Bills Receivable A/c	Dr.	4,900.00	
	To Birla Stores Ltd. A/c			4,900.00
	(B/R received for net balance due)			
	Consignment to Mumbai A/c	Dr.	2,950.00	
	To *P* & *L* A/c			2,950.00
	(Transfer of the profit on consignment)			
Dec. 31	*P* & *L* A/c	Dr.	50.00	
	To Discount A/c			50.00
	(Discount written off)			

NOTES

Ledger Accounts

Dr. CONSIGNMENT TO MUMBAI ACCOUNT Cr.

Date	Particulars	₹	Date	Particulars	₹
2016			2016		
April	To Goods sent on Consignment	5,000.00	May 31	By Birla Stores, Mumbai	7,500.00
				By Stock on Consignment	1,500.00
	To Cash (Expenses)	450.00			
	To Birla Stores, Mumbai (Expenses)	150.00			
May 31	To Birla Stores, Mumbai (Commission)	450.00			
	To *P* & *L* A/c (transfer of Profit)	2,950.00			
		9,000.00			9,000.00

BIRLA STORES, MUMBAI ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan 31	To Bank	1,60,020	Jan 1	By Balance b/d	
2016			2016		2,26,000
	To Consignment A/c (Sale proceeds)	7,500.00	April	By Bills Receivable A/c	2,000.00
				By Consignment A/c (Expenses)	150.00
				By Consignment A/c (Commission)	450.00
				By B/R	4,900.00
		7,500.00			7,500.00

Dr. GOODS SENT ON CONSIGNMENT ACCOUNT Cr.

Date	Particulars	₹	Date	Particulars	₹
Jan 31	To Bank	1,60,020	Jan 1	By Balance b/d	
2016			2016		2,26,000
Dec. 31	To Consignment A/c	5,000.00	April	By Consignment A/c	5,000.00

5.7 JOINT VENTURE ACCOUNTS

A joint venture is an association of two or more than two persons who have combined for the execution of a specific transaction and divide the profit or loss thereof in the agreed ratio. For example, if *A* and *B* undertake the job of construction of a school building for a sum of ₹1,00,000 their coming together for this specific job will be termed as a joint venture and each one of them will be termed as a co-venturer. The venture will be over as soon as this transaction is over *i.e.,* the school building is completed. Joint venture agreements can be made for similar other transactions, *e.g.,* joint consignment of goods, underwriting of the shares or debentures issued by a particular company, purchasing and selling of a specific property etc.

The essential features of a joint venture agreement can be put as follows:

(*i*) There is an agreement between two or more than two persons.

(*ii*) The agreement is made for the execution of a specific venture.

NOTES

(*iii*) The profit or loss on account of the venture is shared by the venturers in the agreed ratio. However, in the absence of any agreement between the venturers, the profits and losses are to be shared equally.

(*iv*) The agreement regarding the venture is automatically over as soon as the transaction is completed.

Joint Venture and Partnership

According to the Indian Partnership Act, "Partnership is the relations between persons who have agreed to share the profits of a business carried on by all or any of them acting for all." Thus, both in joint venture and partnership there is some business activity whose profit (or loss) is agreed to be shared by two or more than two persons. As a matter of fact in law, a joint venture is treated as a partnership. Of course, a partnership covers or is meant to cover a long period whereas a joint venture is only for a limited purpose sought to be achieved in a short period. On account of this reason, joint venture is also sometimes termed as a 'temporary partnership' or 'partnership for a specific venture' or 'particular partnership'.

Joint Venture and Consignment

The difference between Joint Venture and Consignment can be put as follows:

(*a*) *Relationship* Joint venture is a sort of temporary partnership. The relation between the co-venturers is that of partners. However, consignment is a sort of joint relationship in which the consignor is a principal and the consignee is an agent.

(*b*) *Sharing of Profits* In case of joint venture, the profits or losses are shared by the co-venturers in the agreed ratio. While in case of consignment, consignor and consignee do not share the profits and losses of the business. The consignee simply gets commission as reward for the services rendered by him.

(*c*) *Contribution of Funds* In case of joint venture the funds for the venture are provided by the co-venturers. While in case of consignment, the consignee does not provide any funds. All funds are provided by the consignor only.

(*d*) *Risk* In case of joint venture the business operations are at the risk of all the co-venturers. While in case of consignment, consignee carries on business operations at the risk of the consignor.

(*e*) *Rights* In case of joint venture, the co-venturers have rights to buy or sell or make payments on account of the joint venture. While in case of consignment, the consignee has to work in accordance with the instructions of his principal *i.e.,* the consignor. The consignee has no independent rights on his own.

Accounting Records

There are three ways in which Joint Venture Accounts can be kept. They are as follows:

NOTES

1. When *Separate Set of Books* for the venture are maintained. This will be necessary when venture is of a large magnitude.
2. When *One Venturer* keeps the accounts. In this case entire work is entrusted to one of the venturers and the rest simply contribute their share of investment and place it at the disposal of the working venturer.
3. When *All Venturers* keep accounts. Where venture is not of such magnitude as to warrant a distinct set of books being kept, each venturer will record only such transactions as directly concern him.

In the following pages each of these methods, has been discussed in detail.

When Separate Set of Books are Maintained

Where a complete set of books are maintained for the Joint Venture, following accounts are opened:

(*i*) Joint Bank Account

(*ii*) Joint Venture Account

(*iii*) Personal Accounts of Each Venturer.

In this method parties first pay their contribution to joint funds in the Joint Bank Account and their payments on joint account are made out of Joint Bank Account.

Joint Venture Account is of the nature of an ordinary Trading and Profit & Loss Account. It is debited with goods purchased, and expenses incurred, while credited with the sales made. Its balance shows the profit or loss incurred on the joint venture.

Personal account of each venturer is also opened. It is credited with the amount of contribution made by him to the joint funds and his share of profit (and debited in case of loss).

JOURNAL ENTRIES

Transaction	*Debit*	*Credit*
(1) When venturers contribute cash to the joint funds.	Joint Bank A/c (with total amt.)	Venturer's A/c (with individual contribution separately)
(2) When amount is spent on account of expenses, or for purchasing goods for the venture.	Joint Venture A/c	Joint Bank A/c
(3) If any expenses are paid by the venturers.	Joint Venture A/c	Venturer's A/c
(4) For Sales:		
(*i*) Cash	Joint Bank A/c	Joint Venture A/c
(*ii*) Credit	Sundry Drs. A/c	Joint Venture A/c
(5) If Stock is taken by a venturer.	Venturer's A/c	Joint Venture A/c
(6) If any stock remains unsold.	Joint Venture Stock A/c	Joint Venture A/c
(7) Balance of the Joint Venture A/c will be either profit or loss.		
(*i*) If profit	Joint Venture A/c	Venturers A/c
(*ii*) If loss	Venturer's A/c	Joint Venture A/c
(8) Joint Bank account and personal accounts of Venturers' will be automatically closed by introduction or withdrawal of cash.		

Illustration 5.10. Banerjee and Mukherjee agree to import Russian timber into India. On 1st July, 2016 they opened a joint bank account with ₹25,000 towards which Banerjee contributed ₹15,000 and Mukherjee contributed ₹10,000. They agree to share profits and losses in proportion to their cash contributions.

They remitted to their agent in Russia ₹20,000 to pay for timber purchased, and later ₹2,100 in settlement of his account. Freight, insurance and dock charges amounted to ₹3,900. On Dec. 31, 2016 the sales amounted to ₹28,740 which enabled them to repay themselves with cost originally advanced, (no account to be taken of interest). They then decided to close the venture and Mukherjee agreed to take over the timber unsold for ₹1,260, which is to be deducted from his share of profit.

Prepare the necessary accounts showing the amount of cash available for division by way of profits and how the same is divisible between Banerjee and Mukherjee.

Solution:

JOINT VENTURE ACCOUNT

Particulars	₹	*Particulars*	₹
To Joint Bank A/c	20,000	By Joint Bank A/c (Sales)	28,740
To Joint Bank A/c		By Mukherjee	1,260
(commission of agent)	2,100		
To Joint Bank A/c			
(freight and insurance)	3,900		
To Profit transferred to:			
Banerjee 3/5	2,400		
Mukherjee 2/5	1,600		
	30,000		30,000

JOINT BANK ACCOUNT

Particulars	₹	*Particulars*	₹
To Banerjee	15,000	By Joint Venture A/c	20,000
To Mukherjee	10,000	By Joint Venture A/c	2,100
To Joint Venture A/c	28,740	By Joint Venture A/c	3,900
		By Banerjee	17,400
		By Mukherjee	10,340
	53,740		53,740

BANERJEE

Particulars	₹	*Particulars*	₹
To Joint Bank A/c	17,400	By Joint Bank A/c	15,000
		By Joint Venture A/c	2,400
	17,400		17,400

MUKHERJEE

Particulars	₹	*Particulars*	₹
To Joint Venture A/c	1,260	By Joint Bank A/c	10,600
To Joint Bank A/c	10,340	By Joint Venture A/c	1,600
	11,600		11,600

NOTES

When One Venturer Keeps Accounts

Where work for recording joint venture transactions is entrusted to one of the co-venturers, he is usually allowed an extra remuneration out of the profit for his services.

Following main accounts are maintained by him:

(*i*) Joint Venture Account which shows the amount of Profit or Loss made on the venture.

(*ii*) Personal accounts of all other co-venturers.

JOURNAL ENTRIES

Sl. No	*Transaction*	*Debit*	*Credit*
1.	When the working partner receives from other co-venturers their share of investment	Cash/Bank	Venture's A/c
2.	When goods are purchased.	Joint Venture A/c	Cash or Crs. A/c
3.	When expenses for the venture are incurred.	Joint Venture A/c	Cash A/c
4.	When goods are sold.	Cash or Drs. A/c	Joint Venture A/c
5.	When he is allowed an extra commission for his services.	Joint Venture A/c	Commission A/c (later on transferred to his *P* & *L* A/c)
6.	The balance of Joint Venture Account will show either a profit or loss.		
	(*i*) His own share of profit will be transferred to his *P* & *L* A/c.	Joint Venture A/c	*P* & *L* A/c
	(*ii*) The shares of co-venturers will be transferred to their respective personal accounts.	Joint Venture A/c	Individual A/cs of the co-venturers.
	(*iii*) The venturers accounts will then show what is due to them in respect of their investments and their share of profit or loss.		

Illustration 5.11. A and B entered into a joint venture agreement to share the profits and losses in the ratio of 2 : 1. A supplied goods worth ₹60,000 to B incurring expenses amounting to ₹2,000 for freight and insurance. During transit goods costing ₹5,000 became damaged and a sum of ₹3,000 was recovered from the insurance company. B reported that 90% of the remaining goods were sold at a profit of 30% of their original cost. Towards the end of the venture, a fire occurred and as a result the balance stock lying unsold with B was damaged. The goods were not insured and B agreed to compensate A by paying in cash 80% of the aggregate of the original cost of such goods plus proportionate expenses incurred by A. Apart from the joint venture share of profit, B was also entitled under the agreement to a commission of 5% of net profits of joint venture after charging such commission. Selling expenses incurred by B totalled ₹1,000. B had earlier remitted an advance of ₹10,000. B duly paid the balance due to A by draft.

You are required to prepare in *A*'s books:

(*i*) Joint Venture Account. (*ii*) *B*'s account.

NOTES

Solution:

Books of *A*

JOINT VENTURE ACCOUNT

Particulars	₹	*Particulars*	₹
To Purchases (Cost of goods suppld.)	60,000	By Bank (Insurance Claim)	3,000
To Bank (Expenses)	2,000	By *B* (Sales)	64,350
To *B* (Expenses)	1,000	By *B* (agreed value for damaged goods)	4,546
To *B* (Commission—1/21 of 8,896)	424		
To Profit transferred to:			
P & L A/c	5,648		
B	2,824		
	71,896		71,896

B's ACCOUNT

Particulars	₹	*Particulars*	₹
To Joint Venture A/c (Sales)	64,350	By Bank (Advance)	10,000
To Joint Venture A/c (Claim portion)	4,546	By Joint Venture A/c (Expenses)	1,000
		By Joint Venture A/c (Commission)	424
		By Joint Venture A/c (Share of profit)	2,824
		By Bank (Balance received)	54,648
	68,896		68,896

Working Notes:

1. It has been assumed that the goods damaged in-transit have no residual value.
2. Computation of Sales:

	₹
Cost of goods sent	60,000
Less: Cost of damaged goods	5,000
	55,000
Cost of goods remaining unsold	5,500
Cost of goods sold	49,500
Profits 30%	14,850
Sales	64,350

3. Claim for loss of fire admitted by *B*:

	₹
Cost of goods	5,500
Add: Proportionate expenses (2,000 × 5,500)/60,000	183
	5,683
Less: 20%	1,137
Amount of claim	4,546

When All Venturers Keep Accounts

There are two methods of keeping books:

(*i*) When each party informs the other party regarding transactions made by him on account of joint venture at regular intervals.

(*ii*) When such information is furnished at the completion of the venture. This is popularly known as 'memorandum method'.

NOTES

1. *When each Venturer gets complete information from other Venturer(s).* In this case each party maintains the following accounts:

(*i*) *Joint Venture Account.* It is similar to an ordinary *P & L* A/c. It is debited with total purchases and total expenses incurred and credited with the amount of sales and stock in hand. The balance of this account is either a profit or a loss.

(*ii*) *Personal Account or Accounts of the Co-venturers.* This personal account is written as "Joint Venture with... Account". The words "Joint Venture with..." are added before the name of the Venturer, only to distinguish it from other personal accounts of the main business. It is a record of transactions made by the co-venturer on account of joint venture. The account is closed by settling the balance.

The Journal entries to be passed in case of this method are given below:

JOURNAL ENTRIES

Sl. No	*Transaction*	*Debit*	*Credit*
(1)	When goods are brought or money is spent on Joint Venture.	Joint Venture A/c	Seller's A/c or Bank A/c
(2)	When he receives a report that his co-venture has bought goods or spent money on the Joint Venture.	Joint Venture A/c	Co-venturers Personal A/c
(3)	When he sells goods bought on Joint Venture A/c	Cash A/c or Purchasers A/c	Joint Venture A/c
(4)	When he receives a report that his co-venturer has sold goods bought on Joint Venture A/c.	Co-venturers A/c	Joint Venture A/c

Sl. No	*Transaction*	*Debit*	*Credit*
(5)	The balance of Joint Venture A/c will be either Profit or Loss.		
	(*i*) For his share of profit.	Joint Venture A/c	*P & L* A/c
	(*ii*) For his co-venturer's share of profit.	Joint Venture A/c	Co-venturer's A/c
	In case of loss entries will be reversed.		
(6)	The personal account of the co-venturer when balanced will show what is due from him or what is due to him.		

Illustration 5.12. *X* and *Y* entered into a joint venture of underwriting the subscription at par of the entire share capital of Copper Mines Limited consisting of 10,000 shares of ₹10 each and to pay all expenses up to allotment. They were to share profits in the ratio of 3 : 2 respectively. The consideration in return for the guarantee was 1,200 other shares of ₹10 each fully paid to be issued to them.

X provided the funds for registration fees ₹1,200; advertising ₹1,100 and printing and stationery ₹950. *Y* contributed towards payment of office rent ₹300; legal charges ₹1,550 and staff salaries ₹900.

The prospectus was issued and the applications fell short of the full issue by 1,500 shares. *X* took these over on joint account and paid for the same in full. They received the 1,200 fully paid shares as underwriting commission. They sold their entire holding at ₹12 per share. The proceeds were received by *X* for 1,500 shares and by *Y* for 1,200 shares.

NOTES

Write up the necessary accounts in the books of both the parties showing the final adjustment.

Solution:

In the Books of *Y*

JOINT VENTURE ACCOUNT

Particulars	₹	*Particulars*	₹
To Bank (Registration Fee)	1,200	By *Y* (Sales)	14,400
To Bank (Advertising)	1,100	By Bank (Sales)	18,000
To Bank (Printing and Stationery)	950		
To *Y* (Office Rent)	300		
To *Y* (Legal Charges)	1,550		
To *Y* (Staff Salaries)	900		
To Bank (Shares)	15,000		
To Profit:			
P & L A/c	6,840		
Y	4,560		
	32,400		32,400

Y's ACCOUNT

Particulars	₹	*Particulars*	₹
To Joint Venture A/c	14,400	By Joint Venture A/c (Office Rent)	300
		By Joint Venture A/c (Legal charges)	1,550
		By Joint Venture A/c (Salaries)	900
		By Joint Venture A/c (Profit)	4,560
		By Bank	7,090
	14,400		14,400

In the Books of *Y*

JOINT VENTURE ACCOUNT

Particulars	₹	*Particulars*	₹
To X	1,200	By Bank	14,400
To X	1,100	By *X*	18,000
To X	950		
To Bank	300		
To Bank	1,550		
To Bank	900		
To *X*	15,000		
To Profit			
P & L A/c	4,500		
X	6,840		
	32,400		32,400

X's ACCOUNT

Particulars	₹	*Particulars*	₹
To Joint Venture A/c	18,000	By Joint Venture A/c	1,200
To Bank A/c	7,090	By Joint Venture A/c	1,100
		By Joint Venture A/c	950
		By Joint Venture A/c	15,000
		By Joint Venture A/c	6,840
	25,090		25,090

2. *Memorandum Joint Venture Method or Memorandum Method*. The following are the salient features of this method:

(*i*) Each party will maintain only ONE account in his books. This account will be personal account of other parties. It may be very carefully noted that even if there are more than two venturers only one personal account is to be opened in each party's books. For example, if *A, B, C,* have entered into a joint venture. *A* will open one personal account of *B* and *C* in his books and not separate accounts. Similarly *B* will open joint personal account of *A* and *C* will maintain joint account of *A* and *B.*

(*ii*) Each party will record only such transactions as entered by him on joint venture account *e.g.* if goods are purchased by *A*, it will be recorded in *A*'s books and not in the books of *B* and *C*.

(*iii*) In order to find out profit or loss made on the venture a 'Memorandum Joint Venture Account' will be opened. It is merely a combination of personal accounts, *i.e.,* debit side of personal accounts is posted on the debit side of Memorandum Joint Venture Account and credit side of personal accounts is posted on the credit side of Memorandum Joint Venture Account. However, such transactions which will not affect profit or loss on the venture *e.g.* receiving or sending of cash by one venturer from or to another will not be entered in his account.

Illustration 5.13. *A* and *B* entered into a joint venture as dealers in land with effect from 1st July, 2016. On the same day *A* advanced ₹90,000 and a plot of land measuring 9,000 square yards, was purchased with this money. It was decided to sell the land in smaller plots and a plan was got prepared at a cost of ₹1,000 paid by *B.* In the said plan 1/3 of the total area of the land was left over for public roads and the remaining land was divided into 6 plots of equal size. On 1st October, 2016, two of the plots were sold at ₹30 per square yard, the buyer deducting ₹1,000 per plot for stamp duty and registration expenses agreed to be borne by the sellers. The remaining plots were sold at a net price of ₹25 per square yard on 1st December, 2016. The sale proceeds of all the plots were received by *A*. After charging interest at 6% p.a. on the investments of *A* (allowing for money received by him) and allowing 1% on the net sale proceeds of plots as commission to *B*, the net profit of the joint venture is to be shared in proportion of 3/4 to *A* and 1/4 to *B*.

Draw up the Memorandum Joint Venture and personal accounts in the books of *A* and *B* showing the balance payable to one to the other.

Assume joint venture was completed on December 1.

Solution:

***A*'s Books**

Dr. JOINT VENTURE WITH *B* ACCOUNT *Cr.*

Particulars	₹	*Particulars*		₹
To Bank (Advance)	90,000.00	By Bank (Sale)		
To Interest (See Working Notes)	1,670.00	2,000 × 30 =	60,000	
To *P* & *L* A/c (Share of Profit)	47,812.50	*Less* @ ₹1,000 per plot		
To Bank (Final Settlement)	18,517.50		2,000	58,000.00
		By Bank (Sales) 4,000 × 25		1,00,000.00
	1,58,000.00			1,58,000.00

NOTES

B's Books

JOINT VENTURE WITH *A* ACCOUNT

Particulars	₹	Particulars	₹
To Bank (Expense)	1,000.00	By Bank (Final Settlement)	18,517.50
To Commission	1,580.00		
To *P* & *L* A/c (Share of Profit)	15,937.50		
	18,517.50		18,517.50

MEMORANDUM JOINT VENTURE ACCOUNT

Particulars		₹	Particulars	₹
To Purchases (*A*)		90,000	By Sales	1,58,000
To Interest (*A*)		1,670		
To Expenses (*B*)		1,000		
To Commission (*B*)		1,580		
To Profit				
A	47,812.50			
B	15,937.50	63,750		
		1,58,000		1,58,000

Working Notes:

Interest receivable by *A*:

July 1, 2016 to Dec. 1, 2016

$$₹90{,}000 \times \frac{6}{100} \times \frac{5}{12} = ₹2{,}250$$

Interest payable by *A*:

1st October, 2016 to Dec. 1, 2016

$$₹58{,}000 \times \frac{6}{100} \times \frac{2}{12} = ₹\ 580$$

Net interest receivable by *A* 1,670

Illustration 5.14. *A* and *B* enter into a joint venture sharing profits and losses equally. *A* purchased goods for ₹5,000 and *B* spent ₹1,000 for freight on 1st January, 2017. On the same day *B* bought goods worth ₹10,000 on credit. Further expenses were incurred as follows:

on 1.2.2017	₹	1,500 by *B*
on 1.3.2017	₹	500 by *A*

Sales were made against each as follows:

15.1.2017	₹	3,000 by *A*
31.1.2017	₹	6,000 by *B*
15.2.2017	₹	3,000 by *A*
1.3.2017	₹	4,000 by *B*

Creditors for goods were paid as follows:

1.2.2017 ₹ 5,000 by *A*

1.3.2017 ₹ 5,000 by *B*

On 31st March, 2017 the balance stock was taken over by *B* at ₹9,000. The accounts between the venturers were settled by cash payment on this date. The venturers are entitled to interest of 12% per annum.

Prepare necessary ledger accounts in the books of the venturers.

Solution:

MEMORANDUM JOINT VENTURE ACCOUNT

Particulars		₹	*Particulars*		₹
To Cost of goods:	*A*	5,000	By Sales:	*A*	6,000
	B	10,000		*B*	10,000
To Freight	*B*	1,000	By Interest	*B*	50
To Expenses	*A*	500	By Stock	*B*	9,000
To Expense	*B*	1,500			
To Interest	*A*	135			
To Profit:					
	A	3,457			
	B	3,458			
		25,050			25,050

Calculation of Interest

PAYMENTS BY *A*

Date	*Amount* ₹	*Month*	*Int. till 31.3.2017 @ 1% p.m.* ₹	₹
1.1.2017	5,000	3	150	
1.3.2017	500	1	5	
1.2.2017	5,000	2	100	255

AMOUNTS RECEIVED BY *A*

15.1.2017	3,000	2 1/2	75	
15.2.2017	3,000	1 1/2	45	120
	Net Interest due to *A*			135

PAYMENTS BY *B*

1.1.2017	1,000	3	30	
1.2.2017	1,500	2	30	
1.3.2017	5,000	1	50	110

AMOUNT RECEIVED BY *B*

31.1.2017	6,000	2	120	
1.3.2017	4,000	1	40	160
	Net Interest due to *B*			50

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***A*'s Ledger**

JOINT VENTURE WITH *B* ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
2017			2017		
Jan. 1	To Bank (Purchase)	5,000	Jan. 15	By Bank (Sale proceeds)	3,000
Feb. 1	To Bank (Purchase)	5,000	Feb. 15	By Bank (Sale proceeds)	3,000
Mar. 1	To Bank (Expenses)	500	Mar. 31	By Bank (amount received in settlement)	8,092
Mar. 31	To Interest A/c	135			
	To Profit & Loss A/c (Share of Profit)	3,457			
		14,092			14,092

***B*'s Ledger**

JOINT VENTURE WITH *A* ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
2017			2017		
Jan. 1	To Bank (Freight)	1,000		By Bank (Sales)	6,000
	To Creditors (goods bought on credit)	10,000*	Mar. 1	By *B* (Creditors paid)	5,000*
				By Bank (Sales)	4,000
Feb. 1	To Bank (Exp.)	1,500	Mar. 1	By Purchases A/c (stock taken over)	9,000
Mar. 31	To Profit & Loss A/c (share to profit)	3,458	Mar. 31	By Interest A/c	50
	To Bank (amount paid to *A* in settlement)	8,092			
-		24,050			24,050

*Alternatively only ₹5,000 be debited to Joint Venture Account in *B*'s Ledger.

Check Your Progress

3. What is the forward method for the calculation of days?
4. What is a red ink interest?
5. When is the periodical balance method used?

5.8 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. A promissory statement is an instrument in writing containing an unconditional undertaking signed by the maker to pay a certain sum of money only to the order of a certain person or to the bearer of the instrument.
2. A truncated cheque means a cheque which is truncated during the course of a clearing cycle, either by the clearing house or by the bank weather paying or receiving payment, immediately on generation of an electronic image for transmission, substituting the further physical movement of the cheque in writing.
3. In the forward method, the number of days is calculated from the due date of the transaction to the date of settlement.
4. Sometimes, the due date of a transaction falls after the closing date of the account current. In order to differentiate it from other products,

the products of such an amount is entered in red ink. This is the reason why such a product is known as "red ink interest" product.

5. Periodical balance method is usually followed in banks. The balance is struck after each transaction and is multiplied by the number of days up to the next transaction. Interest is charged for one day on the difference of the products. In case the rates of interest are different for debits and credits interest will be calculated for the debits of the products and the credits of the products separately. The difference of the two amounts will be the amount of interest chargeable to or receivable from the party concerned.

5.9 SUMMARY

- A Bank Reconciliation Statement is a statement reconciling the balance as shown by the bank pass book and the balance as shown by the cash book. The objective of preparing such a statement is to know the causes of difference between the two balances and pass necessary correcting or adjusting entries in the books of the firm.
- It highlights the causes of difference between the bank balance as per cash book and the bank balance as per pass book. Necessary adjustments or corrections can therefore be carried out at the earliest.
- A Bank Reconciliation Statement is prepared usually at the end of a period, i.e., a quarter, a half year or a year, as may be found convenient and necessary by the firm, taking into account the number of transactions involved.
- Section 5 of the Negotiable Instruments Act defines a Bill of Exchange as "an instrument in writing containing an unconditional order, signed by the maker, directing a certain person, to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument."
- Bills of Exchange and Promissory Notes, being Negotiable Instruments, are freely transferable. The transfer is made by endorsement and delivery in case of order instrument in case of non-payment of the bill, or promissory note can recover the money from all previous endorsers or the payee or the maker of the instrument.
- A Bill of Exchange is to be presented on maturity for payment. In case, the acceptor of the Bill refuses to make payment of the Bill on the date of maturity, it is said that the Bill of Exchange has been dishonoured.
- In case there are several transactions between two parties, it will be necessary to take into account the question of interest besides ensuring the correctness of amount due by one party to the other.
- It will be appropriate in such a case that each party should send a Statement of Account to the other party instead of settling each

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transaction individually. Such a statement when rendered in the form of an account by one party to another, duly setting out in chronological order the details of the transactions together with interest, is termed as an Account Current.

5.10 KEY WORDS

- **Bank Reconciliation Statement:** A statement reconciling the balance as shown by the Bank Pass Book and the balance as shown by the Cash Book.
- **Bill of Exchange:** An instrument in writing containing an unconditional order signed by the maker, directing the said person to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument.

5.11 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State the importance of bank reconciliation statement.
2. What are the fundamental concepts of bills of exchange?
3. State the utility of average due date.
4. What are the main features of a consignment transaction?

Long Answer Questions

1. What is a Bank Reconciliation Statement? How is it prepared? Submit a pro-forma of a Bank Reconciliation Statement with imaginary figures.
2. Differentiate between a Bill of Exchange and a Promissory Note.
3. Describe the computation of average due date.
4. Analyse the differences between joint venture and consignment.

5.12 FURTHER READINGS

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

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

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UNIT 6 ACCOUNTS OF NON-TRADING CONCERNS

Structure

6.0 Introduction
6.1 Objectives
6.2 Receipts and Payment Accounts, Income and Expenditure Accounts and Balance Sheet
 6.2.1 Receipts and Payments Account
 6.2.2 Income and Expenditure Account
 6.2.3 Balance Sheet
6.3 Items Peculiar to Non-Trading Concerns
6.4 Answers to Check Your Progress Questions
6.5 Summary
6.6 Key Words
6.7 Self Assessment Questions and Exercises
6.8 Further Readings

6.0 INTRODUCTION

The non-profit making organizations or institutions are different from the profit making institutions in several aspects. They do not have to purchase or sell goods or receive bills of exchange, nor do they have to make credit transactions. Most of their transactions are cash transactions and, therefore, they are not required to maintain detailed books of account like profit making concerns. However, they do maintain Cash Books and a minimum number of such other books which may be required for their purposes. For example, a Register of Members and a Minute Book are maintained in the case of a club or a society, a Students Fees Register is maintained in schools and colleges, a summary record of outstanding fees may be kept by an Advocate or a Chartered Accountant. At the end of the accounting period, a non-profit making institution also prepares its final accounts which include the following:

(*i*) Receipts and Payments Account

(*ii*) Income and Expenditure Account

(*iii*) Balance Sheet

6.1 OBJECTIVES

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

- Identify non-profit making organizations
- Get familiar with the statements or accounts which form final accounts of a non-profit making organizations

- Understand the meaning and preparation of Receipts & Payments Account and Income & Expenditure Account
- Identify and understand the accounting treatment of items which are peculiar to a non-profit making organization

6.2 RECEIPTS AND PAYMENT ACCOUNTS, INCOME AND EXPENDITURE ACCOUNTS AND BALANCE SHEET

In the preceding unit, we have explained the preparation of final accounts in the case of profit making organizations or institutions, *i.e.*, those organizations whose objective is to earn profit through business operations. However, there are organizations or institutions whose main objective is not to earn profit, but to provide service to the society. These institutions can broadly be divided into three categories:

(*i*) Institutions which work for the general welfare of their members, e.g., clubs, staff associations, residents' associations, etc.

(*ii*) Charitable institutions, *viz*., educational institutions, hospitals, etc.

(*iii*) Professional firms, *viz*., Chartered Accountants, Advocates, Tax Consultants, Doctors, etc.

In this unit, we first explain the preparation of final accounts which are applicable to all non-profit making organizations in general. However, some specific aspects relating to educational and professional institutions will be discussed later in the unit.

6.2.1 Receipts and Payments Account

Receipts and Payments Account is merely a summary of cash transactions under proper heads which have taken place during the accounting period. It is prepared at the end of the accounting period from the cash book. The Cash Book contains a record of cash receipts and cash payments in a chronological order while the receipts and payments account is a summary of the total cash receipts and the total cash payments received and made under different heads during a particular period. For example, if a club receives subscriptions from its members on different dates of the accounting year, they will be recorded on these dates separately in the Cash Book. However, Receipts and Payments Account will contain the total subscriptions received during the accounting year. Similarly, Cash Book contains the payment of salaries made on different dates of the month on different pages.

The main features of the Receipts and Payments Account can be summarised as follows:

(*i*) It is an abbreviated copy of the cash book. The cash and bank items are usually merged in one column. Thus, contra entries between cash and bank are eliminated.

(*ii*) It is a real account.

(*iii*) All cash receipts are recorded on the debit side while all the cash payments are recorded on the credit side.

(*iv*) It records all cash receipts and payments, irrespective of the fact whether they are of capital or revenue nature or whether they relate to the current year or not. Similarly, it records all the cash payments whether they are of capital or revenue nature or whether they relate to the current year or the next year. What is necessary is the receipts and the payments should have been received or made during the period to which the Receipts and Payments Account relates.

(*v*) It starts with the balance in the beginning of the accounting year and ends with the balance at the end of the accounting year.

Illustration 6.1. From the following particulars taken from the Cash Book of a Club, prepare a Receipts and Payments Account.

Particulars	₹
Opening Balance:	
Cash in Hand	100
Cash in Bank	500
Receipts:	
Subscriptions	3,300
Donations	260
Payments:	
Investment Purchased	1,000
Rent Paid	400
Postage and Stationery	70
Sundry Expenses	30
Closing Cash Balance	20

Solution:

RECEIPTS AND PAYMENTS ACCOUNT

for the year ended ...

Receipts		₹	*Payments*		₹
To Balance b/d			By Investments		1,000
Cash in Hand	100		By Rent		400
Cash in Bank	500	600	By General Expenses		210
To Subscriptions		3,300	By Postage & Stationery		70
To Donations		260	By Sundry Expenses		30
			By Balance c/d:		
			Cash in Hand	20	
			Cash at Bank (balancing figure)	2,430	2,450
		4,160			4,160

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6.2.2 Income and Expenditure Account

This may be described as an equivalent to the Profit and Loss Account. It performs the same functions and is compiled and constructed on precisely the same principles. Its essential features can be put as follows:

(*i*) It is a nominal account.

(*ii*) It records all the losses and expenses on its debit side while all the incomes and gains are recorded on its credit side.

(*iii*) The balance of this account represents either the excess of income over the expenditure (if the total of the credit side is more than that of the debit side) or the excess of expenditure over income (if the total of the debit side of the account is more than that of its credit side).

Illustration 6.2. From the information given in Illustration 6.1, prepare an Income and Expenditure Account.

Solution:

INCOME AND EXPENDITURE ACCOUNT

for the year ending on ...

Expenditure	₹	*Income*	₹
To Rent	400	By Subscriptions	3,300
To General Expenses	210	By Donations	260
To Postage and Stationery	70		
To Sundry Expenses	30		
To Excess of Income Over Expenditure	2,850		
	3,560		3,560

6.2.3 Balance Sheet

Balance Sheet in the case of a non-trading concern is prepared in the usual manner and contains particulars of all the assets and liabilities of the concern/institution on the date on which it was prepared. The excess of assets over liabilities is termed as Capital Fund. The Capital Fund is made up of excess of income over expenditure, and other income or surplus which might have been capitalised by the institution from time to time. Sometimes, two Balance Sheets may have to be prepared — (*i*) Balance Sheet in the beginning of the accounting year to ascertain the amount of Capital Fund in the beginning of the accounting year and (*ii*) Balance Sheet at the end of the accounting year to show the financial position of the Institution as on that date.

6.3 ITEMS PECULIAR TO NON-TRADING CONCERNS

The technique of preparing the Final Accounts of a non-trading concern is similar to that used for preparing the Final Accounts of a trading concern.

However, there are certain peculiar items in the case of a non-trading concern. The treatment of these items and their presentation in the Final Accounts are explained below:

1. **Subscriptions** In the case of trading concerns, subscriptions are usually given, *e.g.*, subscriptions for trade journals, subscriptions for membership to a club, etc. In the case of a non-trading concern, subscriptions are usually received. For example, a club receives subscriptions from its members and this may be a major source of income to the club. The Receipts, and Payments Account records the amount of actual subscriptions received while the Income and Expenditure Account records only the subscriptions which relate to the accounting period, whether received or not. Adjustments may, therefore, be required to find out the actual amount of income from subscriptions. The following illustrations are being given to clarify this point:

Illustration 6.3. With the following extracts from the Receipts and Payments Account and the additional information given, you are required to compute the income from subscriptions for the year ending 31st December, 2017 and show the subscription item in the Final Accounts of the Club.

RECEIPTS AND PAYMENTS ACCOUNT

for the year ending 31st December, 2017

Receipts	₹	*Payments*	₹
Subscriptions	10,000		

Additional Information:

(*i*) Subscriptions outstanding as on 31.12.2016, ₹2,000.
(*ii*) Subscriptions outstanding as on 31.12.2017, ₹4,000.
(*iii*) Subscriptions received in advance as on 31.12.2016, ₹3,000.
(*iv*) Subscriptions received in advance as on 31.12.2017, ₹2,000.

Solution:

INCOME AND EXPENDITURE ACCOUNT

for the year ending 31st December, 2017

Expenditure	₹	*Income*	₹	
		By Subscriptions	10,000	
		Add: Subscriptions outstanding as on 31.12.17	4,000	
		Add: Subscriptions received in advance as on 31.12.16	3,000	
			17,000	
		Less: Subscriptions outstanding as on 31.12.16	2,000	
			15,000	
		Less : Subscriptions received in advance as on 31.12.2017	2,000	13,000

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BALANCE SHEET

as on 31st December, 2017

Liabilities	₹	*Assets*	₹
Subscriptions received in advance (as on 31.12.2017)	2,000	Outstanding Subscriptions (as on 31.12.2017)	4,000

Illustration 6.4. From the following extracts from the Receipts and Payments Account and the additional information provided, compute the income from subscriptions for the year ending 31.12.2017 and show the subscription item in the Final Accounts of the club.

RECEIPTS AND PAYMENTS ACCOUNT

for the year ending 31st December, 2017

Receipts	₹	*Payments*	₹
To Subscriptions			
2016	1,800		
2017	10,000		
2018	4,000		

Additional Information:

(*i*) Subscriptions outstanding as on 31.12.2016: ₹200.

(*ii*) Subscriptions outstanding as on 31.12.2017: ₹3000.

(*iii*) Subscriptions received in advance as on 31.12.2016: ₹2000.

Solution:

INCOME AND EXPENDITURE ACCOUNT

for the year ending 31st December, 2017

Expenditure	₹	*Income*	₹	
		By Subscriptions	10,000	
		Add: Subscriptions outstanding as on 31.12.2017 (₹3,000 – 200)	2,800	
		Add : Subscriptions received in advance as on 31.12.2016	2,000	14,800

BALANCE SHEET

as on 31st December 2017

Liabilities	₹	*Assets*	₹	
Subscriptions received in advance as on 31.12.2017	4,000	Subscriptions outstanding on 31.12.2017		
		for 2016	200	
		for 2017	2,800	3,000

Notes:

(*i*) Subscriptions received for the year 2017 have been given separately in the Receipts and Payments Account. The amount does not include any subscriptions which had been received on account of the last year or the next year as was the case in the previous illustration.

(*ii*) Subscriptions outstanding as on 31.12.2017 amount to ₹3,000. It, therefore, includes subscriptions outstanding for the year 2016 amounting ₹200. The subscriptions outstanding for the year 2017, therefore, amounts to only ₹2,800.

In case the question had stated 'Subscriptions outstanding for 2017 is ₹3,000' this would have meant that the subscriptions amounting to ₹3,000 are outstanding only for the year 2017. In the Income and Expenditure Account, the subscriptions outstanding would have been taken as ₹3,000, and not as ₹2,800 as is the case. In the Balance Sheet, the total amount of subscriptions outstanding would have been shown at ₹3,200, *i.e.*, ₹3,000 for 2017 and ₹200 for 2016.

2. **Donations** A charitable institution may receive donations from time to time. The amount of donations may be taken as income or capitalised and taken to the Balance Sheet depending upon whether it is a specific donation or a general donation.

(*a*) *Specific donation* In case a donation has been received for a specific purpose, the donation is termed as a specific donation. For example, an institution may receive donation for the construction of a building or for giving prizes to the best sportsman. The amount of such donation, therefore, cannot be used for any other purpose. It should be taken to the Balance Sheet (on the liabilities side) and used only for the purpose for which it is meant, irrespective of the amount.

(*b*) *General donation* A donation not received for a specific purpose is termed as a General Donation. Its treatment depends upon the amount received. In case the donation is of a substantial amount, it can be fairly taken for granted that such donation is of a non-recurring nature and therefore, should be taken to the Balance Sheet on the liabilities side. However, if the donation is of a small amount and not meant for a specific purpose, it can be safety taken to the Income and Expenditure Account.

The size and nature of the institution will decide to a great extent, the amount of donation being small or big. For example, in the case of a hospital of a moderate size, a sum of ₹10,000 can be taken as a small donation, but for a badminton club, the amount of ₹10,000 is quite substantial and therefore, it will be proper to take the amount of such donation received to the Balance Sheet.

Illustration 6.5. Following are the extracts from the Receipts and Payments Account of a sports club. You required to show the different items in the Income and Expenditure Account and the Balance Sheet of the club after taking into account the additional information given.

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RECEIPTS AND PAYMENTS ACCOUNT

for the year ending 31st December, 2017

Receipts	₹	*Payments*	₹
To Donations for Pavilion	5,000		
To Subscriptions for Governor's Party	2,000		
To Donations	100		

Additional Information:

(*i*) Amount spent on Pavilion ₹1,000.

(*ii*) Outstanding subscriptions for Governor's Party: ₹500.

Solution:

INCOME AND EXPENDITURE ACCOUNT

for the year ending 31st December, 2017

Expenditure	₹	*Income*	₹
Subscriptions	10,000	By Donations	100

Balance Sheet

as on 31st December, 2017

Liabilities	₹	*Assets*	₹
Fund for Pavilion (donations received)	5,000	Outstanding subscriptions for	
Subscription for Governor's Party		Governor's Party	500
(including outstanding)	2,500	Pavilion (cost incurred)	1,000

Notes:

(*i*) The amount of donations received for the Pavilion is a specific donation and, therefore, has been taken to the liabilities side on the Balance Sheet.

(*ii*) The subscriptions received for the Governor's Party is also for a specific purpose, and, therefore, has been taken to the Balance Sheet. The amount of outstanding subscription has also been added to this amount and has been shown on both sides of the Balance Sheet.

(*iii*) The expenditure of ₹1,000 incurred on the construction of the Pavilion has been shown as an asset in the Balance Sheet. It is not to be subtracted from the Pavilion Fund. As a matter of fact, the Pavilion Fund was previously represented by cash, now it is partly represented by cash and partly by the cost incurred on the construction of the Pavilion so far.

3. **Special funds** An institution may keep special funds for some special purposes. For example, a sports club may keep a special fund for meting sports expenses of for awarding of sports prizes. In case such special funds are maintained, any income relating to such special funds should be added to these funds to the liabilities side on the Balance Sheet. Similarly, all expenses on account of these funds should be deducted out of these funds. In case of a deficit, the amount should be deducted from the Income and Expenditure Account. In case of a surplus, it will be better on account of convention of conservatism to keep it in the Balance Sheet or merge it with the Capital Fund.

However, whatever has been stated above is not applicable to any income which an institution may receive on account of General Fund. Income on account of General Fund investments can very well be taken to the Income and Expenditure Account.

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Illustration 6.6. Following is the information given in respect of certain items of a sports club. Your are required to show them in the Income and Expenditure Account and the Balance Sheet of the Club.

	₹
Sports Fund as on 1.1.2017	10,000
Sports Fund Investments	10,000
Interest on Sports Fund Investments	1,000
Donation for Sports Fund	4,000
Sports Prizes awarded	3,000
Expenses on Sports Events	1,000
General Fund	20,000
General Fund Investments	20,000
Interest on General Fund Investments	2,000

Solution:

INCOME AND EXPENDITURE ACCOUNT

for the year ending 31st December, 2017

Expenditure	₹	*Income*	₹
		By Interest on General Fund Investments	2,000

BALANCE SHEET

as on 31st December, 2017

Expenditure		₹	*Income*	₹
Sports Fund	10,000		Sports Fund Investments	10,000
Add: Interest on Sports Fund			General fund Investments	20,000
Investment	1,000			
Sports Fund Donations	4,000			
	15,000			
Less: Sports Prizes awarded	3,000			
	12,000			
Less: Expenses on Sports Events	1,000	11,000		
General Fund		20,000		

4. **Legacy** Legacy refers to the amount which one gets on account of a will. The amount received on account of a legacy is as good as donation and should generally be taken to the Balance Sheet (on the liabilities side) since it is generally of a non-recurring nature. However, small amounts received on account of legacy may be taken to the Income and Expenditure Account.

5. **Entrance fee** Entrance Fee or Admission Fee is usually charged by a club or a society or an educational institution to the new entrants. It is usually taken as an item of income. However, in the case of clubs and similar institutions some people favour capitalising the entrance fee on the ground that it is of a non-recurring nature. It is considered as being charged by the

club as a premium from the new members towards the capital cost involved in establishing and maintaining the club by older members. This argument, of course, is not applicable in the case of educational institutions or hospitals where the admission fee is charged from students or patients. [In the absence of any specific instructions in the question, the students are advised to take it as an item of income.]

6. **Fee for life membership** Certain institutions charge fees for making persons as life members. Such members have to pay the fee only once in their lifetime. Of course, they continue to enjoy the benefit of the institution throughout their life.

The amount received as life membership fee can e dealt in the accounts of the institution by any of the following methods:

(*i*) The amount received may be taken as a capital receipt and therefore be taken to the Balance Sheet on the liabilities side under the head "Life Membership Fee."

(*ii*) The amount received as life membership fee may be credited to a separate account, *viz*., "Life Membership Fee Account." The normal annual subscriptions may be transferred from the Life Membership Fee Account to the Income and Expenditure Account and the balance may be carried forward till it is exhausted. In the case of death of a member, the balance if any, in the Life Membership Fee Account may be transferred to the Capital Fund Account.

(*iii*) The amount received may be credited to the Life Membership Fee Account. The amount computed according to the average life of a member amy annually be transferred from this account to the Income and Expenditure Account.

Tutorial Note: The students are advised to adopt the first method in the absence of any specific instructions in an examination problem.

7. **Sale of old newspaper** The amount received on account of sale of old newspapers is of a recurring nature and should, therefore, be taken as income in the Income and Expenditure Account.

8. **Miscellaneous** Adjustments may have to be made in respect of certain items such as sports material, printing and stationery material, etc. to find out the actual materials used during a particular period for the concerned expenditure. This will be clear with the help of the following illustration.

Illustration 6.7. From the following information, compute the amount to be debited or credited to the Income and Expenditure Account in respect of the following items:

(*i*) Sports Material:	₹
Opening Stock as on 1.1.2017	2,000
Purchases of Sports Material during 2017	8,000

Stock of Sports Material as on 31.12.2017	3,000
Sale of Sports Material scrapped	50
(*ii*) Printing and Stationery Material:	
Opening Stock as on 1.1.2017	3,000
Purchase of Printing and Stationery	5,000
Stock of Printing and Stationery as on 31.12.2017	2,000
(*iii*) Tinned Provisions:	
Stock as on 1.1.2017	2,000
Purchase during the year	10,000
Stock as on 31.12.2017	3,000
Sale of tinned provisions	15,000

Solution:

INCOME AND EXPENDITURE ACCOUNT

for the year ended on 31st December, 2017

Expenditure		₹	*Income*	₹
To Sports Material used:			By Sale of Sports Material	50
Opening Stock	2,000		By Sale of Tinned Provisions	15,000
Add: Purchases	8,000			
	10,000			
Less: Closing Stock	3,000	7,000		
To Printing and				
Stationery Material used:				
Opening Stock	3,000			
Add: Purchases	5,000			
	8,000			
Less: Closing Stock	2,000	6,000		
To Cost of Tinned				
Provisions sold:				
Opening Stock	2,000			
Add: Purchases	10,000			
	12,000			
Less: Closing Stock	3,000	9,000		

In the following pages, we are giving comprehensive illustrations to cover the four different types of problems which are generally asked in the examinations.

These types are:

(*i*) Preparation of the Income and Expenditure Account and the Balance Sheet from the Receipts and Payments Account and additional information.

(*ii*) Preparation of Receipts and Payments Account from the Income and Expenditure Account with additional information.

(*iii*) Preparation of Balance Sheet from the Receipts and Payments Account and Income and Expenditure Account.

(*iv*) Preparation of correct statements/accounts from wrong statements/accounts.

Check Your Progress

1. State any two features of receipts and payment account.
2. What are the features of income and expenditure account?

Preparation of Income and Expenditure Account and Balance Sheet from Receipts and Payments Account, etc.

Illustration 6.8. The Receipts and Payments Account of Navkar Football Club for the year ended 31st March, 2017, was as under.

Receipts	₹	*Payments*	₹
To Balance b/d (1.4.16)	48,000	By Purchase of Balls	80,000
To Subscriptions received	2,46,000	By Tournament Fees	10,000
To Interest	2,000	By Affiliation Fees	2,000
To Sale of Furniture	10,000	By Rent of Playground	5,000
To Donations for Club Building	60,000	By Refreshment Expenses	4,000
		By Travelling Expenses	30,000
		By Investments Purchased at face value	1,00,000
		By Salary	12,000
		By Miscellaneous Expenses	8,000
		By Balance c/d (31.3.17)	1,15,000
	3,66,000		3,66,000

Prepare the Club's Income and Expenditure Account for the year ended 31st March, 2017, and the Balance Sheet as on that date, after taking the following information into account:

(1) The subscriptions received include ₹10,000, outstanding subscriptions of the year 2015-16. Subscriptions for the year 2016-2017 amounting to ₹16,000 is still outstanding from members. Some members have paid subscriptions for the year 2017-18 amounting to ₹8,000 which is included in the subscriptions received.

(2) Interest accrued but not received: ₹500.

(3) The book value of the furniture sold was ₹14,000.

(4) The rent of playground: ₹6,000 and salary: ₹5,000 of the year 2016-17 are still outstanding and rent of playground of the year 2015-16: ₹1,000 has been paid during this year.

(5) There is a stock of balls with the club valued at ₹4,000 as on 31st March, 2017.

Solution:

Navkar Football Club

INCOME AND EXPENDITURE ACCOUNT

for the year ended 31st March, 2017

Expenditure		₹	*Income*		₹
To Balls consumed	80,000		By Subscriptions	2,46,000	
Less: Closing stock	4,000	76,000	*Add*: Outstanding for		
To Tournament Fees		10,000	the current year	16,000	
To Affiliation Fees		2,000		2,62,000	
To Rent of Playground	5,000		*Less*: Outstanding for		
Add: Outstanding for			last year	10,000	
the current year	6,000			2,52,000	
	11,000		*Less*: Received in		
Less: Rent Outstanding			advance for next year	8,000	2,44,000
for last year	1,000	10,000	By Interest	2,000	
			Add: Interest due but		
To Refreshment of Players		4,000	not received	500	2,500
To Players' Travelling Expenses		30,000			
To Salary	12,000				
Add: Outstanding for					
the current year	5,000	17,000			
To Office Expenses		8,000			
To Loss on Sale of Furniture					
(14,000 – 10,000)		4,000			
To Excess of Income					
over Expenditure		85,500			
		2,46,500			2,46,500

Navkar Football Club

BALANCE SHEET

as on 31st March, 2017

Liabilities		₹	*Assets*	₹
Subscriptions received in advance		8,000	Cash	1,15,000
Outstanding Expenses:			Investments	1,00,000
Salary	5,000		Accrued Interest	500
Rent	6,000	11,000	Outstanding Subscriptions	16,000
Building Fund		60,000	Stock of Balls	4,000
Capital Fund as on 1.4.16	71,000			
Add: Excess of Income over				
Expenditure	85,500	1,56,500		
		2,35,500		2,35,500

Working Note:

Navkar Football Club

BALANCE SHEET

as on 1st April, 2016

Liabilities	₹	*Assets*	₹
Outstanding Rent for 2015-16	1,000	Cash	48,000
Capital Fund	71,000	Subscriptions Outstanding	10,000
(balancing figure)		Furniture	14,000
	72,000		72,000

NOTES

Illustration 6.9. The following is the Receipts and Payments Account of the Madras Sports Club for the year ended 31st December, 2017:

Receipts	₹	*Payments*	₹
To Balance 1.1.17	2,400	By Secretary's Salary	3,600
To Entrance Fees	500	By Upkeep of Grounds	2,100 (*c*)
To Subscriptions	8,700 (*a*)	By Wages of Groundsmen	2,400 (*d*)
To Proceeds of Concerts	1,500	By Ground Rent	150
To Interest on Investments	500 (*b*)	By Printing and Postage	200
By Sundry Repairs	175	By Balance as on 3 1.12.17	4,975
	13,600		13,600

(*a*) This item includes subscriptions outstanding brought over from the previous year ₹500.

(*b*) This amount includes ₹100 in respect of interest accrued in the preceding period.

(*c*) This item includes ₹300 applicable to the previous year.

(*d*) This item includes ₹150 applicable to the previous year.

Other ledger balances at the commencement of the financial period were:

(*i*) Capital Fund ₹40,100.

(*ii*) Income and Expenditure Account credit balance brought forward ₹8,900.

(*iii*) Club Premises and Grounds (as per valuation) ₹30,000.

(*iv*) Investments ₹10,000.

(*v*) Sports Material ₹2,450.

(*vi*) Furniture and Fixtures ₹4,000.

From the above particulars, prepare (*a*) a Balance Sheet at the commencement of the period, (*b*) Income and Expenditure Account for the period and (*c*) a Balance Sheet at the end of the period.

Entrances Fees are to be capitalised. The outstanding liabilities as on 31st December, 2017, were Wages ₹200 and Printing ₹100. Interest accrued and outstanding on investments were ₹120. Depreciate Club Premises by 2%, Furniture by 5% and Sports Equipment by $33^1/_3$%.

NOTES

Solution:

BALANCE SHEET

as on 1st January, 2017

Liabilities	₹	*Assets*	₹
Income and Expenditure Account:		Cash	2,400
Credit balance brought forward	8,900	Premises	30,000
Outstanding Expenses	450	Investments	10,000
Capital Fund (balancing figure)	40,100	Furniture and Fixtures	4.000
		Outstanding Interest	100
		Outstanding Subscriptions	500
		Sports Equipment	2,450
	49,450		49,450

INCOME AND EXPENDITURE ACCOUNT

for the year ending 31.12.2017

Expenditure	₹	*Income*	₹
To Secretary's Salary	3,600.00	By Subscriptions	8,200.00
To Wages of Groundsman	2,450.00	By Proceeds of Concerts	1,500.00
To Upkeep of Grounds	1,800.00	By Interest on Investments	520.00
To Printing and Postage	300.00		
To Sundry Repairs	175.00		
To Ground Rent	150.00		
To Depreciation:			
Sports Equipment	816.67		
Premises	600.00		
Furniture	200.00		
To Excess of Income over Expenditure	128.33		
	10,220.00		10,220.00

BALANCE SHEET

as on December 31, 2017

Liabilities		₹	*Assets*	₹
Capital Fund	40,100.00		Premises *less* depreciation	29,400.00
Add: Entrance fees	500.00	40,600.00	Furniture *less* depreciation	3,800.00
*Income and Expenditure A/c			Sports Equipment *less* depreciation	1,633.33
Balance b/d	8,900.00		Investments	10,000.00
Add: Income of current year	128.33	9,028.33	Interest Outstanding	120.00
Outstanding Expenses		300.00	Cash Balance	4,975.00
		49,928.33		49,928.33

* Attentively, the amount could have been added to the Capital Fund.

Preparation of Receipts and Payments Account from Income and Expenditure Account and the Balance Sheet

This requires finding out the Cash receipts and Cash payments received or made during the accounting year. It can be done by simply putting the things in reverse gear, *i.e.*, items which were added while preparing an Income and

NOTES

Expenditure Account from a Receipts and Payments Account should now be subtracted and vice versa.

Illustration 6.10. The Income and Expenditure accounts of the Delhi Club for the year 2017 is as follows:

INCOME AND EXPENDITURE ACCOUNT

for the year ended 31.12.2017

Expenditure	₹	*Income*	₹
To Salaries	4,750	By Subscriptions	7,500
To General Expenses	500	By Entrance Fees	250
To Audit Fees	250	By Contribution for Annual Dinner	1,000
To Secretary's Honorarium	1,000	By Profit on Annual Sports	750
To Printing and Stationery	450		
To Annual Dinner Expenses	1,500		
To Insurance and Bank Charges	150		
To Depreciation	300		
To Surplus	600		
	9,500		9,500

This account has been prepared after the following adjustments: ₹

	₹
Subscriptions outstanding at the end of 2016	600
Subscriptions received in advance on 31.12.2016	450
Subscriptions received in advance on 31.12.2017	210
Subscriptions outstanding as on 31.12.2017	750

The salaries outstanding at the beginning and end of 2017 were ₹400 and ₹450 respectively. General expenses include insurance prepaid to the extent of ₹60. Audit fees for 2017 are unpaid as yet. During 2017 audit fees for the year 2016 were paid amounting to ₹200.

The club owned a freehold lease of grounds valued at ₹10,000. The club had sports equipments valued at ₹2,600 as on 1.1.2017. At the end of the year, after depreciation, the equipment amounted to ₹2,700. In 2016, the club had raised a bank loan of ₹2,000. This was outstanding throughout 2017. On 31st December, 2017 cash in hand amounted to ₹1,600.

Prepare a Receipts and Payments Account for the year 2017 and a Balance Sheet at the end of the year.

Solution:

NOTES

Delhi Club

RECEIPTS AND PAYMENTS ACCOUNT

for the year ending 31.12.2017

Particulars		₹	Particulars		₹
To Balance b/d (balancing figure)		1,390	By Salaries	4,750	
To Subscriptions	7,500		*Less*: Outstanding at the end of 2016	450	
Add: Outstanding 2016	600			4,300	
	8,100		*Add*: Outstanding in the beginning of 2016	400	4,700
Less: Received in advance 2016	450		By General Expenses	500	
	7,650		*Add*: Prepaid	60	560
Add: Received in advance 2017	270		By Audit Fee for 2016		200
			By Secretary's Honorarium		1,000
	7,920		By Printing & Stationery		450
Less : Outstanding 2017	750	7,170	By Annual Dinner Expenses		1,500
To Entrance Fee		250	By Insurance and Bank Charges		150
To Contribution to Annual Dinner		1,000	By Sports Equipment purchased		400
To Profit on Annual Sports		750	By Balance: Cash in hand		1,600
		10,560			10,560

Sports Equipment

Particulars	₹	Particulars	₹
To Balance b/d	2,600	By Depreciation	300
To Cash (Purchases)	400	By Balance c/d	2,700
	3,000		3,000

Delhi Club

BALANCE SHEET

as on 31st December, 2017

Particulars		₹	Assets	₹
Subscription received in advance		270	Cash in Hand	1,600
Salaries Outstanding		450	Subscriptions Outstanding	750
Audit Fee Outstanding		250	Sports Equipments	2,700
Bank Loan		2,000	Freehold Grounds	10,000
Capital Fund:			Prepaid insurance	60
as on 1.1.2017	11,540			
Add: Surplus	600	12,140		
		15,110		15,110

Working Notes:

Delhi Club

BALANCE SHEET

as on 31st December, 2016

Liabilities	₹	Assets	₹
Subscription Received in Advance	450	Cash in Hand	1,390
Salaries Outstanding	400	Subscriptions Outstanding	600
Audit Fee Outstanding	200	Sports Equipments	2,600
Bank Loan	2,000	Freehold Grounds	10,000
Capital Fund	11,540		
	14,590		14,590

NOTES

Preparation of Balance Sheet from Receipts and Payments Account and Income and Expenditure Account

This requires the following steps:

1. Ascertain the amount of Capital Fund in the beginning of the accounting year by preparing an Opening Balance Sheet.
2. Compare each item of the Income and Expenditure Account with each item of the Receipts and Payments Account. This will help in ascertaining the amount of outstanding or prepaid expenses or incomes. For example, if the Income and Expenditure Account shows the amount of salary as ₹10,000 while the Receipts and Payments Account show a payment of only ₹8,000, it means that a salary of ₹2,000 is outstanding.
3. The fixed assets shown in the Opening Balance Sheet should be taken in the Closing Balance Sheet after charging depreciation as per the Income and Expenditure Account:
4. Sale or Purchase of any asset should be ascertained from the Receipts and Payments Account.
5. The amount of cash in hand as well as cash in bank, at the end of the accounting year, should be ascertained from the Receipts and Payments Account.

Illustration 6.11: The following particulars relate to the Ajmer Club:

Income and Expenditure Account

for the year ended 31.12.2017

Expenditure	₹	*Income*	₹
To Salaries	1,500	By Entrance Fees	10,500
To Printing & Stationery	2,200	By Subscriptions	15,600
To Advertising	1,600	By Rents	4,000
To Audit Fees	500		
To Fire Insurance	1,000		
To Depreciation on Sports Equipments	9,000		
To Excess of Income over Expenditures	14,300		
	30,100		30,100

Receipts and Payments Account

for the year ended 31.12.2017

Receipts	₹	*Payments*	₹
To Balance b/d	4,200	By Salaries	1,000
To Entrance Fees	10,500	By Printing & Stationery	2,600
To Subscriptions:		By Advertising	1,600
2016	600	By Fire Insurance	1,200
2017	15,000	By Investments	20,000
2018	400	By Balance c/d	7,800
To Rents Received	3,500		
	34,200		34,200

NOTES

The Assets on 1.1.2017 included Club Grounds and Pavilion ₹44,000; Sports Equipments ₹25,000 and Furniture and Fixtures ₹4,000. Subscriptions in arrears as on that date were ₹800.

Prepare the Balance Sheet as on 31.12.2017.

Solution:

Balance Sheet

as on 31st December 2017

Liabilities		₹	*Assets*	₹
Subscriptions received in advance		400	Club Grounds and Pavilion	44,000
Salaries Outstanding		500	Sports Equipments	16,000
Audit Fees Outstanding		500	Furniture & Fixtures	4,000
Capital Fund	78,000		Subscriptions Outstanding	800
Add: Excess of Income			Cash in Hand	7,800
over Expenditure	14,300	92,300	Rent Receivable	
			Outstanding	500
			Fire Insurance Prepaid	200
			Printing & Stationery	
			Prepaid	400
			Investments	20,000
		93,700		93,700

Working Note:

BALANCE SHEET

as on 1st January, 2017

Liabilities	₹	*Assets*	₹
Capital Fund (balancing figure)	78,000	Club Grounds and Pavilion	44,000
		Sports Equipments	25,000
		Furniture & Fixtures	4,000
		Subscriptions Outstanding	800
		Cash in Hand	4,200
	78,000		78,000

Note: ₹400 for Printing and Stationery was assumed to have been paid in advance. ₹200 was assumed in respect of Insurance for the next year.

Preparation of Correct Accounts from the Wrong Accounts Given

Illustration 6.12. The account given below has been submitted to you for audit. If you do not approve of it, criticise and amend it. Also prepare the Balance Sheet of the Club.

Able Checkers Society

INCOME AND EXPENDITURE ACCOUNT

for the year ending 31st Dec., 2017

Expenditure		₹	*Income*	₹
To Entrance Fees (21 @ 10)		210	By Salaries & Wages	675
To Fees for Life Membership			By Secretary's Salary	350
(5 @ ₹52)		260	By Rent, Rates etc.	1,265
To Annual subscription	1,565		By Printing & Postage	37
Annual subscription			By Repairs to Premises	124
paid in advance	65	1,630	By Interest on Bank Loan	57

To Interest on G.P. Notes	70	By Balance carried down	960
To Sundry Receipts	60		
To Balance from last year	1,238		
	3,468		3,468

NOTES

Treasurer's Note: The subscriptions in arrears amount to ₹120. Sundry Tradesmen's bills of ₹42 were outstanding as on 31st December, but have since been paid. The Secretary's salary although sanctioned by the resolution of the Committee has not yet been paid. The 3½% G.P. Notes of the face value ₹2,000 were purchased at ₹90. The lease of the club premises cost ₹2,124. The balance of the Bank Loan now outstanding is ₹1,000 secured by mortgage on the leasehold premises.

Solution:

Able Checkers Society

INCOME AND EXPENDITURE ACCOUNT

for the year ending 31st December, 2017

Expenditure	₹	*Income*		₹
To Salaries & Wages	675	By Entrance Fees		210
To Secretary's Salary outstanding	350	By Annual Subscription	1,630	
To Rent, Rates etc.	1,265	*Less:* Received in advance	65	1,565
To Printing and Postage	37	By Interest on G.P. Notes		70
To Repairs to Premises	124	By Sundry Receipts		60
To Interest on Bank Loan	57	By Excess of Expenditure over		
To Sundry Expenses outstanding	42	Income		645
	2,550			2,550

Able Checkers Society

BALANCE SHEET

as on 31.12.2017

Particulars		₹	*Particulars*	₹
Subscriptions recd. in advance		65	Cash in hand	1,190
Outstanding Secretary's salary		350	G.P. Notes	1,800
Outstanding Sundry Expenses		42	Outstanding Subscriptions	120
Bank Loan		1,000	Leasehold Club Premises	2,124
Fee for Life Membership		260		
Capital Fund	4,162			
Less: Excess of Expenditure				
over Income	645	3,517		
		5,234		5,234

Working Notes:

RECEIPTS & PAYMENTS ACCOUNT

Receipts	₹	*Payments*	₹
To Balance b/d	1,238	By Salaries & Wages	675
To Entrance Fees	210	By Rent, Rates etc.	1,265
To Fees for Life Membership	260	By Printing & Postage	37
To Subscriptions received (1,565 – 120 + 65)	1,510	By Repairs to Premises	124
To Interest on G.P. Notes	70	By Interest on Bank Loan	57
To Sundry Receipts	60	By Balance c/d	1,190
	3,348		3,348

Balance Sheet

as on 1st January, 2017

Particulars	₹	*Particulars*	₹
Bank Loan	1,000	Cash in hand	1,238
Capital Fund	4,162	G.P. Notes	1,800
		Leasehold Club Premises	2,124
	5,162		5,162

Illustration 6.13. The chief accountant of "Best Club Limited" suddenly expired on December 31, 2017, and the following information were available on that date:

(*a*) The Books of Account were maintained improperly and the last Balance Sheet as on December 31, 2016 showed the following:

Assets:	₹	₹
Furniture and Fixtures	76,570	
Less: Depreciation to date	36,570	40,000
Bar Stocks	26,560	
Members' Subscription	720	
Bank Balance	96,820	
Cash in hand	1,900	1,26,000
Total		1,66,000
Liabilities:		
General Fund		1,52,540
Creditors for Bar Purchases		13,100
Members' Subscription in advance		360
Total		1,66,000

(*b*) Members of the club paid an annual subscription of ₹60. Duplicate receipts issued showed that as on December 31, 2017, 540 members had paid the current year's subscription, 10 members paid arrears of previous year and 5 members paid advance for 2018. Two members resigned without paying their arrears of previous year and as at the end of the year, there were 550 members as per the records.

(*c*) The Cash Book was not written up-to-date and the records showed that the following bills were paid:

	₹
Food for Bar	33,280
Sundry Expenses	5,440
Repairs and Renewals	2,400
Salaries	36,690
Stationery	2,290

(*d*) The Club's main source of Income was from bar sales and the bartender generally hands over daily cash collections to the accountant along with cash collection list. On enquiry, it was found that certain cash collection lists were misplaced or lost. The bartender stated that the average gross profit on bar sales were fifty per cent of sales. Bar stocks as on December 31, 2017 were ₹30,260 and cash on hand ₹125.

(*e*) Summarised Bank Statements showed the following:

NOTES

Particulars	₹	Particulars	₹
Balance as on 1.1.2017	96,820	Bar Purchases	2,39,040
Cash Deposited	3,92,310	Salaries	1,19,450
		Rent	62,420
		Power	12,570
		Telephone	910
		Repairs and Renewals	18,510
		Washing Machine	5,940
		Balance on 31.12.2017	30,290
Total	4,89,130	Total	4,89,130

(*f*) The accountant's records were searched and following unpaid bills were located:

	₹
Bar Purchases	62,540
Power	1,830
Stationery	2,170
Telephone	460

From the above inadequate date, you are required to prepare (1) an Income and Expenditure Account for the year ended December 31, 2017 and (2) a Balance Sheet as on that date after providing depreciation at 20 per cent on written down value of Fixed Assets.

Solution:

Best Club Ltd.

INCOME & EXPENDITURE ACCOUNT

as on 31st December, 2017

Expenditure	₹	*Income*		₹
To Bar Stock Consumed	2,84,780	By Subscriptions		33,000
To Bar Food	33,280	By Bar Sales	5,69,560	
To Sundry Expenses	5,440	*Less*: Pilferage	1,32,225	4,37,335
To Repairs & Renewals (₹2,400 + 18,510)	20,910	By Excess of Expenditure over		
To Salaries (₹1,19,450 + 36,690)	1,56,140	Income transferred to		
To Stationery (₹2,290 + 2,170)	4,460	General Fund		1,22,173
To Rent	62,420			
To Power (₹12,570 + 1,830)	14,400			
To Bad Debts	120			
To Telephone (₹910 + 460)	1,370			
To Depreciation*	9,188			
	5,92,508			5,92,508

Balance Sheet

as on 31st December, 2017

Liabilities		₹	*Assets*		₹
General Fund			Fixed Assets as on 1.1.17	76,570	
Balance as on 1.1.17	1,52,540		Additions		
Less: Excess of Exp. over			(Washing Machine at Cost)	5,940	
Income for the year	1,22,173	30,367		82,510	
			Less: Depreciation	45,758	36,752
Members Subscription in Advance			Bar Stocks		30,260
(See Subscription A/c)		300	Members Subscription Due		
Sundry Creditors		67,000	(see Subscription A/c)		240
			Bank Balance		30,290
			Cash in Hand		125
		97,667			97,667

*Depreciation 20% of (Furniture and Fixture `40,000 + Washing Machine `5,940) `45,940 = `9,188

NOTES

Working Notes:

(1) Sundry Creditors

	₹
(*i*) Bar Purchases	62,540
(*ii*) Power	1,830
(*iii*) Stationery	2,170
(*iv*) Telephone	460
	67,000

(2) Creditors for Bar Purchases

Particulars	₹	*Particulars*	₹
To Bank	2,39,040	By Balance b/d	13,100
To Balance c/d	62,540	By Purchases (Balancing figure)	2,88,480
	3,01,580		3,01,580

(3) BAR STOCKS

Particulars	₹	*Particulars*	₹
To Opening Balance	26,560	By Stocks Sold (Balancing figure)	2,84,780
To Purchases	2,88,480	By Closing Stock	30,260
	3,15,040		3,15,040

(4) BAR SALES

Particulars	₹
Cost of Goods sold	2,84,780
Profit (50% of sales)	2,84,780
	5,69,560

(5) RECEIPTS AND PAYMENTS ACCOUNT

Receipts		₹	*Payments*	₹
To Balance 1.1.17		1,900	By Bar Food	33,280
To Bar Sales	5,69,560		By Sundry Expenses	5,440
Less: Pilferage	1,32,225	4,37,335	By Repairs and Renewals	2,400
(Balancing figure)			By Salaries	36,690
To Members Subscription		33,300	By Stationery	2,290
			By Bank Deposits	3,92,310
			By Balance (31.12.17)	123
		4,72,535		4,72,535

(6) MEMBERS' SUBSCRIPTION ACCOUNT

Particulars	*No. of Members*	₹	*Particulars*	*No. of Members*	₹
To Balance b/d	12	720	By Balance b/d	6	360
To Income & Expenditure A/c	550	33,000	By Receipts:		
To Balance c/d	5	300	Current	540	32,400
			Arrears	10	600
			Advance	5	300
			By Bad Debts	2	120
			By Balance c/d	4	240
	567	34,020		567	34,020

NOTES

Check Your Progress

3. How are the receipts and payments accounts prepared from income and expenditure account and balance sheet?
4. How is the preparation of balance sheet done from receipts and payments account and income and expenditure account?

6.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The main features of the Receipts and Payments Account can be summarised as follows:
   (i) It is an abbreviated copy of the cash book. The cash and bank items are usually merged in one column. Thus, contra entries between cash and bank are eliminated.
   (ii) It is a real account.
2. The essential features of income and expenditure account can be put as follows:
   (i) It is a nominal account.
   (ii) It records all the losses and expenses on its debit side while all the incomes and gains are recorded on its credit side.
   (iii) The balance of this account represents either the excess of income over the expenditure (if the total of the credit side is more than that of the debit side) or the excess of expenditure over income (if the total of the debit side of the account is more than that of its credit side).
3. The preparation of receipts and payment account requires finding out the Cash receipts and Cash payments received or made during the accounting year. It can be done by simply putting the things in reverse gear, i.e., items which were added while preparing an Income and Expenditure Account from a Receipts and Payments Account should now be subtracted and vice versa.
4. This requires the following steps:
   - Ascertain the amount of Capital Fund in the beginning of the accounting year by preparing an Opening Balance Sheet.
   - Compare each item of the Income and Expenditure Account with each item of the Receipts and Payments Account. This will help in ascertaining the amount of outstanding or prepaid expenses or incomes.

- The fixed assets shown in the Opening Balance Sheet should be taken in the Closing Balance Sheet after charging depreciation as per the Income and Expenditure Account.
- Sale or Purchase of any asset should be ascertained from the Receipts and Payments Account.
- The amount of cash in hand as well as cash in bank, at the end of the accounting year, should be ascertained from the Receipts and Payments Account.

6.5 SUMMARY

- Receipts and Payments Account is merely a summary of cash transactions under proper heads which have taken place during the accounting period. It is prepared at the end of the accounting period from the cash book.
- The Cash Book contains a record of cash receipts and cash payments in a chronological order while the receipts and payments account is a summary of the total cash receipts and the total cash payments received and made under different heads during a particular period.
- Balance Sheet in the case of a non-trading concern is prepared in the usual manner and contains particulars of all the assets and liabilities of the concern/institution on the date on which it was prepared.
- The technique of preparing the Final Accounts of a non-trading concern is similar to that used for preparing the Final Accounts of a trading concern. However, there are certain peculiar items in the case of a non-trading concern.
- Legacy refers to the amount which one gets on account of a will. The amount received on account of a legacy is as good as donation and should generally be taken to the Balance Sheet (on the liabilities side) since it is generally of a non-recurring nature. However, small amounts received on account of legacy may be taken to the Income and Expenditure Account.
- The fixed assets shown in the Opening Balance Sheet should be taken in the Closing Balance Sheet after charging depreciation as per the Income and Expenditure Account:
- Sale or Purchase of any asset should be ascertained from the Receipts and Payments Account.
- The amount of cash in hand as well as cash in bank, at the end of the accounting year, should be ascertained from the Receipts and Payments Account.

6.6 KEY WORDS

NOTES

- **Income and expenditure account:** A final statement often prepared by non-profit making institutions to present their revenues and expenses for an accounting period, and shows the excess of revenues over expenses (or vice-versa) for that period.
- **Receipts and expenditure account:** An account often prepared by professionals, presenting their revenues on cash basis and expenses on mercantile basis for an accounting period to show the excess of receipts over expenditure (or vice-versa) for that period.
- **Receipts and payments account:** A summary of cash transactions, often prepared by non-profit making organizations, presenting receipts and payments for an accounting period and showing the excess of receipts over payments (or vice-versa) for that period.

6.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State whether each of the following statement is 'True or False'.
   (i) Receipts and Payments Account is a nominal account.
   (ii) Income, and Expenditure Account is a real account.
   (iii) Receipts and Payments Account starts with an opening balance.
   (iv) Income and Expenditure Account records all the incomes and expenses received or paid during the year in cash.
2. Select the most appropriate answer.
   (i) Donations received for a special purpose will be taken to the
      (a) Income and Expenditure Account.
      (b) Assets side of the Balance Sheet.
      (c) Liabilities side of the Balance Sheet.
   (ii) Receipts and Payments Account record receipts and payments of
      (a) Capital nature only.
      (b) Revenue nature only.
      (c) Both capital and revenue nature.
   (iii) Income and Expenditure Account is
      (a) a real account.
      (b) a normal account.
      (c) a personal account.

NOTES

Long Answer Questions

1. State the difference between Receipts and Payments Account and Income and Expenditure Account.
2. Explain the meaning of the following terms and show how you will deal with them while preparing the Final Accounts of a club. Your answer should be supported by proper examples:
   (a) Subscriptions (b) Entrance Fee
   (b) Life Membership Fee (d) Donations
   (e) Receipts for a Sports Fund (f) Loss on sale of an old fixed asset
   (g) Legacy.
3. Distinguish between 'Profit and Loss account' and 'Income and Expenditure account'.

6.8 FURTHER READINGS

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

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UNIT 7 PARTNERSHIP ACCOUNTS

NOTES

Structure

7.0 Introduction
7.1 Objectives
7.2 Meaning and Characteristics of Partnership
7.3 Final Accounts: Current and Drawing, Interest on Capital and Drawing and Salary and Commission
7.4 Fixed and Fluctuating Capitals
7.5 Answers to Check Your Progress Questions
7.6 Summary
7.7 Key Words
7.8 Self Assessment Questions and Exercises
7.9 Further Readings

7.0 INTRODUCTION

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

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

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

7.1 OBJECTIVES

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

- Understand the meaning of partnership;
- Enumerate the essential characteristics of partnership;

- Appreciate the importance of partnership deed;
- Get familiarised with the basic accounting problems concerning partnership firms

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7.2 MEANING AND CHARACTERISTICS OF PARTNERSHIP

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

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

   Partners must enter into the contract with a motive to earn and distribute amongst themselves profits of the business. Agreement to share losses is not essential. Agreement to share profits also implies an agreement to share losses.
3. **Business must be carried on by all or any of the persons concerned acting for all** Partners in a firm act in both the capacities of an agent as well as principal. Active partners act as agents and conduct the business for all the partners under an implied authority to do so by the latter. Partners are mutual agents for each other and principals for

themselves. A partner has an authority to bind his co-partners by his acts done in the ordinary course of the business of the firm. Partner's liability is not limited to his share in the business but it extends to his personal assets too.

Partnership Deed

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

Contents of the Deed

The deed usually contains the following information:

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

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

Provisions Affecting Accounting Treatment

The partnership deed is usually very elaborate. It covers all matters affecting the partnership business. However, *in the absence of any provision to the*

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contrary in the partnership deed/agreement, the following provisions govern the accounting treatment of certain items:

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

Check Your Progress

1. What is a deed of partnership?
2. How is partnership created?

7.3 FINAL ACCOUNTS: CURRENT AND DRAWING, INTEREST ON CAPITAL AND DRAWING AND SALARY AND COMMISSION

The method of preparing final accounts for the partnership firm is not different from the one followed for preparation of final accounts of a sole proprietary concern. Some of the important points to be taken care of while preparing the final accounts are as follows:

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1. Capital Accounts

There will be a separate capital account for each partner. For example, if *A*, *B* and *C* are three partners in a partnership firm, there will be three capital accounts, one each of *A*, *B* and *C*. The capital accounts may be maintained either on fixed or fluctuating capital system. This has been explained in detail later in the chapter.

2. Profit and Loss Appropriation Account

A separate Profit & Loss Appropriation Account may be prepared to show the distribution of profits among different partners. The amount of profit to be distributed is arrived at after making following adjustments:

(*a*) **Interest on capital** Interest will be allowed to each partner on the capital contributed by him. While computing such interest, due care must be taken of the capital introduced or withdrawn by a partner during course of an accounting year. The accounting entries for such interest on capital will be as follows:

(*i*) Interest on Capital A/c Dr.
To Partners' Capital A/c (individually)

(*ii*) Profit & Loss Appropriation A/c Dr.
To Interest on Capital A/c

Alternatively, only one entry may be passed in placed of the above two entries, as follows:

(*iii*) Profit & Loss Appropriation A/c Dr.
To Partners' Capital A/c (individually)

Illustration 7.1. *A*, *B* and *C* are partners in a firm. Their capital accounts as on 1.1.2016 were ₹1,00,000, ₹50,000 and ₹30,000 respectively. They are sharing profits and losses equally. Interest on capital is allowed at 12% p.a. On 1.7.2016, the partners decided that their capital should be ₹50,000 each. The necessary adjustment in the capital are to be made by introducing or withdrawing cash. Profit for the year ended on 31.12.2009 before charging interest on capital amounts to ₹50,000. You are required to prepare a Profit & Loss Appropriation Account showing the distribution of profit among the partners.

Solution:

NOTES

PROFIT AND LOSS APPROPRIATION ACCOUNT

for the year ending 31.12.2016

Particulars		₹	Particulars	₹
To Interest on Capital:			By Profit for the year	50,000
A	9,000			
B	6,000			
C	4,800	19,800		
To Net Profit transferred to Capital Accounts:				
A	10,067			
B	10,067			
C	10,066	30,200		
		50,000		50,000

Working Note:

COMPUTATION OF INTEREST ON CAPITAL

			₹	*Total*
A	$\frac{1,00,000 \times 12 \times 6}{100 \times 12}$	=	6,000	
	$\frac{50,000 \times 12 \times 1}{100 \times 2}$	=	3,000	9,000
B	$\frac{50,000 \times 12}{100}$	=		6,000
C	$\frac{30,000 \times 12 \times 6}{100 \times 12}$	=	1,800	
	$\frac{50,000 \times 12 \times 6}{100 \times 12}$	=	3,000	4,800

Interest on capital is allowed to partners on the capital balances standing to their credit in the beginning of the accounting year. Of course, as explained above, suitable adjustments are made for the capital introduced or withdrawn by a partner during the course of the accounting year. In case, in an examination question, information regarding capitals of partners in the beginning of the accounting year has not been given, such capitals will have to be found out by making suitable adjustments and interest will have to be charged accordingly. The following illustration clarifies this point.

Illustration 7.2. *A* and *B* are partners in a partnership business sharing profits and losses in the ratio of 3 : 2. They are entitled to interest on capital @ 10% p.a. Balance Sheet at the end of 31.12.2016 of the firm was as follows:

BALANCE SHEET

Liabilities	₹	Assets	₹
Capital Accounts:		Sundry Assets	40,000
A	20,000	Drawings of *A*	5,000
B	15,000		
Profit & Loss Appropriation Account	10,000		
	45,000		45,000

NOTES

During the year, *A* withdrew ₹5,000 while *B* withdrew ₹3,000. Profits for the year 2009 before charging interest on capital amounted to ₹15,000. You are required to calculate interest on capital due to partners, prepare a Profit & Loss Appropriation A/c, Capital Accounts of Partners and revised balance sheet of the firm, presuming that no adjustments for interest on capital have so far been made.

Solution:

In order to calculate interest on capital, it will be necessary to compute the capitals of the partners in the beginning of the year. In the balance sheet, capitals of the partners at the end of the accounting year have been given. The drawings made by *A* have not been adjusted/deducted out of his capital since they are appearing in the balance sheet of the firm. Similarly, a part of the profit made in the year *i.e.*, ₹5,000 (*i.e.*, 15,000 – 10,000) has already been credited to the partners in the ratio of 3 : 2. In order to compute the capitals of the partners at the beginning, it will be necessary to make adjustments for the above items as given below:

Particulars		₹
A's Capital as on 31.12.2016		20,000
Less: Profit credited during the year		3,000
Capital as on 1.1.2016		17,000
	Interest on Capital @ 10% p.a.	1,700
B's Capital as on 31.12.2016		15,000
Add: Drawings made during the year		3,000
		18,000
Less: Profit credited during the year		2,000
Capital as on 1.1.2016		16,000
	Interest on Capital @ 10% p.a.	1,600

PROFIT AND LOSS APPROPRIATION ACCOUNT

for the year ending 31st December, 2016

Particulars		₹	*Particulars*	₹
To Interest on Capital			By Profit during the year	15,000
A		1,700		
B		1,600		
To Net Profit transferred to Partners' Capital A/cs				
A	7,020			
B	4,680	11,700		
		15,000		15,000

CAPITAL ACCOUNTS

for 2016

Particulars	*A* (₹)	*B* (₹)	*Particulars*	*A* (₹)	*B* (₹)
To Drawings	5,000	3,000	By Balance b/d	17,000	16,000
To Balance c/d	20,720	19,280	By Interest on Capital	1,700	1,600
			By Share of Profit	7,020	4,680
	25,720	22,280		25,720	22,280

REVISED BALANCE SHEET OF THE FIRM

as on 31.12.2016

Liabilities	₹	Assets	₹
Capital Accounts:		Sundry Assets	40,000
A	20,720		
B	19,280		
	40,000		40,000

NOTES

(*b*) **Interest on drawings** The partnership agreement may provide for charging of interest on drawings *i.e.*, the money withdrawn by the partners for their personal use out of the firm. All such interest is computed on the basis of the period for which the money remained outstanding from the partners during the course of the accounting year.

The accounting entries for the interest on drawings will be as follows:

(*i*) Partners' Capital Accounts (individually) Dr.

To Interest on Drawings A/c

(*ii*) Interest on Drawings A/c Dr.

To Profit & Loss Appropriation A/c

Alternatively, a single entry may be passed in place of the above two entries as follows:

(*iii*) Partners' Capital Accounts (individually) Dr.

To Profit & Loss Appropriation A/c

Computation of Interest on Drawings

(*i*) **When drawings are of uneven amounts and/or made at uneven time intervals** It will be convenient in such a case to calculate the interest on drawings according to the product method as illustrated below.

Illustration 7.3. *A*, *B* and *C* are three partners in a partnership firm since 1.1.2018. They are sharing profits and losses equally. According to the partnership agreement, interest on drawings is to be charged at the rate of 10% p.a. Drawings made by the partners during the year 2018 are as follows:

Date	*A* (₹)	*B* (₹)	*C* (₹)
January 1	5,000	3,000	2,000
April 1	3,000	2,000	3,000
September 1	5,000	4,000	2,000
December 1	2,000	1,000	1,000

The profits for the year amount to ₹30,000. You are required to compute the interest on drawings recoverable from the partners and prepare the Profit & Loss Appropriation Account showing the distribution of profits among the partners.

NOTES

Solution:

COMPUTATION OF INTEREST ON DRAWINGS

A			B			C		
Amount (1)	Period (2)	Product (3)	Amount (1)	Period (2)	Product (3)	Amount (1)	Period (2)	Product (3)
		(1 × 2)			(1 × 2)			(1 × 2)
5,000	12	60,000	3,000	12	36,000	2,000	12	24,000
3,000	9	27,000	2,000	9	18,000	3,000	9	27,000
5,000	4	20,000	4,000	4	16,000	2,000	4	8,000
2,000	1	2,000	1,000	1	1,000	1,000	1	1,000
		1,09,000			71,000			60,000

Amount of Interest (On the total product for one month):

$$A \quad \frac{1,90,000 \times 10 \times 1}{100 \times 12} = ₹908$$

$$B \quad \frac{71,000 \times 10 \times 1}{100 \times 12} = ₹592$$

$$C \quad \frac{60,000 \times 10 \times 1}{100 \times 12} = ₹500$$

PROFIT AND LOSS APPROPRIATION ACCOUNT

for the year ending 31st December, 20016

Particulars		₹	Particulars		₹
To Net Profit transferred to Capital Accounts (individually)			By Profit for the year		30,000
			By Interest on Drawings		
A	10,667		A	908	
B	10,667		B	592	
C	10,666	32,000	C	500	2,000
		32,000			32,000

(*ii*) **When drawings are of even amounts and made at equal time intervals** In case drawings are of even amounts and have been made at equal time intervals during the course of the year, the interest on drawings may be calculated on the basis of the following simple rules.

(*a*) In case it is presumed that money for drawings was withdrawn on a date middle of each month, interest should be charged for the six months on the full amount of drawings.

(*b*) In case it is presumed that money was withdrawn on the 1st day of each month, interest should be charged for 6½ months on the full amount of drawings.

(*c*) In case it is presumed that money was withdrawn at the end of each month, interest should be charged for 5½ months on the full amount of drawings.

It is to be noted that in each of the above cases, the total amount of interest, if calculated by the product method, will be the same as above.

NOTES

In the absence of any instruction in the question, it will be appropriate to work out the interest on the basis of presumption (*a*) above.

Illustration 7.4. *A* and *B* are partners in a business. During the course of 2016, *A* withdrew ₹12,000 while *B* withdrew ₹6,000 out of the business for personal use. Interest on drawings to be charged at 10% p.a. You are required to calculate the amount of interest on drawings making such presumptions as you deem necessary.

Solution:

Since the question does not mention the dates of each amount of drawings by each partner, it may be presumed that drawings were made by each partner evenly during the course of the accounting year. The interest on drawings may, therefore, be calculated according to any of the following three presumptions.

(*i*) Drawings were made in the middle of each month.

(*ii*) Drawings were made on the first of each month.

(*iii*) Drawings were made on the last date of the month.

The interest on drawings in each case will be as follows:

(*i*) *When drawings were made in the middle of each month*

A			*B*		
Amt. of Drawings (₹) 1	*Period (Months)* 2	*Product* 3 (1 × 2)	*Amt. of Drawings (₹)* 1	*Period (Months)* 2	*Product* 3 (1 × 2)
1,000	11.5	11,500	500	11.5	5,750
1,000	10.5	10,500	500	10.5	5,250
1,000	9.5	9,500	500	9.5	4,750
1,000	8.5	8,500	500	8.5	4,250
1,000	7.5	7,500	500	7.5	3,750
1,000	6.5	6,500	500	6.5	3,250
1,000	5.5	5,500	500	5.5	2,750
1,000	4.5	4,500	500	4.5	2,250
1,000	3.5	3,500	500	3.5	1,750
1,000	2.5	2,500	500	2.5	1,250
1,000	1.5	1,500	500	1.5	750
1,000	0.5	500	500	0.5	250
		72,000			36,000

Interest on drawings (On total product for one month):

$$A \quad \frac{72{,}000 \times 1}{12} \times \frac{10}{100} = ₹600 \qquad B \quad \frac{36{,}000 \times 1}{12} \times \frac{10}{100} = ₹300$$

Alternatively, the interest on drawings may be calculated on the basis of the average of the first and the last periods for which the drawings remained outstanding *i.e.*, $\frac{11.5 + 0.5}{2} = 6$ months as shown below:

$$A \quad \frac{12{,}000 \times 10 \times 6}{100 \times 12} = ₹600 \qquad B \quad \frac{6{,}000 \times 10 \times 6}{100 \times 12} = ₹300$$

NOTES

(*ii*) *When drawings were made on the first day of each month*

The interest on such drawings can be calculated either by the product method or by taking the average of period for which the first and the last instalments of drawings remained outstanding.

The first instalment of drawings remained outstanding for 12 months while the last instalment of drawings remained outstanding for one month. The interest on total drawings may, therefore, be charged for 6½ months *i.e.*, $\left(\frac{12+1}{2}\right)$

The amount of interest will, therefore, be calculated as follows:

Interest on Drawings of *A*	$\frac{12,000 \times 13 \times 10}{2 \times 12 \times 100} = ₹650$
Interest on Drawings of *B*	$\frac{6,000 \times 13 \times 10}{2 \times 12 \times 100} = ₹325$

The amount of interest on drawings will also be the same as given above, if calculated according to the product method.

(*iii*) *When drawings were made on the last date of each month*

Interest on such drawings can also be calculated either according to the product method or by taking the average of the periods for which the first instalment and the last instalment of drawings remained outstanding. In this case, the interest on total drawings would be charged for 5½ months *i.e.*, $\left(\frac{11+0}{2}\right)$

The amount of interest on drawings will, therefore, be calculated as follows.

Interest on Drawings of *A*	$\frac{12,000 \times 11 \times 10}{2 \times 12 \times 100} = ₹550$
Interest on Drawings of *B*	$\frac{6,000 \times 11 \times 10}{12 \times 2 \times 100} = ₹275$

Tutorial Note: In the illustration given above, the students may calculate interest on drawings by taking any one of the three presumptions, given above.

(*vi*) *When drawings of even amounts are made at equal Quarterly Time Intervals:*

(*a*) If it is presumed that even amount is withdrawn in the beginning of each quarter during the year, interest is charged on the whole amount for an average period of 7.5 months.

NOTES

$$\text{Interest on Drawings} = \frac{\text{Total Drawings} \times \text{Rate of Interest}}{100} \times \frac{7.5}{12}$$

The average of months for which period the drawings are made is computed as under:

$$\text{Average Period} = \frac{\text{Months left after First Drawings + Months left after Last Drawings}}{2}$$

$$= \frac{12+3}{2} = \frac{15}{2} = 7.5 \text{ months}$$

(*b*) If it is presumed that fixed even amount is withdrawn during the middle of each quarter during the year, interest is charged on the whole amount for an average period of 6 months.

$$\text{Interest on Drawings} = \frac{\text{Total Drawings} \times \text{Rate of Interest}}{100} \times \frac{6}{12}$$

The average of months for which period the drawings are made is computed as under:

$$\text{Average Period} = \frac{\text{Months left after First Drawings + Months left after Last Drawings}}{2}$$

$$= \frac{10.5+1.5}{2} = \frac{12}{2} = 6 \text{ months}$$

(*c*) If it is presumed that even amount is withdrawn at the end of each quarter during the year, interest is charged on the whole amount for an average period of 4.5 months.

$$\text{Interest on Drawings} = \frac{\text{Total Drawings} \times \text{Rate of Interest}}{100} \times \frac{4.5}{12}$$

The average of months for which period the drawings are made is computed as under:

$$\text{Average Period} = \frac{\text{Months left after First Drawings + Months left after Last Drawings}}{2}$$

$$= \frac{9+0}{2} = 4.5 \text{ months}$$

Illustration 7.5. Computed interest on drawings of Mr. Suneel @ 10% p.a. for the year ended 31st March, 2015 in each of the following alternative cases:

Case *X*: If he withdrew ₹60,000 at the beginning of each quarter.

Case *Y*: If he withdrew ₹60,000 at the end of each quarter.

Case *Z*: If he withdrew ₹60,000 during the middle of each quarter.

Solution:

Total Drawings in Cases X and Y = ₹ 60,000 × 4 = ₹ 2,40,000

Total Drawings in Case Z = ₹ 90,000 × 4 = 3,60,000

Case	*X*	*Y*	*Z*
Average Period	$= \frac{12+3}{2} = 7.5$ months	$= \frac{9+0}{2} = 4.5$ months	$= \frac{10.5+1.5}{2} = 6$ months
Interest on Drawings	₹ 2,40,000 × $\frac{7.5}{12} \times \frac{10}{100}$ = ₹ 15,000	₹ 2,40,000 × $\frac{4.5}{12} \times \frac{10}{100}$ = ₹ 9,000	₹ 3,60,000 × $\frac{6}{12} \times \frac{10}{100}$ = ₹ 18,000

NOTES

(*v*) *If even amount is withdrawn every half year:*

(*a*) If it is presumed that drawing amount is withdrawn at the beginning of each half year, interest will be charged on the total drawings for 9 months computed as follows:

$$\text{Average Period (in months)} = \frac{\text{Time left after first drawing + Time left after second drawing}}{2}$$

$$= \frac{12 + 6}{2} = 9 \text{ months}$$

(*b*) If it is presumed that even amount is withdrawn in the middle of each half year, Interest will be charged for $\frac{9+3}{2}$ = 6 months.

(*c*) If it is presumed that even amount is withdrawn at the end of each half year, Interest will be charged for $\frac{6+0}{2}$ = 3 months

Illustration 7.6. Calculate interest on drawings of Vimal if he withdrew ₹ 48,000 in year withdrawn evenly (*i*) at beginning of each half year (*ii*) in the middle of each half year (*iii*) at end of each half year. Rate of interest is 10% p.a.

Solution:

Half Yearly Drawings for a year when

(*a*) Drawings are made in the beginning of each period (half-year)

$$\text{Interest on drawings} = \frac{\text{Amount} \times \text{Rate}}{100} \times \frac{9}{12}$$

$$= 48{,}000 \times \frac{10}{100} \times \frac{9}{12} = ₹\ 3{,}600$$

(*b*) Drawings are made in the middle of each period (half-year)

$$\text{Interest on drawings} = \frac{\text{Amount} \times \text{Rate}}{100} \times \frac{6}{12}$$

$$= 48{,}000 \times \frac{10}{100} \times \frac{6}{12} = ₹\ 2{,}400$$

(*c*) Drawings are made in the middle of each period (half-year)

$$\text{Interest on drawing} = \frac{\text{Amount} \times \text{Rate}}{100} \times \frac{3}{12}$$

$$= 48{,}000 \times \frac{10}{100} \times \frac{3}{12} = ₹\ 1{,}200$$

(*vi*) If fixed amount is withdrawn every month during 6 months, total interest on total drawings made for 6 months will be computed as under:

(*a*) If withdrawal is presumed to be in the beginning of each month:

$$\text{Average Period} = \frac{6+1}{2} = \frac{7}{2} = 3.5 \text{ months}$$

$$\text{Interest on Drawings} = \text{Total Drawings} \times \frac{\text{Rate}}{100} = \frac{3.5}{12}$$

(*b*) If withdrawal is presumed to be in the middle of each month:

$$\text{Average Period} = \frac{5.5 + 0.5}{2} = \frac{6}{2} = 3 \text{ months}$$

Interest on Drawings = Total Drawings × $\frac{Rate}{100} = \frac{3}{12}$

(*c*) If withdrawal is presumed at the end of each month:

Average Period = $\frac{5+0}{2}$ = 2.5 months

Interest on Drawings = Total Drawings × $\frac{Rate}{100} = \frac{2.5}{12}$

NOTES

Illustration 7.7. Calculate the interest in drawing if *A*'s drawing up are ₹ 48,000 in a period of 6 months withdrawn evenly if drawing up are made (*a*) in the beginning of each month (*b*) in the middle of each month and (*c*) at the end of each month. The rate of interest is 10% p.a.

Solution:

Total Interest for monthly drawings for 6 months

(*a*) Drawings are made in beginning of each month

Total Interest = Amount × $\frac{Rate}{100} = \frac{3.5}{12}$

= 48,000 × $\frac{10}{100} = \frac{3.5}{12}$

= ₹ 1,400

(*b*) Drawings are made in beginning of each month

Total Interest = Amount × $\frac{Rate}{100} = \frac{3}{12}$

= 48,000 × $\frac{10}{100} = \frac{3}{12}$ = ₹ 1,200

(*c*) When drawings are made at the end of each month

Total Interest = Amount × $\frac{Rate}{100} = \frac{3}{12}$

= 48,000 × $\frac{10}{100} = \frac{2.5}{12}$ = ₹ 1,000

The rules given above for charging interests on drawings for a period can be summarized as under:

S. No.	*Case*	*Monthly Drawings for 12 Months*	*Quarterly Drawings for 12 Months*	*Half-Yearly for 12 Months*	*Monthly Drawings for 6 Months*
1.	When drawing are made in the beginning of each period	$\frac{12+1}{2}$ = 6.5 months	$\frac{12+3}{2}$ = 7.5 months	$\frac{12+6}{2}$ = 9 months	$\frac{6+1}{2}$ = 3.5 months
2.	When drawing are made in the Middle of each period	$\frac{11.5+0.5}{2}$ = 6 months	$\frac{10.5+1.5}{2}$ = 6 months	$\frac{9+3}{2}$ = 6 months	$\frac{5.5+0.5}{2}$ = 3 months
3.	When drawing are made in the end of each period	$\frac{11+0}{2}$ = 5.5 months	$\frac{9+0}{2}$ = 4.5 months	$\frac{6}{2}$ = 3 months	$\frac{5+0}{2}$ = 2.5 months

NOTES

(*d*) **Salaries to partners** Partnership agreement may provide for payment of salaries to partners who are taking active part in the management of the firm. Accounting entry for such salaries will be as follows:

(*i*) Salaries to Partners' A/c Dr.
To Partners' Capital A/c (individually)

(*ii*) Profit & Loss Appropriation A/c Dr.
To Salaries to Partners A/c

Alternatively, a single entry may be passed in place of two entries, as follows:

Profit & Loss Appropriation A/c Dr.
To Partners' Capital A/c (individually)

(*e*) **Distribution of profits** As stated in the preceding pages, in the absence of any agreement to the contrary, the profits and losses are shared equally by the partners. The share in profit or loss does not usually depend upon the capital of a partner in the firm. However, the partners may agree to share the profits and losses in the ratio of their capitals. In such an event, no problem will arise if the capitals of the partners remain fixed throughout the accounting year. However, in case of frequent withdrawals and introduction of capitals during the course of the accounting year, it will be appropriate to calculate the weighted average ratio keeping in view the time when the additional capital was introduced or withdrawn from the business. This will be clear with the following illustration.

The accounting entry for distribution of profits amongst the partners will be as follows:

Profit & Loss Appropriation A/c Dr.
To Partners' Capital A/cs (individually)

Illustration 7.8. *A* and *B* started a business on 1.1.2018 with capitals of ₹40,000 and ₹20,000 respectively. They agreed to share the profits and losses in the ratio of their capitals. The profits for the year 2018 amounted to ₹20,000. Following are the details regarding additional capital introduced or capital withdrawn by the partners during the year 2015:

	Capital Introduced		*Capital Withdrawn*	
	A	*B*	*A*	*B*
1.4.2018		5,000	10,000	
1.6.2018	4,000			8,000
1.11.2018	5,000			3,000

NOTES

Solution:

Computation of Total Capital Employed By *A* for One Month

Capital	*Months for which capital remained in the business*	*Product*
40,000	3	1,20,000
30,000	2	60,000
34,000	5	1,70,000
39,000	2	78,000
		4,28,000

Computation of Total Capital Employed By *B* For One Month

Capital	*Months for which capital remained in the business*	*Product*
20,000	3	60,000
25,000	2	50,000
17,000	5	85,000
14,000	2	28,000
		2,23,000

On the basis of capitals, profits are to be shared in a ratio of 428 : 223.

The profit of ₹20,000 will, therefore, be shared as follows:

			₹
A	$\frac{20,000 \times 428}{651}$	=	13,149
B	$\frac{20,000 \times 223}{651}$	=	6,851
			20,000

3. Commission to Partner

A partner may be allowed a certain percentage of net profits as commission for the services rendered by him to the partnership firm. Such commission is a charge against the profits of the firm and may be allowed on net profits before or after charge his commission as per the terms of the agreement. The computation of the commission in both the cases can be understood with the following examples :

Illustration 7.9. *P*, *Q* and *R* are partners in a partnership firm. As per the terms of the partnership agreement, the partners are to be remunerated as under:

(*a*) *P* is to be paid salary of ₹ 10,000.

(*b*) *Q* is to be given commission of 10% of net profits before charging any salary or commission due to any partner.

(*c*) *R* is entitled to commission of 10% after charging of salaries and commission to partners.

The net profits for the year before charging any salary or commission to a partner amounting to ₹ 60,000. The balance of

profits and losses are to be shared by the partners in the ratio of 1 : 2 : 2.

You are required to prepare the Profit and Loss Appropriation Account and show your workings.

NOTES

PROFIT AND LOSS APPROPRIATION ACCOUNT

for the year ending ....

Particulars		*Amount* ₹	*Particulars*	*Amount* ₹
To Salary to *P*		10,000	By Profit for the year	60,000
To Commission to *Q* (WN-1)		6,000		
To Commission to *R* (WN-2)		4,000		
To Profit transferred to Partners' Capital Accounts				
P	8,000			
Q	16,000			
R	16,000	40,000		
		60,000		60,000

Working Notes:

1. Computation of Commission payable to *Q*

$$\frac{60,000 \times 10}{100} = ₹\ 6,000$$

2. Computation of Commission payable to *R*

Firm's Profit before charging Commission and Salary			= ₹ 60,000
Less :	Salary to *P*	10,000	
	Commission to *Q*	6,000	= ₹ 16,000
			= ₹ 44,000

R is entitled to commission of 10% after charging of salary and commission to partners :

Let us, therefore, assume the profit after charging *R*'s commission is ₹ 100. This means profit before charging *R*'s commission will be ₹100 + 10 = 110. Hence, share of *R*'s commission will be 10/110 × 44,000 = ₹4,000.

4. Guarantee of Profit to a Partner

The partnership agreement may provide for a guaranteed amount as profit to a partner (or partners). In such a case, the term of guaranteed profit will be significant only in those years, when the guaranteed amount of profit is more than the share or profit which the partner (or partners) concerned would have got otherwise in the absence of any guarantee. In such an event, the partner (or partners) to whom guarantee has been given will get the guaranteed share of profit while the others will have to share the remaining profits (or bear the losses) as per the terms of the partnership agreement. This can be understood with the help of the following illustration.

Illustration 7.10. *A*, *B* and *C* are partners in a firm sharing profits in the ratio of 2 : 2 : 1. According to the terms of the partnership agreement, *C* has to get a minimum of ₹6,000 irrespective of the profits of the firm. Any excess payable to *C* on account of such guarantee shall be borne by *A*. Prepare the profit and loss appropriation account showing the distribution of profits among the partners in case the profits for the year 2016 are (*a*) ₹25,000 and (*b*) ₹40,000.

Solution:

(*a*) *In case the profit is ₹25,000:*

In this case, *C*'s guaranteed share is ₹6,000 while he would have got ₹5,000 in the absence of any such guarantee. The excess of the guaranteed amount over his normal share of profit will have to be borne by *A* as per the terms of partnership agreement. *B*'s share will remain unaffected on account of this guarantee. In other words, *B*'s share of profit will remain ₹10,000 (*i.e.,* 25,000 × 2/5). The Profit and Loss Appropriation Account can now be prepared as follows:

PROFIT AND LOSS APPROPRIATION ACCOUNT

for the year ending 31st December, 2016

Particulars		₹	*Particulars*	₹
To Profit transferred to Capital Account			By Net Profit for the year	25,000
A 2/5	10,000			
Less: Given to *C*	1,000	9,000		
B 2/5		10,000		
C 1/5	5,000			
Add: Received from *A*	1,000	6,000		
		25,000		25,000

(*b*) *In case the profits are ₹40,000:*

In this case, *C* is getting ₹8,000 (*i.e*., 40,000 × 1/5) as his share of profits. The amount is more than his guaranteed share. Hence, he will get ₹8,000 and *A* will not have to make any sacrifice. The Profit and Loss Appropriation Account can now be prepared as follows:

PROFIT AND LOSS APPROPRIATION ACCOUNT

for the year ending 31st December, 2016

Particulars	₹	*Particulars*	₹
To Profit transferred to Partners' Capital A/c		By Net Profit for the year	40,000
A	16,000		
B	16,000		
C	8,000		
	40,000		40,000

NOTES

Illustration 7.11. Mehra and Ratnam are in partnership with capitals of ₹28,000 and ₹14,000 respectively sharing profits and losses as 2 : 1. Interest on capital @ 5% per annum and salary of ₹2,800 per annum to Ratnam are allowable.

Due to ill health, Mehra ceased to take active part in the business with effect from 1st January, 2016 and the following terms were agreed upon.

(1) That the Manager, Jahar, shall be taken as partner with a capital of ₹5,000, he being entitled to a salary of ₹5,250, per annum, the excess over ₹2,800 (the salary received by him as Manager) to be borne by Mehra personally,

(2) That Ratnam shall get a salary of ₹3,500 per annum,

(3) That Jahar shall be entitled to one-tenth share of profits and losses after charging interest on capitals and partners' salaries,

(4) That interest on capital shall be allowed @ 5% per annum.

The net profit for the year ended 31st December, 2016 was ₹22,400 before charging interest on capital and partners' salaries.

You are required to show the division of the profits for the year 2016 between the partners.

Solution:

Books of Mehra & Ratnam

PROFIT & LOSS APPROPRIATION ACCOUNT

for the year ending 31st December, 2016

Particulars		₹	Particulars	₹
To Ratnam's salary		3,500	By Net Profit b/d	22,400
To Jahar's salary		5,250		
To Interest on Capitals:				
Mehra	1,400			
Ratnam	700			
Jahar	250	2,350		
To Capital Accounts:				
Net Profit:				
Mehra (Balance)		6,045		
Ratnam (3/10 of 13,750 profit after interest and salaries (taking Jahar's salary to be ₹2,800)]		4,125		
Jahar 1/10 of ₹11,300, profit after interest and partners' salaries		1,130		
		22,400		22,400

The comprehensive illustration given in the following pages clarify further items peculiar to partnership final accounts as explained in the perceding pages.

7.4 FIXED AND FLUCTUATING CAPITALS

NOTES

Partners capital accounts can be maintained either on 'fixed capital system' or 'fluctuating capital system'.

In case of a fixed capital system, there are two accounts for each partner:

(*i*) Partner's Capital Account.

(*ii*) Partner's Current Account.

The partner's capital account is credited with the original amount of capital introduced by the partner into the business. It is to be credited subsequently with extra capital introduced by the partner or debited with the amount of capital permanently withdrawn by the partner. No other adjustments are made in this account.

The partner's current account is maintained for making all entries relating to interest, share of profit, drawings, etc. The balance in this account will go on fluctuating but the balance of the capital account will remain fixed. That is why the system is termed as "fixed capital system".

In case of fluctuating capital system there is only one account for each partner. This account is termed as his "Capital Account". All entries relating to introduction of fresh capital, drawings, interest, profit etc. are made in this account. The balance in the capital account, therefore, goes on fluctuating. The system is, therefore, called as 'fluctuating capital system'.

Illustration 7.12. *A* and *B* started a partnership business on 1st January, 2016 with capitals of ₹15,000 and ₹10,000 respectively. On 30th June, 2016, *A* introduced a further capital of ₹5,000. Drawings during the year amounted to ₹3,000 and ₹2,000 respectively for *A* and *B*. Interest on capital is to be allowed at 5% p.a. No interest is to be charged on drawings. *B* is to be allowed a salary of ₹500 p.m. The profit for the year before charging salary and interest amounted to ₹20,000.

You are required to prepare the accounts of the partners presuming:

(*i*) Capitals to be fixed, and

(*ii*) Capitals to be fluctuating.

NOTES

Solution:

PROFIT & LOSS APPROPRIATION ACCOUNT

for the year ending 31 December, 2016

Particulars	₹	Particulars	₹
To Interest on Capital:		By Net profit for the year	20,000.00
A (₹750 + ₹125)	875.00		
B	500.00		
To Salary:			
B	6,000.00		
To Net Profit:			
A	6,312.50		
B	6,312.50		
	20,000.00		20,000.00

When Capitals are Fixed:

Dr. CAPITAL ACCOUNTS *Cr.*

Date	Particulars	*A* ₹	*B* ₹	Date	Particulars	*A* ₹	*B* ₹
Dec. 31	To Balance c/d	20,000	10,000	Jan. 1	By Cash	15,000	10,000
				June 30	By Cash	5,000	—
		20,000	10,000			20,000	10,000

CURRENT ACCOUNTS

Date	Particulars	*A* ₹	*B* ₹	Date	Particulars	*A* ₹	*B* ₹
	To Drawings	3,000.00			By Interest	875.00	500.00
Dec. 31	To Balance c/d	4,187.50	12,812.50		By Salary		6,000.00
					By Net Profit	6,312.50	6,312.50
		7,187.50	12,812.50			7,187.50	12,812.50

When Capitals are Fluctuating:

CAPITAL ACCOUNTS

Date	Particulars	*A* ₹	*B* ₹	Date	Particulars	*A* ₹	*B* ₹
	To Drawings	3,000.00	2,000.00	1 Jan.	By Cash	15,000.00	10,000.00
31 Dec.	To Balance c/d	24,437.50	20,812.50	30 June	By Cash	5,000.00	
				31 Dec.	By Interest	875.00	500.00
					By Salary	—	6,000.00
					By Net Profit	6,437.50	6,812.50
		27,437.50	22,812.50			27,437.50	22,812.50

Check Your Progress

3. What is the interest on capital?
4. What two accounts are made in case of a fixed capital system?

7.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

NOTES

1. The document in writing containing the important terms of partnership as agreed by the partners between themselves is called the Deed of Partnership.
2. Partnership is created by an agreement. It is not necessary that the agreement should be in writing. It may be oral but to avoid future disputes it is always better to have it in writing.
3. Interest will be allowed to each partner on the capital contributed by him. While computing such interest, due care must be taken of the capital introduced or withdrawn by a partner during course of an accounting year.
4. In case of a fixed capital system, there are two accounts for each partner:
   - Partner's capital account
   - Partner's current account

7.6 SUMMARY

- Partnership form of business organisation came into existence on account of limitations of sole proprietary concerns. The major limitations of sole proprietary concerns are those of shortage of funds, uncertainty about existence, unlimited personal liability etc.
- The term 'firm' is merely a commercial notion. Law does not invest the firm with legal personality apart from its partners except for the purposes of assessment of income-tax. A 'firm' cannot become a member of another partnership firm though its partners can join any other firm as partners.
- A person cannot become a partner with himself. Reduction in the number of partners to one shall bring about compulsory dissolution of the firm.
- The relation of partnership arises from contract and not from status or by operation of law. Partners must enter into an agreement voluntarily to form a partnership.
- Partnership is created by an agreement. It is not necessary that the agreement should be in writing. It may be oral but to avoid future disputes it is always better to have it in writing.
- The method of preparing final accounts for the partnership firm is not different from the one followed for preparation of final accounts of a sole proprietary concern.

- Interest on capital is allowed to partners on the capital balances standing to their credit in the beginning of the accounting year.

NOTES

7.7 KEY WORDS

- **Partnership:** The relation between persons who have agreed to share the profits of business carried on by all and any of them acting for all.
- **Partnership Deed:** A document in writing containing the important terms of partnership as agreed by the partners between themselves.

7.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Differentiate between capital accounts and profit and loss appropriation account.
2. How does the relationship between partners arise?

Long Answer Questions

1. State the rule applicable to each of the following cases in the absence of a partnership agreement.
   (a) Salaries to partners
   (b) Interest on a loan given by a partner to the firm
   (c) Interest on capital
   (d) Sharing profit and losses
   (e) Interest on drawings
2. Define partnership. Explain its salient features.

7.9 FURTHER READINGS

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

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UNIT 8 REVALUATION OF ASSETS AND LIABILITIES DUE TO ADMISSION, RETIREMENT AND DEATH OF PARTNERS

Structure

8.0 Introduction
8.1 Objectives
8.2 Admission of a Partner
8.3 Retirement of a Partner
8.4 Death of a Partner
8.5 Answers to Check Your Progress Questions
8.6 Summary
8.7 Key Words
8.8 Self Assessment Questions and Exercises
8.9 Further Readings

8.0 INTRODUCTION

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

8.1 OBJECTIVES

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

- Identify the accounting problems arising on admission of a partner
- Appreciate the need for making different accounting adjustments on admission of a partner
- State the circumstances under which a partner may retire from the firm
- Identify the accounting problems on retirement or death of a partner

8.2 ADMISSION OF A PARTNER

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

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

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

(*a*) the reconstituted firm has assumed the liability to pay the debt; and

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

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

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

Accounting Problems

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

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

(*ii*) Adjustment for goodwill.

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

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

(*v*) Adjustment for capital.

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

Adjustment in the Profit Sharing Ratio

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

1. The new partner may be given a certain proportion of the total profit or required to bear a certain proportion of the total loss and the old partners continue to share the balance of profit or bear the balance of loss in the old ratio in between themselves.

Illustration 8.1. *A* and *B* are partners in a business sharing profits and losses in the ratio of 3:2. They admit a new partner *C* with 1/5 share in the profits. Calculate the new profit sharing ratio of the partners.

Solution:

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

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

The shares of the two partners will therefore be:

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

Thus the new profit sharing ratio is

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

Illustration 8.2. *A* and *B* share profits in the ratio of 3 : 2. They admit *C* with 1/5 share in the profits, which he gets equally from *A* and *B*. Calculate the new profit sharing ratio.

Solution:

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

A's share of profit will therefore be:

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

B's share of profit will therefore be:

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

Thus, the new profit sharing ratio is:

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

Illustration 8.3. *A* and *B* are partners sharing profits in the ratio of 7 : 3. *A* surrenders1/7 of his share and *B* surrenders 1/3 of his share in favour of *C*, the new partner. What is the new ratio and what is the sacrificing ratio?

Solution:

Old Profit sharing ratio

A	: *B*
7	: 3

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

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

New Ratio:

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

NOTES

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

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

New Ratio:

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

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

Adjustment for Goodwill

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

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

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

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

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

Illustration 8.4. *A* and *B* are sharing profits in the ratio 3 : 2. They admit a new partner *C* with 1/5 share in the profits. At the time of admission of *C*, goodwill is appearing in the firm's books at ₹10,000 and it is agreed by all partners (including *C*) that it is properly valued. Should *C* pay anything for goodwill?

Solution:

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

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

NOTES

Illustration 8.5. With the information given in Illustration 8.4, pass the necessary journal entry if the goodwill is agreed to be valued at ₹15,000 on *C*'s admission.

Solution:

Goodwill A/c	Dr.	5,000	
To *A*'s Capital A/c			3,000
To *B*'s Capital A/c			2,000

(Being value of goodwill raised by ₹5,000)

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

Illustration 8.6. *A* and *B* are partners sharing profits in the ratio of 3 : 2. Goodwill appears in the books at ₹4,000. *C* is admitted as a partner and pays ₹1,000 as premium for 1/5 share of the profits of the firm. Journalise the above transaction presuming that the profit sharing ratio between *A* and *B* remains unchanged.

Solution:

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

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

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

Where goodwill account is not to be disturbed

As *C* is acquiring 1/5 share of goodwill for ₹1,000 the whole goodwill is ₹5,000, of which ₹4,000 already appears in the books. Hence, the value of undisclosed goodwill is ₹1,000 and *C*'s share, thereof is ₹200. This amount should be debited to his capital account and credited to *A* and *B* in the ratio in which they sacrifice on account of admission of *C*. The amount of ₹1,000 brought in by *C*, should then be credited to his capital account. *C*'s account thus gets a credit of ₹800. The journal entries will be:

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

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

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

When goodwill account is to be disturbed

There could be two alternatives:

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

The following journal entries will be passed in such a case on basis of information given in Illustration 8.6.

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

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

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

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

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

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

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

Illustration 8.7. *A* and *B* are sharing profits equally. They admit a new partner *C* with 1/5 share in profits. The new profit sharing ratio being 2 : 2 : 1. The value of firm's goodwill is ₹10,000. *C* brings his share of goodwill in cash. Pass the necessary journal entry.

Solution:

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

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

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

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

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

The amount of goodwill ₹2,000 (*i.e.*, 10,000 × 1/5) will, therefore, be shared by *A* and *B* equally. The journal entry will be:

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

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

The journal entries in such a case would be:

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

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

Illustration 8.8. *A* and *B* are two partners sharing profits in the ratio of 3 : 2. They admit a new partner *C*. The new ratio being 2 : 2 : 1 for *A*, *B* and *C* respectively. *C* brings ₹10,000 as capital and ₹5,000 as goodwill. Pass the necessary journal entries.

Solution:

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

The amount brought in by new partner for goodwill may be either wholly or partly withdrawn by the old partners. For example, if in the Illustration 8.7 *A* and *B* withdraw in cash 50% of the amount of goodwill brought in by *C*, the accounting entry will be:

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

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

Illustration 8.9. *A* and *B* are sharing profits in a business in ratio of 3 : 2. They admit *C* as a partner. The new ratio being 2 : 2 : 1 for *A*, *B* and *C* respectively. The value of the firm's goodwill is estimated at ₹15,000. *C* is not in a position to bring any cash for his share of goodwill. Pass a suitable journal entry for adjustment of goodwill in the partners' capital accounts.

Solution:

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

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

Illustration 8.10. With the information given in Illustration 8.9 state the journal entries to be passed when the partners first decide to raise the goodwill account and subsequently decide to write it off.

Solution:

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

(*iv*) The partners may desire to make adjustment for goodwill without raising the goodwill account at all. In such an event the following entry may be passed on the basis of data given in Illustration 8.9.

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

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

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

Illustration 8.11. *X, Y* and *Z* were partners sharing profits and losses as to *X* one-half, *Y* one-third and Z one-sixth. As from January 1, 2016, they agreed to admit *A* into partnership for a one-sixth share in profits and losses, which he acquired equally from *X* and *Y*, and he agreed to bring in ₹20,000 for his capital and ₹10,000 as premium for goodwill. *A* paid in his capital money but in respect of premium for goodwill he could bring in only ₹5,000 and in regard to the unpaid amount he agreed to the raising of goodwill account in the books of the new firm as would be appropriate in the circumstances.

You are requested to:

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

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

NOTES

Solution: (*i*)

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(as on January 1, 2016)

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

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

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

Illustration 8.12. *A* and *B* are equal partners in a partnership firm with capitals of ₹14,000 each. They admit a new partner *C* in the firm with 1/4 share in the profits of the firm. *C* is to bring ₹12,000 as his capital. No Goodwill account, at present, appears in the books of the firm. Pass the necessary journal entry for Goodwill in the books of the firm.

Solution:

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

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

AS 10, AS 26, Ind AS 38 and Goodwill

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

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

1. **AS 10: Accounting for Fixed Assets.** Goodwill should be recorded in the books only when some consideration in money or money's worth has

been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess should be termed as "goodwill" (*Para 36*).

2. **AS 26: Intangible Assets.** Internally generated goodwill should not be recognised as an asset. (*Para 35*). Such goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost (*Para 36*).
3. **Ind AS 38: Intangible Assets.** An intangible asset shall be recognized if, and only if:
   (*a*) It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
   (*b*) The cost of the asset can be measured reliably (*Para 21*).

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

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

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

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

Bank Account Dr.

To Old Partners' Capital A/cs

(In the sacrificing ratio)

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

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

Old Partners' Capital (A/cs) Dr.

To Bank A/c

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

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

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

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

New Partner's Capital A/c Dr.

To Old Partners' Capital A/cs

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

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

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

Adjustment for Revaluation of Assets and Liabilities

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

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

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

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

Asset/Liability A/c Dr.

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

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

P & *L* Adjustment A/c Dr.

To Asset/Liability A/c

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

P & *L* Adjustment A/c Dr.

To Old Partners Capital A/cs (Individually).

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

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

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

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

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

To Old Partners'Capital Accounts (in old ratio)

In case of loss the entry will be reversed.

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

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

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

In case of loss the entry will be reversed.

Illustration 8.13. Following is the Balance Sheet of Messers *A* and *B* who are sharing profits in the ratio of 3 : 2.

BALANCE SHEET

as on 31 December, 2016

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

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

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

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

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

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

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

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

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

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

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

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

BALANCE SHEET

as on January 1, 2017

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

Working Notes:

P & *L* ADJUSTMENT ACCOUNT

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

PARTNERS' CAPITAL ACCOUNTS

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

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

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

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

PARTNERS' CAPITAL ACCOUNTS

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

BALANCE SHEET

as on January 1, 2017

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

Working Notes:

MEMORANDUM *P* & *L* ADJUSTMENT ACCOUNT

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

Adjustments for Reserves and other Accumulated Profits

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

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

General Reserve Dr.

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

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

All Partners' Capital Accounts Dr.

(in the new ratio)

To *P* & *L* A/c

To General Reserve

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

Illustration 8.14. *A* and *B* are partners in a business sharing profits and losses in the ratio of 3 : 2. They admit a new partner *C* with 1/5 share in the profits. The following amounts represented undistributed profits among the partners on the date of admission of *C*:

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

You are required to pass the necessary Journal entries when:

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

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

Solution:

(*i*) JOURNAL ENTRIES

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

(*ii*) JOURNAL ENTRIES

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

OR

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

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

8.3 RETIREMENT OF A PARTNER

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

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

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

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

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

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

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

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

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

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

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

Accounting Problems

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

(*i*) Adjustment for Goodwill.

(*ii*) Revaluation of assets and liabilities.

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

(*iv*) Adjustments regarding profit sharing ratios.

(*v*) Payment to the retiring partner.

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

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

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

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

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

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

There could be several alternatives:

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

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

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

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

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

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

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

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

Illustration 8.15. *A, B* and *C* are partners in business sharing profits and losses in the ratio of 2 : 2 : 1. *C* retires from the firm and on this date the value of firm's goodwill (for which no account appears in the books) was determined at ₹10,000.

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

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

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

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

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

Solution:

JOURNAL

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

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

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

Illustration 8.16. *A, B* and *C* are sharing profits in a business in the ratio of 3 : 2 : 1.

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

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

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

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

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

Stock 25,000

Plant 52,000

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

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

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

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

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

Solution:

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

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

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

Dr. CAPITAL ACCOUNTS *Cr.*

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

BALANCE SHEET

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

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

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

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

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

Dr. PARTNERS' CAPITAL ACCOUNTS Cr.

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

BALANCE SHEET

Dr. as on 1st January, 2017 Cr.

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

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

The journal entry will be:

Reserves or P & L A/c Dr.

To Partners' Capital A/c

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

Reserves or P & L A/c Dr.

To Retiring Partners' Capital A/c

(only with his share)

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

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

Continuing Partners' Capital A/c Dr.
(in the ratio they gain)
To Retiring Partner's Capital A/c
(only with his share)

Illustration 8.17. *A, B* and *C* are partners in a business sharing profits and losses in the ratio of 2 : 2 : 1. *C* retires from the business. The General Reserve stands at ₹5,000 on the date of *C*'s retirement. *A* and *B* agree to share the future profits in the ratio of 3 : 2 respectively.

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

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

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

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

Solution:

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

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

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

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

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

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

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

or the ratio comes to 3 : 2.

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

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

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

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

Illustration 8.18. *A, B* and *C* were partners sharing profits and losses in the ratio of 3/6, 2/6 and 1/6.

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

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

Solution:

New Ratios

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

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

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

Gaining Ratio

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

Gaining Ratio = New Ratio – Old Ratio

When A retires

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

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

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

When B retires

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

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

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

When C retires

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

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

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

Illustration 8.19. *A, B* and *C* are partners in a business, sharing profits in the ratio of 2 : 2 : 1. *A* retires and he sells his share in the business for a sum of ₹6,000; ₹4,800 is paid by *B* and ₹1,200 by *C.* The profit for the year after *A*'s retirement amounts to ₹10,000.

You are required to give the necessary Journal entries.

Solution:

JOURNAL

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

Working Notes:

The new profit sharing ratio has been calculated as under:

B pays ₹4,800

C pays ₹1,200

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

B's share would therefore be:

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

C's share would therefore be:

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

Thus, the new ratio would be:

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

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

Retiring Partner's Capital A/c Dr.

To Retiring Partner's Loan A/c

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

Bank Dr.

To Continuing Partners' Capital A/c

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

Retiring Partner's Capital A/c Dr.

To Bank

(For cash paid to the retiring partner)

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

Retiring Partner's Capital Loan A/c Dr.

To Continuing Partner's Capital A/c

Payment in Instalments

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

In such a case there may be two situations:

(*i*) Equal instalments may only be regarding 'principal' amount. Interest on outstanding balance is paid in addition to the instalment amount (*See Illustration 8.20*).

(*ii*) Equal instalment may be both as regards interest as well as principal. In such a case the amount of instalment is calculated with the help of Annuity Table (*See Illustration 8.22*).

Illustration 8.20. The total amount due to the retiring partner *A* is ₹12,000. It is to be paid in ten equal annual instalments with interest at 10% p.a. The first instalment to be paid after the expiry of one year after from the date of retirement. Prepare *A*'s loan account for the first three years.

Solution:

A's LOAN ACCOUNT

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

Illustration 8.21. Nut, Bolt and Screw are partners sharing profits and losses in the ratio of 4 : 2 : 1.On 1st January, 2016, Screw retires. On that date, the capital accounts of the partners showed credit balances of Nut ₹12,000, Bolt ₹10,000 and Screw ₹9,000. It was provided in the Partnership Deed that in case of retirement, the retiring partner should be entitled to a share of the goodwill of the firm to be calculated at two years' purchase of the average profits of the last three years, and that the payment of the capital and share of goodwill to the retiring partner shall be made by annual instalment of ₹4,000 each, for the first two years and the balance in the last year, interest being calculated at 10% on the unpaid balances.

The Profit for the years 2013, 2014 and 2015 were ₹8,600, ₹7,600 and ₹4,800 respectively. The first instalment was paid on 31st December, 2016.

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

Solution:

Dr. SCREW'S CAPITAL ACCOUNT *Cr.*

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

Dr. SCREW'S LOAN ACCOUNT Cr.

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

Working Note:

Computation of Goodwill

Profits for the three years were:

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

Average Profit = 21,000/3 = ₹7,000

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

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

Illustration 8.22. *A, B* and *C* were carrying on business in partnership sharing profit and losses in the ratio of 3 : 2 : 1 respectively. On 31st December, 2015 Balance Sheet of the firm stood as follows:

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

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

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

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

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

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

NOTES

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

Solution:

JOURNAL

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

BALANCE SHEET
as on January 1, 2016

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

Dr. *B*'S LOAN ACCOUNT *Cr.*

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

8.4 DEATH OF A PARTNER

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

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

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

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

(*ii*) Share of goodwill.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Illustration 8.23. *A, B* and *C* are partners in a business sharing profits in the ratio of 2 : 2 : 1. *C* dies on 1st April 2016. The profit for the accounting year ending on 31st December, 2016 amounts to ₹16,000. Calculate the share of the deceased partner in profits of the firm.

Solution:

Profit for the year is ₹16,000

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

16,000 × 1/4 = ₹4,000

C's share will be 4,000 × 1/5 = ₹800.

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

Illustration 8.24. *A, B* and *C* are sharing profits in the ratio of 2 : 2 : 1. *C* dies on April 1, 2017. Sales for the year 2017 amount to ₹3,00,000 out of which sales of ₹1,00,000 amounted between the period from January 1, 2017 to April 1, 2017. The profit for the year amounted to ₹30,000.

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

Solution:

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

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

C's share will be:

$$10{,}000 \times 1/5 = ₹2{,}000.$$

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

Check Your Progress

1. How can we put the admission problems on admission of a new partner?
2. How is the amount standing to the credit of reserves treated?

8.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The accounting problems on admission of a new partner can be put as follows:
   (i) Adjustment in the profit sharing ratio.
   (ii) Adjustment for goodwill.
   (iii) Adjustment for revaluation of assets and liabilities.
   (iv) Adjustment for reserves and other accumulated profits.
   (v) Adjustment for capital.
2. The amount standing to the credit of Reserves, representing accumulated profits or balance in the Profit & Loss Account should be distributed among the old partners in the old profit sharing ratio.

8.6 SUMMARY

- Any change in the relations of the partners will result in the reconstitution of a partnership firm. The firm is, therefore, said to be reconstituted when there is admission, retirement or death of a partner or where a partnership firm gets amalgamated with another partnership firm.
- A newly admitted partner shall be liable only for the debts incurred or transactions entered into by the firm subsequent to his becoming a partner.

- A newly admitted partner will be entitled to share the profits or bear the losses with the other partners. Hence, the profit sharing ratio of the partners will change.
- Since the new partner gets a share in the profits of the firm, he should compensate the old partners for sharing the earning of the firm on account of the reputation or goodwill earned by the partnership firm so far.
- Sometimes adjustment may have to be made for undisclosed goodwill. This happens when goodwill account is already appearing in the books but the new partner is required to bring premium for sharing future profits of the firm. In such an event the goodwill brought in by the new partner will be utilised as basis for revaluation of goodwill.
- The assets and liabilities may have to be revalued on admission of a partner so that the profit or loss on account of improper valuation of the assets or liabilities is shared or borne only by the old partners.
- The accounting problems in the event of retirement of a partner can be put as follows:
    - o Adjustment for Goodwill.
    - o Revaluation of assets and liabilities.
    - o Adjustment regarding Reserves and other undistributed profits.
    - o Adjustments regarding profit sharing ratios.
    - o Payment to the retiring partner.
- According to Section 35 of the Partnership Act, a partnership firm may not be dissolved on the death of a partner.
- Where under a contract between the partners the firm is not dissolved by the death of a partner, the estate of the deceased partner is not liable for any act done or liability incurred after his death. No public notice is required for this purpose.

8.7 KEY WORDS

- **Memorandum Revaluation Account:** This is also known as Memorandum Profit & Loss Adjustment Account. It is similar to revaluation account except that it is only a memorandum record of increase or decrease in the values of assets and liabilities on reconstitution of a partnership firm. The assets and liabilities continue to appear at their old values in the balance sheet and entry is passed only with the net profit or loss made or suffered by the partners on reconstitution of the firm.
- **Revaluation Account:** This is also known as Profit & Loss Adjustment account. The account records any increase or decrease in the values

of assets and liabilities as agreed by the partners on reconstitution of a partnership firm. The balance of the account represents profit or loss made on revaluation to be shared by the partners.

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8.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State whether each of the following statements is 'True' or 'False':
   (i) A dormant partner has to give public notice of his retirement.
   (ii) The amount due to the retiring partner is transferred to his loan account in case it is not paid immediately.
   (iii) The amount due to the retiring partner on account of goodwill is debited to the continuing partners in their gaining ratio.
   (iv) In the event of death of a partner the amount realised on account of a joint life insurance policy is credited only to the deceased partner's executors account.
   (v) The retiring partner may claim a share in the profits of the firm even after his retirement of his accounts are not settled.
   (vi) The assets and liabilities not taken over by the new firm on amalgamation of two or more partnership firms, are transferred to partners' capital accounts in their profit sharing ratio.

Long Answer Questions

1. Why assets and liabilities are revalued on admission of a partner? Give imaginary entries covering such revaluation.
2. What could be the several alternatives regarding adjustment for goodwill in the event of admission of a partner?
3. How can a partner retire from a partnership firm? Is a retiring partner liable for liabilities incurred by the partnership firm after his retirement?

8.9 FURTHER READINGS

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

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BLOCK - III

BASICS OF COMPANY ACCOUNTS

UNIT 9 DISSOLUTION OF A PARTNERSHIP FIRM

Structure

9.0 Introduction
9.1 Objectives
9.2 Dissolution: Meaning, Modes and Settlement of Accounts
9.3 Sale of a Firm to a Company: Implications
9.4 Answers to Check Your Progress Questions
9.5 Summary
9.6 Key Words
9.7 Self Assessment Questions and Exercises
9.8 Further Readings

9.0 INTRODUCTION

On dissolution of the firm, the business of the firm ceases to exist since its affairs are would 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.

If all the partners are in agreement on dissolution, then the partnership firm can be dissolved. This type of dissolution is the most common type and is called as voluntary dissolution.

9.1 OBJECTIVES

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

- Differentiate between dissolution of partnership and dissolution of firm
- State the modes of dissolution of a firm
- Enumerate the rules regarding settlement of accounts of a dissolved firm
- Make appropriate accounting entries regarding dissolution of a firm

9.2 DISSOLUTION: MEANING, MODES AND SETTLEMENT OF ACCOUNTS

NOTES

Dissolution of partnership is different from dissolution of firm.

Dissolution of partnership: Any change in the relations of the partners is called dissolution of partnership. Thus, in all those cases where a partnership is reconstituted, there is a dissolution of the partnership. For example, in case there is a partnership between *X & Y,* and a new partner Z is admitted, the partnership between *X* and *Y* comes to an end and a new partnership among *X, Y* and Z comes into existence. Hence, in dissolution of partnership, the firm continues in a reconstituted form.

Dissolution of firm: The dissolution of partnership among all the partners of a firm is called the dissolution of the firm. In the case of dissolution of a firm, the business of the firm is closed down and its affairs are wound up. The assets are realised and the liabilities are paid off.

The dissolution of a partnership may or may not result in the dissolution of a firm but the dissolution of a firm will necessarily result in the dissolution of the partnership. For example, if there are three partners *A, B* and *C* in a business and *C* becomes insolvent, in the absence of any contract to the contrary, the firm will stand dissolved on the insolvency of *C*. This will automatically result in the dissolution of partnership. However, *A* and *B* may agree to continue the business of the firm. In such a case, the firm continues though in a reconstituted form and, therefore, there is only the dissolution of the partnership.

Modes of Dissolution of a Firm

A partnership firm may be dissolved with or without the intervention of the court.

1. Dissolution without the Intervention of the Court

A partnership firm may be dissolved without the intervention of the court in any of the following ways:

(*a*) **Dissolution by agreement** A partnership firm comes into existence by mutual agreement and, therefore, it can also be dissolved by the mutual consent of all partners.

(*b*) **Compulsory dissolution** In the following cases a partnership firm will have to be compulsorily dissolved

(*i*) by the adjudication of all the partners or of all the partners but one as *insolvent,* or

(*ii*) by the business of firm becoming *unlawful* due to the happening of any such event.

(*c*) **Dissolution on the happening of certain contingencies** In the absence of any contract to the contrary, a firm will be dissolved on the happening of any of the following contingencies:

(*i*) on the *expiry of the fixed period* for which the firm was constituted;

(*ii*) on the *completion of the adventure* or undertaking for the carrying out of which the firm was constituted;

(*iii*) on the *death* of a partner; and

(*iv*) on the *adjudication* of a partner as *insolvent.*

(*d*) **Dissolution by notice** When a partnership is at will, the firm may be dissolved by any partner giving a notice in writing to all the other partners of his intention to dissolve the firm.

The firm will be taken to be dissolved from the date as specified in the notice, or if no date is mentioned from the date of the communication of the notice to the last of the partners.

2. Dissolution by the Court

Following are the cases when a court, on a suit by a partner, will intervene and may order for the dissolution of the firm.

(*a*) **Insanity** When a partner has become *of unsound mind.* Lunacy of a partner does not of itself dissolve the partnership but it will be a ground for dissolution at the instance of other partners.

(*b*) **Permanent incapacity** When a partner, other than the partner suing, has become, in any way, *permanently incapable* of performing has duties as a partner.

(*c*) **Misconduct** When a partner, other than the partner suing, is guilty *of misconduct* which may prejudicially affect the carrying on of the business. It is not necessary that the conduct complained of, should be directly connected with the business *e.g.,* conviction of a partner for travelling on the railway without ticket with intention to defraud.

(*d*) **Breach of agreement** When a partner, other than the partner suing, *wilfully* or *persistently commits breach of agreement* regarding the conduct of business or the management of the affairs of the firm or he conducts himself in matters relating to the business in such a manner that other partners cannot reasonably carry on business in partnership with him. Court will interfere only when the misconduct is of such a nature as will destroy the mutual confidence between the partners.

(*e*) **Transfer of interest** When a partner, other than the partner suing, has *transferred* the whole of his interest in the firm to a third party or has allowed his share to be charged or sold by the court.

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(*f*) **Loss in business** When the business of the firm cannot be *carried on except at a loss.*

(*g*) **Just and equitable** When the court considers any other ground to be *just and equitable* for the dissolution of the firm. *e.g.,* deadlock in the management, partners stop talking to each other, disappearance of the *substratum* of the business etc.

Liabilities of a Partner after Dissolution of the Firm

Partners shall continue to be liable as such to third parties for any act done by any of them which would have been an act of the firm if done before the dissolution, till they give a *public notice* of the dissolution of the firm. But a deceased or an insolvent or a dormant partner shall not be liable for acts done after he has ceased to be a partner. In his case public notice of dissolution need not be given.

Settlement of Accounts

The Partnership Act incorporates various sections (*viz.,* 48 and 55) laying down the following rules for the settlement of accounts and division of profits and losses after dissolution. However, these rules may be changed by and are subject to an agreement entered into by the partners.

1. In settling the accounts of a firm after its dissolution, the goodwill shall be included in the assets and may be sold either separately or along with other property of the firm and any partner may make an agreement with the buyer that such a partner will not carry on any business similar to that of the firm for a specified period of time or within specified local limits and such an agreement is valid if the restrictions imposed are reasonable (Sec. 55).
2. Losses, including deficiencies of capital, shall be paid first out of profit, next out of capital, and lastly, if necessary by the partners individually in the proportion in which they were entitled to share profits [Sec. 48(*a*)].

Example: *A* and *B* were partners in a firm sharing profits and losses equally. *A* dies. The partnership accounts show that he contributed ₹1,929 to the capital of the firm while *B*'s contribution was only ₹29. The assets amounted to ₹1,400. It was held that the deficiency of ₹558 (*i.e.,* 1,958 – 1,400) must be shared equally by *B* and the estate of *A*.

3. The assets of the firm, including any sums of money contributed by the partners to make up deficiencies of capital shall be applied in the following order:
   (*a*) In paying the debts of the firm to third parties.
   (*b*) In paying to each partner rateably, what is due to him from the firm for advances as distinguished from capital.

(*c*) In paying to each partner rateably what is due to him on account of capital.

(*d*) The residue, if any, shall be divided among the partners in the proportion in which they were entitled to share profits [Sec. 48(*b*)].

Example: *A*, *B* and *C* were partners in a business sharing profits and losses equally. The accounts show that their contributions to the firm's capital were ₹10,000, ₹5,000 and ₹1,000 respectively. The assets of the firm after satisfying the outside liabilities are only ₹7,000. The deficiency is, therefore, a sum of ₹9,000. *A*, *B* and *C* must contribute ₹3,000 each. This will make the assets ₹16,000. The distribution of these assets to partners will result in a net loss of ₹3,000 each partner. In actual practice only *C* would be required to bring a sum of ₹2,000 in cash. Out of the assets of ₹9,000 (₹7,000 + ₹2,000) *A* and *B* will be paid ₹7,000 and ₹2,000 respectively.

Payment of Firm's Debts and of Separate Debts

When there are joint debts due from the partnership and also any separate debts due from any partner, firm's property must be first applied in the payment of the debt of the turn and if there is any surplus then the share of each partner in such surplus must be applied in payment of his separate debts or paid to him, if he has no debts. So also the separate property of any partner must be first applied in payment of his separate debts, and the surplus, if any, in the payment of the debts of the firm. Where partnership assets are insufficient to meet out the liabilities of the partnership, the creditors of the firm can resort to the partners' personal property outside the firm provided their personal and private creditors have already been paid out of it.

Order of Payment

The assets of the firm, including any sums of money contributed by the partners to make up deficiencies of capital, shall be applied in the following order:

(*a*) In paying the debts of the firm to third parties.

(*b*) In paying to each partner rateably what is due to him from the firm for advances as distinguished from capital.

(*c*) In paying to each partner rateably what is due to him on account of capital.

(*d*) The residues if any, shall be divided among the partners in the proportion in which they were entitled to share profits.

Accounting Entries

In the event of dissolution of a firm, all its assets are sold away and liabilities are paid off. A Realisation Account is opened in order to find out any profit

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or loss on realisation of assets and making payment of liabilities. The journal entries will be as follow:

1. For transfer of assets:

   Realisation A/c Dr.

   To Sundry Assets

   (Each asset will be credited individually, with its books value. Cash and bank balances will not be transferred unless the business has been taken over by a new firm or company. This will close all accounts of the assets transferred.)

It is to be noted that when an asset is transferred to the Realisation Account, its corresponding provision or reserve appearing on the liabilities side of the balance sheet, will also be transferred to the Realisation Account. For example, Investments and Joint Life Insurance Policy appear on the assets side of the balance sheet while Investments Fluctuation Fund and Joint Life Insurance Policy Reserve appear on the liabilities side of the balance sheet. The accounting entries in the event of dissolution of the firm would be as follows:

(*i*) Realisation A/c Dr.

   To Investments A/c

   To Joint Life Insurance Policy A/c

(*ii*) Investments Fluctuation Fund A/c Dr.

   Joint Life Insurance Policy Reserve A/c Dr.

   To Realisation A/c

2. *For transfer of liabilities:*

   Liabilities A/c Dr.

   To Realisation A/c

   (All liabilities excluding partners' loans will be transferred at book values. Each liability should be debited individually. This will close accounts of all liabilities transferred.)

3. For realisation of assets:

   Cash/Bank A/c Dr.

   To Realisation A/c

4. For payment of liabilities:

   Realisation A/c Dr.

   To Bank/Cash A/c

5. In case a partner takes an asset:

   Partner's Capital A/c Dr.

   To Realisation A/c

6. In case a partner agrees to meet a liability:

   Realisation A/c Dr.

   To Partner's Capital A/c

7. For expenses on realisation:
   Realisation A/c Dr.
   To Bank/Cash A/c
8. For profit on realisation:
   Realisation A/c Dr.
   To Partners'Capital A/c
   (In the profit sharing ratio)
   In case of loss the entry will be reversed.
9. For paying off partner's loan:
   Partner's Loan A/c Dr.
   To Bank/Cash A/c
10. For distribution of reserves, undistributed profit etc.:
    P & L A/c Dr.
    Reserves A/c Dr.
    To Partners' Capital A/c
11. For cash brought in by a partner on account of his 'account' showing a debit balance:
    Cash/Bank A/c Dr.
    To Partner's Capital A/c
12. The credit balance in a partner's capital account will be paid off:
    Partner's Capital A/c Dr.
    To Bank/Cash A/c
    Thus, all accounts in the firm will be closed.

When a Partner is made Incharge of Realisation

The partners by mutual agreement, may decide that one of them will be responsible for realisation of firm's assets and making payment of firm's liabilities. The partner so appointed may be given remuneration for such work. Such remuneration may be in the form of a certain percentage of the assets realised or liabilities paid or both. It may be in the form of a lump-sum also. The partner made 'incharge' of the realisation may also agree to bear all costs of realisation.

Besides the usual accounting entries, as discussed above, the following entries for remuneration etc. due to the partner 'incharge' of realisation will be made:

1. *For remuneration due*:
   Realisation Account Dr.
   To Partner's Capital A/c
2. *For realisation expenses incurred by the partner*:
   Realisation Account Dr.
   To Partner's Capital A/c

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In case the partner has agreed to bear all expenses on realisation in consideration of the remuneration to be received by him on realisation work, no entry will be required in the firm's books for realisation expenses incurred by the partner incharge of realisation. However, if in such a case the firm has paid the realisation expenses on behalf of the partner incharge, the following entry will be passed in the firm's books:

Partner's Capital A/c Dr.

To Bank/Cash A/c

The accounts of the partners will be settled in the usual manner.

Illustration 9.1. *A, B* and *C* were three partners in a business sharing Profits & Losses in the ratio of 2 : 2 : 1. The following was their balance sheet as on 31st Dec., 2017:

Liabilities		₹	*Assets*	₹
Creditors		30,000	Bank	20,000
Capital A/c:			Current Assets	30,000
A	40,000		Fixed Assets	70,000
B	30,000			
C	20,000	90,000		
		1,20,000		1,20,000

It was decided to dissolve the firm w.e.f. 31st Dec., 2017 and C was appointed as incharge of realisation. He was to receive 5% commission on the amounts realised from fixed and current assets. He was also to bear all expenses of realisation.

The fixed assets realised ₹80,000 and the current assets ₹20,000. The realisation expenses amounted to ₹2,000 which were paid by the firm.

You are required to prepare the necessary ledger accounts and close the books of the firm.

Solution:

REALISATION ACCOUNT

Particulars	₹	*Particulars*		₹
To Fixed Assets	70,000	By Creditors		30,000
To Current Assets	30,000	By Bank (assets released)		1,00,000
To Bank (Creditors)	30,000	By Realisation Loss:		
To *C*'s Capital A/c (Comm.)	5,000	*A*'s Capital A/c	2,000	
		B's Capital A/c	2,000	
		C's Capital A/c	1,000	5,000
	1,35,000			1,35,000

BANK ACCOUNT

Particulars	₹	*Particulars*	₹
To Balance b/d	20,000	By Realisation A/c	
To Realisation A/c		(Creditors)	30,000
(assets realised)	1,00,000	By *C*'s Capital A/c	2,000
		(realisation expenses)	
		By *A*'s Capital A/c	38,000
		By *B*'s Capital A/c	28,000
		By *C*'s Capital A/c	22,000
	1,20,000		1,20,000

CAPITAL ACCOUNTS OF PARTNERS

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To Realisation A/c (loss)	2,000	2,000	1,000	By Balance b/d	40,000	30,000	20,000
To Bank (Expenses)	—	—	2,000	By Realisation Account	—	—	5,000
To Bank A/c	38,000	28,000	22,000				
	40,000	30,000	25,000		40,000	30,000	25,000

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Treatment of Unrecorded Assets and Liabilities

In case certain assets or liabilities have not been recorded in the books of the partnership firm at all and on dissolution of the partnership firm they realise some money or some money is paid for them, the following entries will be passed:

(*i*) *On realisation of an unrecorded asset:*

Bank A/c Dr.

To Realisation A/c

(*ii*) *On payment of an unrecorded liability:*

Realisation A/c Dr.

To Bank A/c

(*iii*) *In case a partner agrees to take an unrecorded asset:*

Partner's Capital A/c Dr.

To Realisation A/c

(*iv*) *In case a partner agrees to take an unrecorded liability:*

Realisation A/c Dr.

To Partner's Capital A/c

(*v*) In case a creditor agrees to take an unrecorded asset. For example, a creditor of ₹10,000 agrees to take an unrecorded asset of ₹6,000 and the balance to that creditor is paid in cash. The following journal entries will be passed.

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	Particulars		Dr. (₹)	Cr. (₹)
(*a*)	Creditor's A/c	Dr.	10,000	
	Realisation A/c			10,000
	(For transfer of the creditor to Realisation A/c)			
(*b*)	Realisation A/c	Dr.	4,000	
	To Bank			4,000
	(Payment to the creditor net ₹10,000 – ₹6,000)			

Illustration 9.2. A and B who were in partnership sharing profits and losses in the proportion of 4 : 3 respectively, decided to dissolve the partnership firm as on 31st December, 2017. At the date of dissolution A's capital was as 1,25,030 and B's ₹2,070; the creditors amounted to ₹23,150 and cash at bank ₹4,520. The remaining assets realised ₹1,24,910 and the expenses of dissolution were ₹1,860. Both A and B were solvent.

Prepare the Balance Sheet of the firm as on the date of dissolution and also the accounts necessary to close the books of the firm, showing the final adjustment of cash among the partners.

Solution:

BALANCE SHEET OF *A* & *B*
as on December 31, 2017

Liabilities	₹	*Assets*	₹
Sundry Creditors	23,150	Sundry Assets	1,45,730
Capital:		(balancing figure)	
A	1,25,030	Bank balance	4,520
B	2,070		
	1,50,250		1,50,250

REALISATION ACCOUNT

Particulars	₹	*Particulars*	₹
To Sundry Assets	1,45,730	By Creditors	23,150
To Bank	23,150	By Bank	1,24,910
(creditors paid)		(assets realised)	
To Cash (expenses)	1,860	By Loss transferred:	
		A's Capital A/c	12,960
		B's Capital A/c	9,720
	1,70,740		1,70,740

PARTNERS' CAPITAL ACCOUNTS

Particulars	*A*	*B*	*Particulars*	*A*	*B*
To Loss on Realisation	12,960	9,720	By Balance b/d	1,25,030	2,070
To Bank	1,20,070	—	By Bank		7,650
	1,25,030	9,720		1,25,030	9,720

BANK ACCOUNT

Particulars	₹	*Particulars*	₹
To Balance b/d	4,520	By Realisation A/c	23,150
To Realisation A/c	1,24,910	By Realisation A/c	1,860
To *B*'s Capital	7,650	By *A*'s Capital A/c	1,12,070
	1,37,080		1,37,080

Check Your Progress

1. Differentiate between dissolution of partnership and dissolution of firm.
2. What is dissolution by notice?

9.3 SALE OF A FIRM TO A COMPANY: IMPLICATIONS

Sometimes the business of the partnership firm may be sold to a limited company. In such an event, the procedure regarding closing of the books of accounts of the partnership firm is the same as in case of dissolution of a firm. However, the following are some special points:

NOTES

1. The purchasing company, generally purchases all assets including cash. Hence, unless otherwise stated, cash account should be transferred to the realisation account.
2. The purchase consideration for the business is generally paid by the purchasing company in the form of its own shares and debentures. There is a conflict of opinion among the accountants regarding the distribution of such shares or debentures among the partners.
   (*i*) According to some accountants, the shares or debentures received from the purchasing company should be distributed among the partners in the same ratio in which profits and losses are shared by them. The reason behind this mode of distribution is to give the partners the same right to the benefit of appreciation and the same liability to loss by way of depreciation in the value of the shares (or debentures) or in respect of liabilities to calls, just as if they had still remained as partnership assets.
   (*ii*) According to another group of accountants, the shares or debentures received from the purchasing company as purchase consideration, should be distributed among the partners in the ratio of their final claims against the firm *i.e.,* in the ratio of capitals standing after the profit or loss on realisation, other reserves and profits have been transferred to the capital accounts of the partners. In support of this mode of distribution, they put forward the provision contained under Section 48 (*b*) (*iii*) of the Partnership Act, which provides that assets of the firm should be used in paying each partner rateably what is due to him on account of capital.

   This controversy can be resolved by taking the following steps:
   (*i*) The shares or debentures received from the company should be valued according to their present worth. Any profit or loss on account of such revaluation should be transferred to partners capital accounts in their profit sharing ratio.
   (*ii*) The shares or debentures so revalued should now be distributed among the various partners in the ratio of the final claims of the partners.

In the absence of any information regarding the present worth of shares of debentures, it may be presumed that the shares or debentures are worth their book values and they, therefore, be distributed among the partners in the ratio of the final claims of the partners.

Tutorial Note:

The students are advised to give clearly their assumption while distributing shares or debentures among the partners in an examination problem in the absence of any specific instructions.

NOTES

3. Sometimes, a partnership firm itself gets converted into a limited company. The partners in such a case may desire that their relationship in the new company as regards, share of profits, interest, salaries, etc. remain the same as it had been in the partnership firm. In such a case the following arrangement may suit the partners:
    (*i*) Partners may take employment in the company in different capacities on the salaries they were getting in the partnership firm.
    (*ii*) Capitals of the partners may be calculated according to their profits sharing ratio taking the capital of the partner who has the least capital in the firm as the base. Equity shares in the company may be issued to the partners in consideration of this capital.
    (*iii*) Preference shares may be given to partners for the capital contributed by them in excess of the capital determined according to (*ii*) above.
    (*iv*) Debentures may be given to partners for any loans that they might have given to the partnership firm.
4. Sometimes, the purchasing company does not take over the debtors and creditors of the partnership firm. It simply agrees to act as the agent of the vendor firm for collection of its debtors and making payment to its creditors for an agreed commission. In such an event, the debtors and creditors of the firm should not be transferred to the Realisation Account. A new account entitled as "Purchasing Company Suspense Account" should be opened in the firm's books and the firm's debtors and creditors accounts should be transferred therein.

The accounting entries in such can be understood with the help of the following illustration.

Illustration 9.3. A firm sells its business to a limited company. The company does not take over the debtors and creditors of the firm but agrees to collect and pay them as the firm's agent at a commission of 5% on all receipts and payments. The firm's debtors are of ₹30,000 and the creditors are of ₹10,000.

The company collects ₹28,000 from the firm's debtors and pays ₹9,000 to firm's creditors in full satisfaction of their claims. After charging its commission it remits the balance of amount to the firm.

You are required to pass the necessary journal entries in the books of the firm.

NOTES

Date	Particulars		Dr. (₹)	Cr. (₹)
	Purchasing Company Suspense Account	Dr.	30,000	
	To Debtors			30,000
	(Being transfer of debtors to purchasing company for collection)			
	Creditors	Dr.	10,000	
	To Purchasing Company Suspense Account			10,000
	(Being transfer of firm's creditors to purchasing company for payment as firm's agent)			
	Bank Account	Dr.	17,150	
	Realisation Account	Dr.	2,850	
	To Purchasing Company Suspense A/c			20,000
	(Being the amount received from the purchasing company)			

Working Notes:

	₹
Commission payable to purchasing company:	
On collection of debtors 28,000 × 5/100	1,400
On payment to creditors 9,000 × 5/100	450
	1,850
Add : Loss suffered on collection of debtors	2,000
	3,850
Less: Profit made on payment to creditors	1,000
Total loss and commission	2,850

Illustration 9.4. Anu and Sonu were in partnership sharing profits and losses in the ratio of 2 : 1. Their summarised Balance Sheet as on 31 March, 2016 was as under.

Liabilities		₹	Assets	₹
Capital Accounts:			Fixed Assets	1,40,000
Anu	1,00,000		(including two motor	
Sonu	80,000	1,80,000	cars of ₹28,000)	
Current Accounts:			Stock	70,000
Anu	40,000		Debtors	1,00,000
Less: Sonu	23,000	17,000	Bills Receivable	25,000
Loan from Sonu		63,000	Bank	20,000
Creditors for Goods		1,10,000	Advertisement	
			Suspense Account	15,000
		3,70,000		3,70,000

They decided to dissolve the business and accepted the offer of Nanak and Co. Ltd. to acquire stock and fixed assets excluding two motor cars at a total price of ₹3,35,000. The debtors realised ₹97,000 and Bills Receivable ₹24,000. Creditors for goods allowed a discount of 5%.

The purchased consideration was to be discharged by a cash payment of ₹83,000, the allotment by the company to the partners of 8,000 preference share of ₹10 each (valued at ₹9 each), and the balance by the allotment of 9,000 ordinary shares of ₹10 each.

NOTES

The partners agreed that following should be the basis of distribution on dissolution of the firm:

(*a*) Anu to take over one motor car at a value of ₹25,000 and Sonu the other car at ₹15,000.

(*b*) Sonu to accept preference shares for her loan to the firm, the remainder to be taken over by Anu.

(*c*) The ordinary shares to be taken over by Anu and Sonu in proportion of their fixed capitals.

(*d*) The balance to be settled in cash.

Prepare the necessary accounts to close the books of the firm.

Solution:

REALISATION ACCOUNT

Particulars		₹	*Particulars*	₹
To Fixed Assets		1,40,000	By Creditors for goods	1,10,000
To Stock		70,000	By Nanak & Co	3,35,000
To Debtors		1,00,000	By Bank (Debtors)	97,000
To Bills Receivable		25,000	By Bank (B/R)	24,000
To Bank (Creditors)		1,04,500	By Anu's Capital A/c	25,000
To Profit on Realisation			By Sonu's Capital A/c	15,000
Anu's Capital A/c	1,10,000			
Sonu's Capital A/c	55,500	1,66,500		
		6,06,000		6,06,000

PARTNERS' CAPITAL ACCOUNTS

Particulars	*Anu* ₹	*Sonu* ₹	*Particulars*	*Anu* ₹	*Sonu* ₹
To Realisation A/c	25,000	15,000	By Balance b/d	1,00,000	80,000
To Pref. Shares in Nanak & Co.	9,000		By Current A/c	1,41,000	27,500
To Equity Shares in Nanak & Co.	1,00,000	80,000			
To Bank	1,07,000	12,500			
	2,41,000	1,07,500		2,41,000	1,07,500

PARTNERS' CURRENT ACCOUNTS

Particulars	*Anu* ₹	*Sonu* ₹	*Particulars*	*Anu* ₹	*Sonu* ₹
To Balance b/d		23,000	By Balance b/d	40,000	
To Advt. Suspense A/c	10,000	5,000	By Realisation A/c	1,11,000	55,500
To Capital Account	1,41,000	27,500			
	1,51,000	55,500		1,51,000	55,500

SONU'S LOAN ACCOUNT

Particulars	₹	*Particulars*	₹
To Pref. Shares in Nanak & Co.	63,000	By Balance b/d	63,000
	63,000		63,000

NOTES

BANK ACCOUNT

Particulars	₹	Particulars	₹
To Balance b/d	20,000	By Realisation A/c	1,04,500
To Realisation A/c	97,000	By Anu's Capital A/c	1,07,000
To Realisation A/c	24,000	By Sonu's Capital A/c	12,500
To Nanak & Co.	83,000		
	2,24,000		2,24,000

NANAK & CO.

Particulars	₹	Particulars	₹
To Realisation A/c	3,35,000	By Bank	83,000
		By Pref. Shares in Nanak & Co.	72,000
		By Equity Shares in Nanak & Co.	1,80,000
	3,35,000		3,35,000

PREF. SHARES IN NANAK & CO.

Particulars	₹	Particulars	₹
To Nanak & Co.	72,000	By Sonu's Loan A/c	63,000
		By Anu's Capital A/c	9,000
	72,000		72,000

EQUITY SHARES IN NANAK & CO.

Particulars	₹	Particulars	₹
To Nanak & Co.	1,80,000	By Anu's Capital A/c	1,00,000
		By Sonu's Capital A/c	80,000
	1,80,000		1,80,000

Illustration 9.5. M. Pande and D. Deshmukh were carrying on business as equal partners. The balance sheet as on 31 December, 2016 was as follows:

Liabilities	₹	Assets	₹
Sundry Creditors	65,500	Stock	54,000
Bank Overdraft	30,000	Plant & Machinery	1,82,000
Bills Payable	12,500	Office Furniture	15,000
Capital Accounts:		Book Debts	73,000
M. Pande	1,50,000	Joint Life Policy (surrender value)	9,500
D. Deshmukh	1,48,000	Leasehold Premises	34,500
		Profit and Loss A/c (debit balance)	26,000
		Drawings Account:	
		M. Pande	9,000
		D. Deshmukh	3,000
	4,06,000		4,06,000

The business was carried on till June 30, 2017. The partners withdrew in equal amounts half the amount of profits made during the period of six months (from January-June, 2017) after 10% p.a. had been written off leasehold premises, 10% p.a. off plant and machinery and 5% p.a. off office furniture. Meanwhile Sundry Creditors were reduced by ₹10,000, Bills Payable by

NOTES

₹2,300 and Bank Overdraft by ₹15,000. On June 30, 2017, Stock was valued at ₹63,400, Book Debts at ₹65,000, the Joint Life Policy was surrendered for ₹9,500 and other items remained the same as on December 31, 2016.

On 30 June, 2017, the firm sold the business to a Limited Company. The value of the goodwill was estimated at ₹1,08,000 and the rest of the assets were valued on the basis of the Balance Sheet as on 30 June, 2017. The company paid the purchase consideration in equity shares of ₹10 each.

Disregarding interest on drawings and capital, you are required to prepare a Realisation Account and Capital Accounts of the partners.

Solution:

BANK ACCOUNT

Particulars	₹	*Particulars*	₹
To Sundry Assets:		By Sundry Creditors	55,500
Stock	63,400	By Bills Payable	10,200
Debtors	65,000	By Bank Overdraft	15,000
Plant & Machinery	1,72,900	By Shares in Ltd. Co.	3,76,000
Leasehold Premises	32,775		
Office Furniture	14,625		
To Profit:			
M. Pande	54,000		
D. Deshmukh	54,000		
	4,56,700		4,56,700

CAPITAL ACCOUNTS

Date	*Particulars*	*M. Pande*	*D. Deshmukh*	*Date*	*Particulars*	*M. Pande*	*D. Deshmukh*
2017				2017			
Jan. 1	To Profit & Loss A/c	13,000	13,000	Jan. 1	By Balance b/d	1,50,000	1,48,000
	To Drawings A/c	9,000	3,000	June 30	By Profit	8,000	8,000
	To Cash (Drawings)	4,000	4,000		By Realisation A/c (Profit)	54,000	54,000
Jan. 30	To Shares in Co. Ltd.	1,86,000	1,90,000				
		2,12,000	2,10,000			2,12,000	2,10,000

Working Notes:

1. Shares have been distributed between the two partners in the ratio of their final claims. It is also possible that the shares are distributed equally (*i.e.*, in the profit sharing ratio). In that case each partner will get ₹1,88,000 worth of shares; M. Pande will have to pay ₹2,000 cash in the firm to pay D. Deshmukh.

NOTES

2. BALANCE SHEET ON 30.6.2017
(to ascertain total capital)

Liabilities	₹	Assets		₹
Sundry Creditors	55,500	Stock		63,400
Bills Payable	10,200	Book Debts		65,000
Bank Overdraft	15,000	Plant & Machinery	1,82,000	
Total Capital (balancing figure)	2,68,000	*Less:* Depreciation	9,100	1,72,900
		Office Furniture	15,000	
		Less: Depreciation	375	14,625
		Leasehold Premises	34,500	
		Less: Depreciation	1,725	32,775
	3,48,700			3,48,700

3. Profit earned during six months to 30 June, 2017.

	₹	₹	₹
Capital (Total) on 30 June, 2017			2,68,000
Capital (Total) on 1 January, 2017			
Pande		1,50,000	
Deshmukh		1,48,000	
		2,98,000	
Less: Loss	26,000		
Drawing Accounts	12,000	38,000	2,60,000
Note increase (after drawings)			8,000

Since drawings are half of profits, profit earned is ₹16,000.

4. Purchase consideration:

Assets [as per (2) above]	3,48,700
Add: Goodwill	1,08,000
	4,56,700
Less: Liabilities	80,700
Purchases consideration	3,76,000

Check Your Progress

3. What happens in the absence of any information regarding the present worth of shares of debentures?
4. When does the purchasing company not take over the debtors and creditors of the partnership firm?

9.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The dissolution of a partnership may or may not result in the dissolution of a firm but the dissolution of a firm will necessarily result in the dissolution of the partnership.
2. When a partnership is at will, the firm may be dissolved by any partner giving a notice in writing to all the other partners of his intention to dissolve the firm. This is called dissolution by notice.

NOTES

3. In the absence of any information regarding the present worth of shares of debentures, it may be presumed that the shares or debentures are worth their book values and they, therefore, be distributed among the partners in the ratio of the final claims of the partners.
4. Sometimes, the purchasing company does not take over the debtors and creditors of the partnership firm. It simply agrees to act as the agent of the vendor firm for collection of its debtors and making payment to its creditors for an agreed commission. In such an event, the debtors and creditors of the firm should not be transferred to the Realisation Account. A new account entitled as "Purchasing Company Suspense Account" should be opened in the firm's books and the firm's debtors and creditors accounts should be transferred therein.

9.5 SUMMARY

- Any change in the relations of the partners is called dissolution of partnership. Thus, in all those cases where a partnership is reconstituted, there is a dissolution of the partnership.
- The dissolution of partnership among all the partners of a firm is called the dissolution of the firm. In the case of dissolution of a firm, the business of the firm is closed down and its affairs are wound up. The assets are realised and the liabilities are paid off.
- Partners shall continue to be liable as such to third parties for any act done by any of them which would have been an act of the firm if done before the dissolution, till they give a public notice of the dissolution of the firm. But a deceased or an insolvent or a dormant partner shall not be liable for acts done after he has ceased to be a partner. In his case public notice of dissolution need not be given.
- When there are joint debts due from the partnership and also any separate debts due from any partner, firm's property must be first applied in the payment of the debt of the turn and if there is any surplus then the share of each partner in such surplus must be applied in payment of his separate debts or paid to him, if he has no debts.
- In the event of dissolution of a firm, all its assets are sold away and liabilities are paid off. A Realisation Account is opened in order to find out any profit or loss on realisation of assets and making payment of liabilities.
- The partners by mutual agreement, may decide that one of them will be responsible for realisation of firm's assets and making payment of firm's liabilities. The partner so appointed may be given remuneration for such work. Such remuneration may be in the form of a certain percentage of the assets realised or liabilities paid or both.

- Sometimes the business of the partnership firm may be sold to a limited company. In such an event, the procedure regarding closing of the books of accounts of the partnership firm is the same as in case of dissolution of a firm.

9.6 KEY WORDS

- **Dissolution of Partnership:** It implies change in the relations of partners. In other words, there is dissolution of partnership whenever a partnership is reconstituted viz., admission, retirement, death or insolvency of a partner. In dissolution of partnership the firm continues to carry on its business in a reconstituted form.
- **Dissolution of Firm:** It is dissolution of partnership among all the partners of a firm. In such an event the business of the firm is closed down and its affairs are wound up.

9.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. How can the controversy to the sale of a firm to company be resolved?
2. Under what cases can a court intervene and can order for the dissolution of a firm?

Long Answer Questions

1. Differentiate between dissolution of partnership and dissolution of firm. State the circumstances under which a partnership firm may be dissolved.
2. When does the implied authority of a partner to bind the firm terminate in the event of dissolution of a partnership firm?

9.8 FURTHER READINGS

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

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NOTES

UNIT 10 COMPANY ACCOUNTS: ISSUE OF SHARES AND DEBENTURES

Structure

10.0 Introduction
10.1 Objectives
10.2 Shares: Essential Features and Types
10.3 Issue of Shares at Premium and Discount
    10.3.1 Issue of Shares at Premium
    10.3.2 Issue of Shares at Discount
10.4 Debentures: Meaning and Classification
    10.4.1 Accounting for Issue of Debentures
10.5 Answers to Check Your Progress Questions
10.6 Summary
10.7 Key Words
10.8 Self Assessment Questions and Exercises
10.9 Further Readings

10.0 INTRODUCTION

Share issue is the process by which companies pass on new shares to shareholders, who may themselves be new or existing shareholders. Companies can issue shares to both individuals and corporate bodies.

A debenture is a type of debt instrument that is not secured by physical assets or collateral. Debentures are backed only by the general creditworthiness and reputation of the issuer. Both corporations and governments frequently issue this type of bond to secure capital. Like other types of bonds, debentures are documented in an indenture.

10.1 OBJECTIVES

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

- Analyse the essential features of shares
- Differentiate between a share and stock
- Understand the methods of issue of shares at premium and discount
- Describe the methods of issuing debentures at par, premium and discount

NOTES

10.2 SHARES: ESSENTIAL FEATURES AND TYPES

A share is one of the units into which the total share capital of a company is divided. The Companies Act, 2013 defines a share as "share in the share capital of a company and includes stock". [Sec. 2(84)].

Essential Features: The following are the essential features of a share:

- A share has a nominal value and bears a distinct number.
- A share certificate issued under the common seal of the company certifies that the person named herein is a registered holder of a specific number of shares bearing distinct numbers as mentioned in the certificate.
- A share is an ownership security. In other words, a shareholder is a part-owner of the company.
- A share is said to be a bundle of rights as well as liabilities. It secures to its owner the right to receive a proportionate part of the profits, if any, and proportionate part of the assets of the company upon liquidation. On the other hand the shareholder may also be required to pay the full value in winding up.
- Shares may be issued generally at par or premium and at discount only in certain cases.
- A share is considered to be a movable property transferable in the manner provided in the articles of the company [Sec. 44].

Stocks

Fully paid up share capital may, if the Articles so permit, be converted into stock by an ordinary resolution (a resolution by simple majority) of the members. Stock is the aggregate consolidated holdings of the share capital of a person. It can be divided and transferred in any fractions and sub-divisions without regard to the original face value of the share for the purpose of convenient holding into different parts.

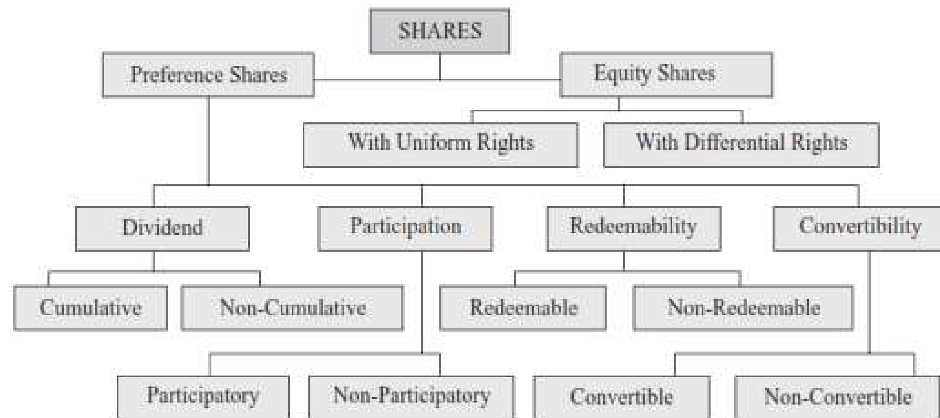
Difference between a Share and a Stock

- A share may not be fully paid up, but a stock is always fully paid up.
- A share has a nominal value, whereas a stock has no nominal value.
- A share cannot be transferred in small fractions, while a stock can be transferred in any fractions.
- All shares bear distinct numbers, while stocks disclose the consolidated value of the share capital. Fractions of the stock do not bear any number.

- All shares are of equal denomination. Stock may be of unequal amounts.
- Unlike shares, stock cannot be directly offered by the company to the public in the first instance. Only fully paid up shares can be converted into stock by the company.

Types of Shares

Shares can be of different types as given in the following chart:



Check Your Progress

1. State two differences between a share and stock.
2. What are stocks?

10.3 ISSUE OF SHARES AT PREMIUM AND DISCOUNT

Let us study the issue of shares at premium and discount.

10.3.1 Issue of Shares at Premium

Legal provisions A company can issue its shares at a premium (*i.e.,* for a value higher than the face value of the shares) whether for cash or for consideration other than cash. The power to issue shares at a premium need not be given in the Articles of Association. However, according to recent guidelines issued by *SEBI,* a new company set up by the entrepreneurs without a track record can issue capital to the public only at par. According to Section 52 of the Companies Act, the amount of such premium, shall have to be transferred by the company to the Securities Premium Account. The balance in this account is treated with the same sanctity as the paid up Share Capital of the company.

Utilisation of Securities Premium Account

This can be studied under two heads:

(a) **Companies which are not required to follow the accounting standards [Sec. 52(2)].**

These Companies can use the Securities Premium Account for the following purposes.

(*i*) towards the issue of unissued shares of the company to members of the company as fully paid bonus shares;

(*ii*) in writing off the preliminary expenses of the company;

(*iii*) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(*iv*) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(*v*) for the purchase of its own shares or other securities under section 68.

(*b*) **Companies which are required to follow the accounting standards [Sec. 52(3)].**

These companies can use Securities Premium Account only for the following purposes:

(*i*) in paying up unissued equity shares of the company to be issued to members of the company as fully bonus shares; or

(*ii*) in writing off the expenses of, or the commission paid or discount allowed on, any issue of equity shares of the company; or

(*iii*) for the purchase of its own shares or other securities under Section 68.

Note: As stated above according to Section 52 of the Companies Act 2013 the amount of premium received on shares is to be transferred to the "Securities Premium Account". However, in the Notes to Accounts under Proforma of Balance Sheet as per Schedule III, under the heading "Reserves & Surplus", there is a sub-heading of "Securities Premium Reserve". Hence, some accountants, while making accounting entries, for share premium prefer the term "Securities Premium Reserve Account" in place of "Securities Premium Account". According to us any of the terms, i.e.,"Securities Premium Reserve Account" or "Securities Premium Account" may be used while making entries in respect of Securities premium.

However, in "Notes to Accounts" the Securities Premium will have to be shown as "Securities Premium Reserve" under the heading Reserves & Surplus as required by the Notes to Accounts given in Schedule *III*.

Accounting entries Generally the amount of premium is payable in a lump sum on allotment. However, a company may require the applicants to pay premium money with application money or with calls. The accounting entries are made as follows:

NOTES

(*i*) Where premium money is payable on allotment:

On amount being due:

Shares allotment A/c *Dr.*

To Share capital A/c

To Securities premium A/c

(Share allotment account will be debited with the amount due on account of share capital as well as securities premium).

On receipt of allotment money:

Bank A/c *Dr.*

To Share allotment A/c

(With the amount actually received)

(*ii*) In case premium money is payable on application:

On receipt of application money:

Bank A/c *Dr.*

To Share application A/c

(With money received on account of share capital as well as securities premium)

On transfer of application money:

Share application A/c *Dr.*

To Share capital A/c

To Securities premium A/c

(*iii*) In case premium is received in parts, say, on application as well as allotment or allotment and first call, entries on the same pattern can be passed. For example, if premium is payable in two installments—on allotment and first call, the following accounting entries will be passed.

For premium due on allotment:

Share allotment A/c *Dr.*

To Share capital A/c

To Securities premium A/c

For receipt of allotment money:

Bank A/c *Dr.*

To Share allotment A/c

For premium due on first call:

Share 1st call A/c *Dr.*

To Share capital A/c

To Securities premium A/c

For receipt of first call money:

Bank A/c *Dr.*

To Share 1st call

Alternative Method

There is an alternative method for treatment of securities premium. No entry is passed for securities premium when it becomes due. However, on receipt of securities premium, the amount of securities premium is credited to Securities Premium Account. For example, if amount is to be received on allotment of 10,000 shares @ ₹ 3 per share (including ₹ 1 per share as premium) and only holders of 9,500 shares pay the allotment money, the following accounting entries will be passed for recording *Dr.* these transactions.

Date	Particulars		₹ Dr.	₹ Dr.
	Share Allotment A/c	Dr.	20,000	
	To Share capital A/c			20,000
	Being money due on allotment on account of share) (capital			
	Bank A/c	Dr.	29,500	
	To Share allotment A/c			20,000
	To Securities premium A/c			9,500
	Being money received on account of share allotment) (and securities premium			

The advantage of this method is that the securities premium account will not have to be debited in the event of the forfeiture of shares in case securities premium money has not been received. This has been explained in detail later while explaining forfeiture of shares.

The amount of securities premium is an item of capital gain. It will appear on the liabilities side of the balance sheet under the heading "Reserves and Surplus."

Illustration 10.1. A company offers 10,000 shares of ₹ 10 each to the public for subscription at ₹ 12 per share. Money is payable as follows:

₹ 3 on application,

₹ 4 on allotment (including ₹ 1 as premium)

₹ 5 on call (including ₹ 1 as premium)

Applications are received for 15,000 shares. No allotment is made to applicants for 3,000 shares and their application money is refunded. Rest are allotted shares on a pro rata basis. All allottees pay the money due on shares as and when called up.

Pass necessary journal entries and show how the items will appear in the company's balance sheet.

Solution:

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	45,000	
	To Share application A/c			45,000
	(Being the application money received on 15,000 shares @ ₹ 3 per share)			
	Share Application A/c	Dr.	45,000	
	To Share capital A/c			30,000
	To Bank A/c			9,000
	To Share allotment A/c			6,000
	(Being application money transferred to share capital on 10,000 shares, application money on 3,000 shares refunded and rest transferred to allotment)			
	Share Allotment A/c	Dr.	40,000	
	To Share capital A/c			30,000
	To Securities premium A/c			10,000

NOTES

Date	Particulars	Dr. ₹	Cr. ₹
	(Being money due of allotment of 10,000 shares @ ₹ 4 per share including ₹ 1 as share premium)		
	Bank A/c Dr.	34,000	
	To Share allotment A/c		34,000
	(Being money received on allotment)		
	Share Call A/c Dr.	50,000	
	To Share capital A/c		40,000
	To Securities premium A/c		10,000
	(Being money due to call @ ₹ 5 per share including ₹ 1 as premium)		
	Bank A/c Dr.	50,000	
	To Share call A/c		50,000
	(Being money received on call)		

.... CO. Ltd.
Balance Sheet
as on **.......**

Particulars	Note No.	₹
(*i*) **Equity & Liabilities**		
(a) Shareholders' Funds	1	1,00,000
(*b*) Reserves & Surplus	2	20,000
		1,20,000
(*ii*) **Assets**		
Current Assets		
Cash & Cash Equivalents	3	1,20,000
		1,20,000

Notes to Accounts

Particulars	₹
1. Share Capital	
(a) *Authorised Capital*	
...... Shares of ₹ ...... each	....
Issued Share Capital	
10,000 shares of ₹ 10 each	1,00,000
Subscribed Capital	
Subscribed but not fully paid up	
10,000 shares of ₹ 10 each fully	1,00,000
2. Reserves & Surplus	
Securities Premium Reserve	20,000
	1,20,000
3. Cash & Cash Equivalents	
Cash at Bank	1,20,000
	1,20,000

10.3.2 Issue of Shares at Discount

NOTES

A company now cannot issue shares at a discount (*i.e.,* for a consideration less than the nominal value of the shares) except sweat equity shares. As discussed earlier, sweat equity shares are those shares which have been issued for consideration other than cash, *e.g.,* for intellectual rights or value additions.Section 53 of the Companies Act, 2013 provides as under:

(1) Except as provided in Section 54 (*i.e.,* Sweat Equity Shares), a company shall not issue shares at a discount.

(2) Any share issued by a company at discount shall be void.

(3) Where a company contravenes the provisions of this Section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

Restrictions on the issue of shares at a discount as set out above do not apply in the case of debentures since they do not form the capital fund of the company but are merely creditorship securities.

Accounting entries The entry for discount has to be invariably made with allotment. The accounting entry will be as follows:

Share Allotment A/c *Dr.*
Discount on Issue of Shares A/c *Dr.*
To Share Capital A/c

"Discount on Issue of Shares" will appear on the Assets side of the Balance Sheet as a negative item under the heading other current/non-current assets depending on whether the amount will be amortised in next 12 month or thereafter.

It is an acceptable practice that discount on issue of shares, share issue expenses, etc., should be written off over the period of benefit, *i.e.,* normally 3 to 5 years from profits available for that purpose.

On writing off discount the following entry shall be

Securities Premium / *P & L* Statement/Account*
To Discount on Issue of Shares A/c

***Note:** Schedule III to the Companies Act, 2013 gives the format in which a company has to prepare its Balance Sheet and Profit and Loss Statement. All appropriations out of profit have to be made in the Balance Sheet itself under the heading Reserves and Surplus. Hence, for reporting purposes the method given as per Schedule III has to be followed. However, accounting entries for appropriation are to be made as per the traditional procedure that is debiting the *P&L* account and crediting the Respective Appropriation Accounts. The illustration given below will explain this concept.

Illustration 10.2. A company offered 5,000 shares of ₹ 10 each, at a discount of 10%, to the public for subscription. Money was payable as follows:

₹ 4 on application, ₹ 3 on allotment, Balance as and when called up. Applications were received for 4,000 shares. The final call had not yet been made. All applicants paid application and allotment moneys.

During the year the company made a net profit of ₹ 15,000. It decided to write off the discount of ₹ 2,000 out of the profit for the year.

You are requested to prepare the necessary ledger accounts and show how the items would appear in the company's balance sheet.

Solution:

Bank Account

Particulars	₹	*Particulars*	₹
To Share application A/c	16,000	By Balance c/d	43,000
To Share allotment A/c	12,000		
To Net profit for the year (presuming that it was realised in cash)	15,000		
	43,000		43,000

Share Application Account

Particulars	₹	*Particulars*	₹
To Share capital A/c	16,000	By Bank	16,000

Share Allotment Account

Particulars	₹	*Particulars*	₹
To Share capital A/c	12,000	By Bank A/c	12,000

Discount on Issue of Shares Account

Particulars	₹	*Particulars*	₹
To Share capital A/c	4,000	By P&L A/c	2,000
		By Balance c/d	2,000
	4,000		4,000

Profit & Loss Statement Account

Particulars	₹	*Particulars*	₹
To Discount on issue of shares A/c	2,000	By Net profit for the year	15,000
To Balance of profit taken to Balance sheet	13000		
	15,000		15,000

Share Capital Account

Particulars	₹	*Particulars*	₹
To Balance c/d	32,000	By Share application A/c	16,000
		By Share allotment A/c	12,000
		By Discount on issue of shares A/c	4,000
	32,000		32,000

NOTES

Co. Ltd.
Balance Sheet
as on **...........**

Particulars	*Note No.*	₹
(*i*) **Equity & Liabilities**		
(a) Shareholder' Funds	1	32,000
(*b*) Reserves & Surplus	2	13,000
		45,000
(*ii*) **Assets**		
None-current Assets		
Other non-current Assets	3	2,000
Current Assets		43,000
Cash & Cash Equivalents	4	45,000

Notes to Accounts

Particulars	₹
1. **Share Capital**	
Authorised Capital	
..... Shares of ₹ ..... each	....
Issued Share Capital	
4,000 shares of ₹ 10 each	40,000
Subscribed Capital	
Subscribed but not fully paid up	
4,000 shares of ₹ 10 each	
₹ 8 per share called & paid up	32,000
2. **Reserves & Surplus**	
Surplus as per profit & loss statement	15,000
Less: Discount on issue of shares written off	2,000
	13,000
3. **Other Non-current Assets**	
Discount on issue of shares (yet to be written off)	2,000
4. **Cash & Cash Equivalents**	
Cash at Bank	43,000

10.4 DEBENTURES: MEANING AND CLASSIFICATION

Companies require money from time to time. This requirement is met by the company partly by raising share capital and partly by depending on public borrowings. One form of such public borrowings is to raise money by issue of debentures. Debentures help the companies in borrowing money from a large section of the general public. A debenture is of a small denomination (usually of ₹ 100) and, therefore, can be purchased even by persons of small means. For example, if a company needs a sum of ₹ 1,00,000 it can offer to the public for subscription 1,000 debentures of ₹ 100 each. It may be difficult for one person to lend a sum of ₹ 1,00,000 to the company but he can conveniently purchase a certain number of debentures, thus helping the company in raising the required funds.

NOTES

Meaning of Debentures

Debenture may be defined as a certificate issued by a company under its seal acknowledging debt due by it to its holder. The most essential characteristic of a debenture is the admission or record of indebtedness.

According to the Companies Act, 2013 the term debenture includes "debenture stock, bonds and any other securities of a company whether constituting a charge of the assets of the company or not". [Sec. 2(30)]

The term "debenture stock" is similar to "share stock". It is the aggregate and consolidated amount of borrowings on account of debentures by a company. Fully paid debentures can only be converted into debenture stock. Such stock can be divided and transferred in any convenient parts. A company cannot issue debentures carrying any voting rights [Sec. 71(2)].

Bonds and Debentures

Bonds are a form of long term debt and can be referred as a debt security. Bond may be defined as a debt security in which the issuer (borrower) of the bond owes the holder (lender), a debt and depending on the terms of the bond is obliged to pay interest on the amount borrowed and repay the principal at maturity. In other words, the bond is a formal contract to repay the borrowed money with interest at fixed intervals.

A bond is similar to a debenture. A debenture, as stated before may be defined, a certificate issued by a company acknowledging the debt due by it to its holder. The most essential characteristic of a debenture is the admission or record of indebtedness. Debentures may be both, secured or unsecured.

In some countries, e.g., in U.S.A., a difference is made between a debenture and a bond. The term debenture is used for a debt instrument which is unsecured or which does not have a charge against some specific property of the borrower. Moreover, a bond has a longer maturity, period as compared to a debenture. In India, no such difference is made between a debenture and a bond. They are used as interchangeable terms. Of course, the term bond is generally used in India for a debt security issued by Government or a Public Institution. Both debentures and bonds are debt securities issued for long term borrowings, i.e., borrowings for more than a year.

Classification of Debentures

A company may issue various kinds of debentures with different rights as given below.

From the Point of View of Security

Naked debentures These are debentures which do not carry any charge on the assets of the company. The holders of such debentures are not given any security as to the payment of interest and repayment of capital.

Mortgage or secured debentures Debentures which are secured by a mortgage or charge on the whole or a part of the assets of the company are known as mortgage debentures.

The date of redemption of secured debentures should not exceed ten years from the date of issue except debentures issued for infrastructure projects where secured debentures may be issued for a period exceeding 10 years but not exceeding 30 years.

Sometimes on the same security, money is borrowed by the company by issuing debentures in two or more instalments. Debentures so issued may be given priority in repayment depending upon the order in which they have been issued, Debentures issued earlier will have priority over debentures issued later. Mortgage debentures may, therefore, be further classified as follows:

(*i*) **First debentures.** These debentures have priority over other debentures as regards payment out of the proceeds of the property mortgaged.

(*ii*) **Second debentures.** These debentures are repaid after the claims of the first debentures have been met.

For example, a company has freehold property worth ₹ 1,00,000 against which First debentures of ₹ 60,000 and Second debentures of ₹ 40,000 were issued. In case the property is sold for ₹ 90,000, out of the sale proceeds, First debentureholders will be paid ₹ 60,000 and the balance of ₹ 30,000 will be used for payment to Second debentureholders.

Trust Deed In case of mortgage debentures issued to public, it becomes essential for the company to appoint trustees who will hold the property given by way of security in trust for the benefit of all debentureholders. This is necessary because it is impossible to give each debentureholder title deeds of the mortgaged property. The company acknowledges its indebtedness to the trustees and conveys them legal and equitable interest in the property given by way of security for the loan by handing over the relevant title deeds.

From the Point of View of Redemption

Redeemable debentures Redeemable debentures provide for the payment of the principal amount on the expiry of a certain period. Redeemable debentures can be reissued even after they have been redeemed until they have been cancelled. Upon such reissue, the person entitled to the debentures will have the same rights and priorities as if the debentures had never been redeemed.

Irredeemable debentures In the case of irredeemable or perpetual debentures, the company does not give any undertaking of repaying the money borrowed by issuing debentures, after a fixed time or within a fixed period during the continuance of business by the company. Company may repay debentures at any time it may choose to do so, but the creditors cannot

compel the company to repay them at certain time. They shall, however, be repaid when the company goes into liquidation or makes a default in the payment of interest.

NOTES

From the Point of View of Convertibility

Convertible debentures These are debentures which are wholly or partly convertible into shares of the company as per the terms of their issue.

The issue of debentures with an option to convert such debentures into shares wholly or partly, must be approved by a special resolution passed at a general meeting. Of course convertible debentures at discount as it is prohibited.

Non-convertible debentures Debentures not convertible into shares of the company are termed as non-convertible debentures.

From the Point of View of Transferability

Registered debentures Registered debentures are made out in the names of specific persons, who are registered as a debentureholders in the books of the company. The names of the debentureholders are recorded in the company's register of debentureholders. They are transferable in the same way as shares or in accordance with the conditions endorsed on their back.

Bearer debentures Bearer debentures are treated as negotiable instruments and are transferable by delivery alone. The names of the holders of such debentures are not required to be registered in the register of debentureholders.

10.4.1 Accounting for Issue of Debentures

The entries for issue of debentures are made on the same pattern as for issue of shares. They can also be issued at par, premium or discount. However, the legal restrictions regarding use of premium money or issuing at discount applicable in the case of shares, are not applicable to debentures. The accounting entries are being given below:

Issue of debentures for consideration other than cash

(*i*) **On acquisition of assets:**

Assets A/c (with value of assets) *Dr.*
To Vendors (with purchase price)

In case the value of assets is more than the purchase price, the balance is credited to Capital Reserve. In a reverse case, *i.e.,* where the purchase price is more than the value of assets purchased, the balance is debited to Goodwill Account.

(*ii*) **On allotment of debentures:**

Vendors *Dr.*
To Debentures A/c

In case debentures are issued at a discount, the 'Debenture Discount Account' will be debited with the amount of discount allowed. In case issue

of debentures is at premium, the "Debenture Premium Account" will be credited with the amount of premium.

NOTES

Issue of debentures for cash

(*i*) **For receipt of application money:**

Bank A/c Dr.
To Debenture application A/c

(*ii*) **On allotment of debentures:**

Debenture application A/c Dr.
To Debentures A/c
(For transfer of debenture application money)
Debenture allotment A/c Dr.
To Debentures A/c
(For allotment money due)
Bank A/c Dr.
To Debenture allotment A/c
(For receipt of allotment money)

In case allotment is made at premium and premium is to be received on allotment, the entry for amount due on allotment will be:

Debenture allotment A/c Dr.
To Debentures A/c
To Debenture premium A/c

In case allotment is made at discount, the entry will be:

Debenture allotment A/c Dr.
Discount on issue of debentures A/c Dr.
To Debentures A/c

(*iii*) **On first/second/final call:**

Debentures first/second/final call A/c Dr.
To Debentures A/c
(For first/second/final call due)
Bank A/c Dr.
To Debenture first/second/final call A/c
(For first/second/final call money received)

(*iv*) **If money is received in one instalment:**

If issued at par:
Bank A/c Dr.
To Debentures A/c
If issued at discount:
Bank A/c Dr.
Discount on issue of Debentures A/c Dr.
To Debentures A/c
If issued at premium:
Bank A/c Dr.
To Debentures A/c
To Debentures Premium A/c

(*v*) **For payment of interest of debentures:**

Debenture interest A/c Dr.
To Bank
To Tax deducted at source

NOTES

Notes:

(a) It is customary to prefix the rate of interest payable on debentures with the "Debentures Account". For example if the rate of interest payable on debentures is 10%, debentures account will be termed as, "10% Debentures Account".

(*b*) Income tax is to be deducted at source at prescribed rates by the company paying interest on debentures. Tax so deducted is deposited by the company on behalf of debentureholders with the Central Government. The debentureholder can get credit for the tax deducted on the basis of Tax deduction certificate issued by the company.

Illustration 10.3 In February 2016 *A* Ltd., offered for subscription 1,000 14% debentures of ₹ 1,000 each at the issue price of 94%, payable ₹ 50 per debenture on application, ₹ 500 on allotment and the balance on 1 May, 2016. Interest was payable half yearly on 30 June and 31 December. The first coupon payable on 30 June 2016, being for 5%. The issue was fully taken up.

Rate of Tax Deducted at source is 10%. Journalise the transactions and show how they would appear in the Company's Balance Sheet as on 31st Dec. 2016.

Solution:

***A* Ltd.**
Journal

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
2016	Bank A/c *Dr.*		
Feb.	To 14% Deb. application A/c	50,000	
	(Being application money received on 1,000 debentures		50,000
	@ ₹ 50 each)		
	14% Debenture application A/c *Dr.*	50,000	
	To 14% Debentures A/c		
	(Being transfer of application money to 14% debentures		50,000
	account on allotment vide Board's Resolution No.		
	dated ......)		
	14% Debenture allotment A/c *Dr.*	5,00,000	
	Discount on issue of deb. A/c *Dr.*	60,000	
	To 14% Debentures A/c		5,60,000
	(Being money due on allotment vide Board's Resolution		
	No......dated.....)		
	Bank A/c *Dr.*	5,00,000	
	To 14% Debenture allotment A/c		5,00,000
	(Receipt of allotment money)		
1 May	14% Debenture first & final call A/c *Dr.*	3,90,000	
	To 14% Debentures A/c		3,90,000
	(Being first and final call due on 1,000 debentures @		
	₹ 390 per debenture)		
	Bank A/c *Dr.*	3,90,000	
	To 14% Debenture first & final call A/c		3,90,000
	(Being receipt of first and final call money)		
30 June	Debenture interest A/c* *Dr.*	50,000	
	To Bank		45,000
	To Tax deducted at source		5,000
	(Interest paid on debentures for half year @ 5 per cent		
	on ₹ 10,00,000		
	after deduction of tax)		

Date	Particulars		Dr. ₹	Cr. ₹
31 Dec.	Debenture interest A/c	Dr.	70,000	
	To Bank			63,000
	To Tax deducted at source			7,000
	(Payment of debenture interest for half-year ended 31 Dec. 2016)			
31 Dec.	Profit and Loss A/c	Dr.	1,20,000	
	To Debenture interest A/c			1,20,000
	(Being transfer of debenture interest to Profit & Loss A/c)			

NOTES

* The money was received on debentures on different dates. Instead of calculating interest on different amounts received on different dates, the question provides for a flat rate of interest of 5% on the entire amount for the first six months.

_A_ Ltd.

Balance Sheet as on 31st Dec. 2016

	Particulars	₹
A	**Equity and Liabilities**	
1.	Shareholders' Funds	
	(*a*) Share Capital	
	Issued & Paid-up Capital _ equity shares of _ each	
	(*b*) Reserves and Surplus	....
	Profit and Loss A/c	(1,20,000)
	Discount on Issue of Debentures	(60,000)
	(*c*) Money Received Against Share Warrants	–
		(1,80,000)
2	Share Application money Pending Allotment	–
3	Non-current Liabilities	
	(*a*) Long-term Borrowings: 14% debentures	10,00,000
	(*b*) Deferred tax Liabilities (net)	
	(*c*) Other Long-term Liabilities	
	(*d*) Long-term Provisions	
		10,00,000
4	Current Liabilities	
	(*a*) Short-term Borrowings	–
	(*b*) Trade Payables	–
	(*c*) Other Current Liabilities	12,000
	(*d*) Short-term Provisions: Tax deducted at source	–
		12,000
	TOTAL (1) + (2) + (3) + (4)	8,32,000
B	**Assets**	
1.	Non-current Assets	–
2.	Current Assets	
	(*a*) Current Investments	–
	(*b*) Inventories	–
	(*c*) Trade Receivables	–
	(*d*) Cash and Cash Equivalents	8,32,000
	(*e*) Short-term Loans and Advances	–
	(*f*) Other Current Assets	–
		8,32,000
	TOTAL (1) + (2)	8,32,000

Note: Separate notes for various items of Balance Sheet have not been made in the absence of detailed information.

NOTES

Different Terms of Issue of Debentures

A company may issue debentures on different terms. These terms may not only relate to issue but also to redemption. Such terms can be as follows:

Debentures issued at par and payable at par They are ordinary type of debentures and accounting entries are the same as discussed earlier.

On issue of debentures

Bank A/c	*Dr.*		
To Debentures A/c			

Some accountants prefer to pass two accounting entries even when amount of debentures is received in one instalment.

Bank A/c	*Dr.*		
To Debenture application & allotment A/c			
(For application money received)			
Debenture application & allotment A/c	*Dr.*		
To Debentures A/c			
(For transfer of application money to debentures Account)			

Passing of two entries may be useful in case of oversubscription since surplus money can be retained in and returned out of Debenture application & allotment account. In the normal course the students may pass only one entry.

On payment

Debentures A/c	*Dr.*		
To Bank A/c			

In case money is received in different instalments, say on application, allotment, first call etc., entries will be made in the manner already discussed in the previous pages.

Debentures issued at discount and payable at par, e.g., a debenture of ₹ 100 is being issued at ₹ 90 and is payable at ₹ 100.

On issue of debentures

Bank A/c	*Dr.*	90	
Discount on issue of debentures A/c	*Dr.*	10	
To Debentures A/c			100

In case money is received in instalments, the entry for discount will be made with money due on allotment.

Debenture allotment	*Dr.*		
Discount on issue of debenture A/c	*Dr.*		
To Debentures A/c			

On payment:

Debentures A/c	*Dr.*	100	
To Bank A/c			100

Debentures issued at premium payable at par *e.g.*, a debenture of ₹ 100 is being issued at 110, but is payable at ₹ 100.

On issue of debentures

Bank A/c	*Dr.*	110	
To Debentures A/c			100
To Premium on issue of debentures A/c			10

In case money is received in instalments, the entry for premium, will be made with money due on allotment unless otherwise stated:

Debenture allotment A/c	*Dr.*		
To Debentures A/c			
To Premium on issue of Debentures A/c			

At the end of the accounting year, the amount of Debenture premium may be transferred to Capital Reserve. Alternatively, it may be shown as a separate item "Premium on issue of debentures" under the heading "Reserves & Surplus" in the balance sheet of the company.

On payment:

Debentures A/c	*Dr.*	100	
To Bank A/c			100

Debentures issued at par, payable at premium, *e.g.*, a debenture of ₹ 100 is payable at ₹ 110.

On issue of debentures

Bank A/c	*Dr.*	100	
Loss on issue of debentures A/c	*Dr.*	10	
To Debentures A/c			100
To Premium on Redemption of debentures A/c			10

In the Balance Sheet, the items will appear as follows:

***A* Ltd.**
Balance Sheet as at 31 March, 2017

	Particulars	₹
A	**Equity and Liabilities**	
1.	Shareholders' Funds	
	Share Capital	
	Reserve & Surplus	......
	Loss on Issue of Debentures	(10)
2.	Share Application Money Pending Allotment	......
3.	Non-current liabilities	
	(a) Long-term Borrowings: Debentures	100
	Premium on Redemption of Debentures	10
		110
4.	Current Liabilities	_
	TOTAL (1) + (2) + (3) + (4)	100
B	**Assets**	......
1.	Non-current Assets	
2.	Current Assets	
	(a) Current Investments	
	(*b*) Inventories	
	(*c*) Trade Receivables	
	(*d*) Cash and Cash Equivalents	100
	(*e*) Short-term Loans and Advances	
		100
	TOTAL (1) + (2)	100

In case the money is received on debentures in instalments, the entry for the amount of premium payable on redemption, will be made for money due on allotment.

Debenture allotment A/c	*Dr.*		
Loss on issue of debentures A/c	*Dr.*		
To Debentures A/c			
To Premium on redemption of debentures A/c			

On payment:

Debentures A/c	*Dr.*	100	
Premium on redemption of debentures A/c	*Dr.*	10	
To Bank A/c			110

Debentures issued at discount, payable at premium, *e.g.*, a debenture of ₹ 100 is issued for ₹ 90 but is payable at ₹ 110.

On issue of debentures:

Bank A/c	*Dr.*	90	
Loss on issue of debentures A/c (₹ 10 + ₹ 10)	*Dr.*	20	
To Debentures A/c			100
To Premium on redemption of debentures A/c			10

In case money on debentures is received in instalments, the entry for loss on issue will be made with allotment as in case of point (4).

On payment:

The entry on payment will also be the same as indicated in point (4).

There is no practice of issuing debentures at par/premium/discount but payable at discount or issuing debentures at premium and also payable at premium. However, if such issue is made, the accounting entries will be as follows:

Debentures issued at par and payable at discount, *e.g.*, a debenture of ₹ 100 is issued at ₹ 100 but is payable at ₹ 95.

On issue of debentures:

Bank A/c	*Dr.*	100	
To Debentures A/c			100

On payment:

Debentures A/c	*Dr.*	100	
To Bank			95
To Profit on redemption of debentures			5

It may be noted that discount receivable on redemption should be recorded only on redemption of debentures and not on issue of debentures. This is as per the accounting convention of conservatism according to which expected losses are to be taken into account but not expected profits.

Debentures issued at discount and redeemable at discount, *e.g.*, a debenture of ₹ 100 is issued at 95 but is payable at ₹ 98.

On issue of debentures:

Bank A/c	*Dr.*	95	
Discount on issue of debentures A/c	*Dr.*	5	
To Debentures A/c			100

On payment:

Debentures A/c	*Dr.*	100	
To Bank			98
To Profit on redemption of debentures			2

NOTES

Debentures issued at premium and redeemable at discount, *e.g.*, a debenture of ₹ 100 is issued at ₹ 105 but is payable at ₹ 95.

On issue of debentures:

Bank A/c	*Dr.*	105	
To Debentures A/c			100
To Premium on issue of debentures A/c			5

On redemption of debentures:

Debentures A/c	*Dr.*	100	
To Bank			95
To Profit on redemption of debentures A/c			5

Debentures issued at premium and payable at premium, *e.g.*, a debenture of ₹ 100 is issued at ₹ 105 but is payable at ₹ 110.

On issue of debentures:

Bank A/c	*Dr.*	105	
Loss on issue of debentures A/c	*Dr.*	10	
To debentures A/c			100
To Premium on issue of debentures A/c			5
To Premium on redemption of debentures A/c			10

On payment:

Debentures A/c	*Dr.*	100	
Premium on redemption of debentures A/c	*Dr.*	10	
To Bank			110

Check Your Progress

3. How can a company issue its shares at premium?
4. State the advantages of the alternative method for treatment of securities premium.

10.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Two differences between a share and stock are:
    - A share may not be fully paid up, but a stock is always fully paid up.
    - A share has a nominal value, whereas a stock has no nominal value.
2. Stock is the aggregate consolidated holdings of the share capital of a person. It can be divided and transferred in any fractions and sub-divisions without regard to the original face value of the share for the purpose of convenient holding into different parts.

3. A company can issue its shares at a premium (i.e., for a value higher than the face value of the shares) whether for cash of for consideration other than cash. The power to issue shares at a premium need not be given in the Articles of Association. However, according to recent guidelines issued by SEBI, a new company set up by the entrepreneurs without a track record can issue capital to the public only at par.
4. The advantage of the alternate method is that the securities premium account will not have to be debited in the event of the forfeiture of shares in case securities premium money has not been received.

10.6 SUMMARY

- A share is one of the units into which the total share capital of a company is divided. The Companies Act, 2013 defines a share as “share in the share capital of a company and includes stock”. [Sec. 2(84)].
- A share certificate issued under the common seal of the company certifies that the person named herein is a registered holder of a specific number of shares bearing distinct numbers as mentioned in the certificate.
- A share is said to be a bundle of rights as well as liabilities. It secures to its owner the right to receive a proportionate part of the profits, if any, and proportionate part of the assets of the company upon liquidation. On the other hand the shareholder may also be required to pay the full value in winding up.
- Fully paid up share capital may, if the Articles so permit, be converted into stock by an ordinary resolution (a resolution by simple majority) of the members.
- Stock is the aggregate consolidated holdings of the share capital of a person. It can be divided and transferred in any fractions and sub-divisions without regard to the original face value of the share for the purpose of convenient holding into different parts.
- A company can issue its shares at a premium (i.e., for a value higher than the face value of the shares) whether for cash of for consideration other than cash. The power to issue shares at a premium need not be given in the Articles of Association.
- However, according to recent guidelines issued by SEBI, a new company set up by the entrepreneurs without a track record can issue capital to the public only at par. According to Section 52 of the Companies Act, the amount of such premium, shall have to be transferred by the company to the Securities Premium Account.

- Generally the amount of premium is payable in a lump sum on allotment. However, a company may require the applicants to pay premium money with application money or with calls.
- There is an alternative method for treatment of securities premium. No entry is passed for securities premium when it becomes due. However, on receipt of securities premium, the amount of securities premium is credited to Securities Premium Account.
- A company now cannot issue shares at a discount (i.e., for a consideration less than the nominal value of the shares) except sweat equity shares. As discussed earlier, sweat equity shares are those shares which have been issued for consideration other than cash, e.g., for intellectual rights or value additions.
- Companies require money from time to time. This requirement is met by the company partly by raising share capital and partly by depending on public borrowings. One form of such public borrowings is to raise money by issue of debentures. Debentures help the companies in borrowing money from a large section of the general public.
- Debenture may be defined as a certificate issued by a company under its seal acknowledging debt due by it to its holder. The most essential characteristic of a debenture is the admission or record of indebtedness.
- The entries for issue of debentures are made on the same pattern as for issue of shares. They can also be issued at par, premium or discount. However, the legal restrictions regarding use of premium money or issuing at discount applicable in the case of shares, are not applicable to debentures.

10.7 KEY WORDS

- **Equity shares:** Shares which have no preferential rights over other classes of shares.
- **Firm underwriting:** An underwriting wherein the underwriter agrees to subscribe himself for securities of the company irrespective of his potential liability under the underwriting contract.
- **Preference shares:** Shares which carry a preferential right in respect of a fixed dividend and a preferential right as to the return of capital, in the event of company's winding up, over other classes of shares.

10.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short Answer Questions

1. What are the essential features of a share?
2. Write a short note on the issue of shares at discount.

Long Answer Questions

1. State how you will deal with loss on issue of debentures in the books of accounts.
2. What is a debenture and its redemption? Describe the various methods for redemption of debentures. Give illustrations.

10.9 FURTHER READINGS

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

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UNIT 11 FORFEITURE OF SHARES AND RE-ISSUE OF FORFEITED SHARES

Structure

11.0 Introduction
11.1 Objectives
11.2 Forfeiture and Reissue of Shares
 11.2.1 Forfeiture of Shares Issued at Par
 11.2.2 Forfeiture of Shares Issued at Premium
 11.2.3 Reissue of Forfeited Shares
 11.2.4 Reissue of Forfeited Shares Originally Issued at Premium
11.3 Answers to Check Your Progress Questions
11.4 Summary
11.5 Key Words
11.6 Self Assessment Questions and Exercises
11.7 Further Readings

11.0 INTRODUCTION

When shares are reissued at a loss, then such a loss should be debited to the share forfeiture account. If the loss on reissue is less than the amount forfeited, then the excess should be transferred to the capital reserve account.

11.1 OBJECTIVES

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

- Analyse the legal provisions for forfeiture of shares
- Explain the accounting entries for forfeiture of shares
- Discuss the process of reissue of forfeited shares
- Describe the process of reissue of forfeited shares originally issued at premium

11.2 FORFEITURE AND REISSUE OF SHARES

Forfeiture of shares may be defined as termination of membership and taking away of the shares because of default in payment of allotment and/or call money by a shareholder. The Companies Act does not contain any specific provision regarding forfeiture of shares. However, Regulation, 28 to 34 of Model Articles of a company limited by shares (as contained in Table F of Schedule I of the Companies Act 2013) make provision forfeiture of shares.

NOTES

These legal provisions can be summarized as under.

(*i*) The power to forfeit shares must be expressly given by the company's Articles.

(*ii*) The procedure given in the Articles must be followed.

(*iii*) There should be a default by the shareholder in payment of a valid call.

(*iv*) A notice of demand, requiring the shareholder to pay calls of a specified amount within 14 days must be given.

(*v*) The Board of Directors must pass a resolution for forfeiture of shares.

(*vi*) The power to forfeiture must be exercised in good faith and in the interest of the company.

(*vii*) Forfeited shares may be sold or otherwise disposed of by the Board, as it deems fit. Board can cancel forfeiture on such terms as it deems fit.

The shareholder, whose shares have been forfeited, shall cease to be the member of the company. If the articles of the company permit, the company can sue him for unpaid calls even after the forfeiture. In such a case the ex-shareholder will be liable as an ordinary debtor and not as a contributory. But where the company goes into liquidation within one year of the forfeiture of shares, the ex-shareholder can be put on "List *B* contributories."[1]

Accounting entries: The following points should be taken into account while passing an accounting entry for forfeiture of shares.

(*i*) The amount called up on the shares forfeited.

(*ii*) The amount unpaid on various calls (including allotment) on the shares forfeited.

(*iii*) The amount received on the shares forfeited.

Forfeiture of shares results in reduction of share capital and therefore the share capital account should be debited with the amount called up on these shares so far. The various unpaid calls account should now be cancelled and therefore they should be credited and the balance representing the amount received on the shares forfeited should be credited to a new account termed as "Forfeited Shares Account."

Share capital A/c	*Dr.*
To Unpaid call(s) A/c	
To Forfeited shares A/c	
(Being forfeiture of…shares as per Board's resolution no…dated…..)	

Shares, as explained before, can be issued at par, at premium or at discount. The accounting entries for forfeiture of shares in each of these cases are being explained as:

[1] A "List B Contributory" can be required to pay the unpaid calls in the event of a company's winding up if the existing shareholder is not in a position to pay such calls.

11.2.1 Forfeiture of Shares Issued at Par

The journal entry will be as follows:

Share capital A/c (with the amount called up) *Dr.*
To Unpaid call(s) A/c (with the amount, remaining unpaid)
To Forfeited shares A/c (with the amount received)

Illustration 11.1. A company forfeits 100 shares of ₹ 10 each fully called up on which the shareholder has failed to pay the allotment money of ₹ 2 per share and call money of ₹ 3 per share.

Solution:

The Journal entry for forfeiture will be as follows:

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	Share Capital A/c *Dr.*	1,000	
	To Share allotment A/c		200
	To Share call A/c		300
	To Shares forfeited A/c		500

11.2.2 Forfeiture of Shares Issued at Premium

There can be two situations.

(*i*) The amount of share premium had not been received but it was credited to "Securities Premium Account", when the amount became due. The journal entry for forfeiture will be:

Share capital A/c (with the amount called up) *Dr.*
Securities premium A/c (with the amount of premium called) *Dr.*
To Unpaid calls A/c
To Forfeited shares A/c

Illustration 11.2. A company forfeits 100 shares of ₹ 10 each issued at ₹ 11 per share. The premium was payable on allotment. The shareholder failed to pay allotment money of ₹ 3 per share (including premium) and the call money of ₹ 2 per share.

Solution:

The journal entry for forfeiture will be as follows:

Date	*Particulars*	₹	₹
	Share capital A/c Dr.	1,000	
	Securities premium A/c Dr.	100	
	To Share allotment A/c		300
	To Share call A/c		200
	To Forfeited shares A/c		600

(*ii*) The amount of share premium has either been received or even if not received, the company has given credit to the securities premium account only with the amount of premium received.

The journal entry will be:

Share capital A/c *Dr.*
(with the amount called up on account of share capital)
To Unpaid calls

(with unpaid amount excluding share premium)
To Forfeited shares A/c
(with the amount received)

NOTES

Share premium once received cannot be cancelled. This is because of Section 52 which provides for the use of share premium received, only for certain specified purposes, as explained before.

Illustration 11.3. A company forfeits the shares held by two shareholders—A and B.

(*i*) *A* holds 100 shares of ₹ 10 each on which he has paid ₹ 5 per share (₹ 3 on application and ₹ 2 on allotment including ₹ 1 as premium payable on allotment) as application and allotment moneys but has failed to pay the call of ₹ 6 per share.

(*ii*) *B* holds 200 shares of ₹ 10 each on which he has paid ₹ 3 per share, as application money. He has failed to pay the allotment and call money.

The company gives credit to securities premium account only when it is received.

Pass necessary journal entries.

Solution:

S.No	*Particulars*	*Dr.* ₹	*Cr.* ₹
(*i*)	Share Capital A/c *Dr.*	1,000	
	To Share call A/c		600
	To Shares forfeited A/c		400
	(Being forfeiture of 100 shares held by *A*)		
(*ii*)	Share Capital A/c *Dr.*	2,000	
	To Share allotment A/c		200
	To Share call A/c		1,200
	To Shares forfeited A/c		600
	(Being forfeiture of 200 shares held by *B*)		

Forfeiture of shares issued at discount In such a case the discount allowed on issue of shares will have to be cancelled. The journal entry will be:

Share Capital A/c *Dr.*
To Unpaid call A/c
To Forfeited shares A/c
To Discount on issue of shares A/c

Illustration 11.4. A company forfeits 100 shares of ₹ 10 each issued at ₹ 9 per share on account of non-payment of final call of ₹ 4 per share by the shareholder.

Solution:

The journal entry for forfeiture will be as follows:

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	Share capital A/c *Dr.*	1,000	
	To Share final call A/c		400
	To Forfeited Shares A/c		500
	To Discount on issue of shares A/c		100

11.2.3 Reissue of Forfeited Shares

Forfeited shares become the property of the company and the company can always reissue them at its convenience. They can be reissued at par, premium or discount. However, in case they are reissued at discount, the amount of discount cannot exceed the amount that had been received on these shares. In other words there cannot be any loss on account of reissue of forfeited shares.

Accounting entries: While passing accounting entries regarding reissue of forfeited shares the following points should be taken into account.

(*i*) The amount at which they are taken as paid up on reissue.

(*ii*) The amount that had already been received on the shares forfeited.

(*iii*) The amount allowed as discount.

The journal entry will be:

Bank A/c (with the amount recd.) *Dr.*
Forfeited Shares A/c (with the discount allowed) *Dr.*
To Share Capital A/c (with the amount taken as paid up)

Illustration 11.5. A company forfeits 100 shares of ₹ 10 each on which ₹ 300 had been received. The company can allow a maximum discount of ₹ 300 on these shares. In case these shares are reissued for ₹ 900 fully paid, pass the necessary journal entries.

Solution:

Date	*Particulars*	*Dr. ₹*	*Cr. ₹*
	Bank A/c *Dr.*	900	
	Forfeited Shares A/c *Dr.*	100	
	To Share capital A/c		1,000
	(Being reissue of 100 forfeited shares)		

The balance standing to the credit of "forfeited shares account", is a capital profit and therefore, it will be transferred to capital reserve. The journal entry will be:

Date	*Particulars*	*Dr. ₹*	*Cr. ₹*
	Forfeited Shares A/c *Dr.*	200	
	To Capital reserve		200
	(Being profit on reissue of forfeited shares transferred to capital reserve)		

In case only a part of the forfeited shares have been reissued, only the proportionate profit on reissue of forfeited shares will be transferred to capital reserve.

For example, if in the above case only 60 shares are reissued at ₹ 9 per share, the amount to be transferred to Capital Reserve will be ₹ 120

$$\left(i.e. ₹\,300 \times \frac{60}{100} - ₹\,60\right)$$

Reissue of forfeited shares originally issued at discount In case the forfeited shares were originally issued at discount, the maximum permissible reissue discount, is the sum received on forfeited shares and original discount.

For example, if a share of ₹ 10 was originally issued at a discount of ₹ 1 is forfeited, and the amount received on it was ₹ 2, the maximum discount on reissue of such a forfeited share can be ₹ 3 (*i.e.,* original discount ₹ 1 + amt. recd. ₹ 2). The Journal entry will be as follows in case the share is reissued for ₹ 7 per share, fully paid up.

	Particulars		₹	₹
	Bank A/c	*Dr.*	7	
	Discount on issue of shares A/c	*Dr.*	1	
	Forfeited shares A/c	*Dr.*	2	
	To Share capital A/c			10

Illustration 11.6. *B* Ltd. forfeited 100 shares of ₹ 10 each, ₹ 8 per share being called up, which were issued at a discount of ₹ 1 per share for non-payment of first call of ₹ 3 per share. Of these forfeited shares, 80 shares were reissued subsequently by the company at ₹ 5, as ₹ 8 paid up per share. Give journal entries for the forfeiture and reissue of shares.

Solution:

In the Books of *B* Ltd.
Journal Entries

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Share Capital A/c (100 × ₹ 8)	*Dr.*	800	
	To Shares forfeited A/c (100 × ₹ 4)			400
	To Discount on issue of shares A/c (100 × ₹ 1)			100
	To Shares first call A/c (100 × ₹ 3)			300
	(Being forfeiture of 160 shares of ₹ 10 each, ₹ 8 called up issued at a discount of ₹ 1 per share for non-payment of first call of ₹ 3 per share)			
	Bank A/c (80 × ₹ 5)	Dr.	400	
	Discount on issue of shares A/c (80 × ₹ 1)	Dr.	80	
	Shares Forfeited A/c (80 × ₹ 2)	Dr.	160	
	To Share Capital A/c (80 × ₹ 8)			640
	(Being reissue of 80 forfeited shares of ₹ 10 each, ₹ 8 called up, originally issued at a discount of ₹ 1 per share, for ₹ 5 per share, credited as ₹ 8 per share)			
	Shares Forfeited A/c	Dr.	160	
	To Capital Reserve A/c			160
	(Being transfer of capital profit proportionate to forfeited shares reissued, i.e., on 80 shares, to capital reserve account)			

11.2.4 Reissue of Forfeited Shares Originally Issued at Premium

It is not necessary that if the shares were originally issued at premium, their reissue after forfeiture should also be at premium or that the premium should be at the same rate. However, if any premium is received (i.e., over and above the amount taken as paid up on account of share capital), the amount should be credited to the "securities premium account."

Illustration 11.7. A company forfeits 100 shares of ₹ 10 each, originally issued at a premium of ₹ 2 per share. The shareholder paid ₹ 4 per share on application but did not pay the allotment money of ₹ 4 per share (including premium) and call of ₹ 4 per share. The company takes credit for the premium as soon as it becomes due. The shares are subsequently reissued at ₹ 11 per share fully paid up.

Pass journal entries for forfeiture and reissue of forfeited shares.

Solution:

Journal

Date	*Particulars*	₹	₹
	Share Capital A/c Dr.	1,000	
	Securities Premium A/c *Dr.*	200	
	To Share Allotment A/c		400
	To Share Call A/c		400
	To Shares Forfeited A/c		400
	(Being forfeiture of 100 shares on account of non-payment of allotment and call moneys)		
	Bank A/c *Dr.*	1,100	
	To Share Capital A/c		1,000
	To Securities Premium A/c		100
	(Being reissue of forfeited shares)		
	Shares Forfeited A/c *Dr.*	400	
	To Capital Reserve		400
	(Being transfer of profit on shares forfeited to capital reserve)		

Alternative approach: Some accountants are of the opinion that securities premium account appearing in the Balance Sheet should have definite relevance with the number of shares actually issued. Hence, in case shares are subsequently issued at a premium at a rate lower than the rate at which they were originally issued and the premium amount had not been received at the time of original issue, the shortfall should be met out of the shares forfeited account. For example, on the basis of the figures given in the previous illustration, the journal entry will be as follows:

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	Bank A/c *Dr.*	1,100	
	Shares Forfeited A/c *Dr.*	100	
	To Share Capital A/c		1,000
	To Securities premium A/c		200
	(Being reissue of 100 forfeited shares)		

However, such an approach may create problems in cases where forfeited shares account does not have sufficient amount to meet the shortfall on account of share premium. Thus, it is better to follow the first method given before.

NOTES

Illustration 11.8. A holds 100 shares of ₹ 10 each on which he has paid ₹ 1 per share as application money.

B holds 200 shares of ₹ 10 each on which he has paid ₹ 1 on application and ₹ 2 on allotment.

C holds 300 shares of ₹ 10 each and has paid ₹ 1 on application, ₹ 2 on allotment and ₹ 3 for the first call.

They all fail to pay their arrears and the second call of ₹ 2 per share and the Directors, therefore, forfeited their shares. The shares of *C* were then reissued at ₹ 7 per share as fully paid-up.

Give the necessary journal entries to record the above transactions.

Solution:

The amount called up has been calculated as follows:

On Application	₹ 1
On Allotment	₹ 2
On First Call	₹ 3
On Second Call	₹ 2
Total Called up	₹ 8

Journal

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Share Capital A/c	*Dr.*	4,800	
	To Share Allotment A/c			200
	To Share First call A/c			900
	To Share Second Call A/c			1,200
	To Forfeited Shares A/c			2,500
	(Being forfeiture of 600 shares)			
	Bank A/c	*Dr.*	2,100	
	Forfeited Shares A/c	*Dr.*	900	
	To Share Capital A/c			3,000
	(Being 300 shares reissued at ₹ 7 each fully paid up)			
	Forfeited Shares A/c	*Dr.*	900	
	To Capital Reserve A/c			900
	(Being surplus on forfeiture and reissue of 300 shares transferred to capital reserve)			

Working Notes:

(*i*) Amount not paid:

	Allotment	*First Call*	*Second Call*
A	200	300	200
B	–	600	400
C	–	–	600
	200	900	1,200

(*ii*) The amount transferred to Capital Reserve has been calculated as follows:

Amount received on *C*'s shares (300 × 6)	₹	1,800
Less: Discount allowed on reissue (300 × 3)	₹	900
Net Gain	₹	900

Check Your Progress

1. Define forfeiture of shares.
2. What happens in case of forfeited shares originally issued at discount?
3. Why can share premium once issued cannot be cancelled?

11.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Forfeiture of shares may be defined as termination of membership and taking away of the shares because of default in payment of allotment and/or call money by a shareholder.
2. In case the forfeited shares were originally issued at discount, the maximum permissible reissue discount, is the sum received on forfeited shares and original discount.
3. Share premium once received cannot be cancelled. This is because of Section 52 which provides for the use of share premium received, only for certain specified purposes.

11.4 SUMMARY

- Forfeiture of shares may be defined as termination of membership and taking away of the shares because of default in payment of allotment and/or call money by a shareholder. The Companies Act does not contain any specific provision regarding forfeiture of shares.
- The shareholder, whose shares have been forfeited, shall cease to be the member of the company.
- If the articles of the company permit, the company can sue him for unpaid calls even after the forfeiture. In such a case the ex-shareholder will be liable as an ordinary debtor and not as a contributory.
- Forfeiture of shares results in reduction of share capital and therefore the share capital account should be debited with the amount called up on these shares so far.
- The various unpaid calls account should now be cancelled and therefore they should be credited and the balance representing the amount received on the shares forfeited should be credited to a new account termed as "Forfeited Shares Account."
- Forfeited shares become the property of the company and the company can always reissue them at its convenience. They can be reissued at par, premium or discount. However, in case they are reissued at discount, the amount of discount cannot exceed the amount that had been received

on these shares. In other words there cannot be any loss on account of reissue of forfeited shares.

- In case the forfeited shares were originally issued at discount, the maximum permissible reissue discount, is the sum received on forfeited shares and original discount.
- Some accountants are of the opinion that securities premium account appearing in the Balance Sheet should have definite relevance with the number of shares actually issued.
- Hence, in case shares are subsequently issued at a premium at a rate lower than the rate at which they were originally issued and the premium amount had not been received at the time of original issue, the shortfall should be met out of the shares forfeited account.

11.5 KEY WORDS

- **Forfeited share:** A forfeited share is a share in a company that the owner loses (forfeits) by failing to meet the purchase requirements.
- **Issue at premium:** A company issues its shares at a premium when the price at which it sells the shares is higher than their par value.

11.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What points should be taken into account while passing an accounting entry for forfeiture of shares?
2. Write a short note on reissue of forfeited shares.

Long Answer Questions

1. Describe the accounting entries for forfeiture of shares at premium and at par.
2. Discuss the process of reissue of forfeited shares originally issued at premium.

11.7 FURTHER READINGS

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

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BLOCK - IV

TRIAL BALANCE AND BALANCE SHEET

UNIT 12 ACCOUNTS OF BANKING COMPANIES

Structure

12.0 Introduction
12.1 Objectives
12.2 Banking Company Accounts: Meaning and Important Provisions of the Banking Companies Act, 1949
12.3 Preparation of Final Accounts of Banking Companies
  12.3.1 Profit and Loss Account
  12.3.2 Preparation of Balance Sheet
  12.3.3 Accounting Policies for Banking Sector
12.4 Answers to Check Your Progress Questions
12.5 Summary
12.6 Key Words
12.7 Self Assessment Questions and Exercises
12.8 Further Readings

12.0 INTRODUCTION

In this unit, you will learn about the accounts of banking companies. Banking business in India is largely governed by the Banking Regulation Act, 1949. According to Section 5 (*b*) of this Act, banking means 'the acceptance for the purpose of lending or investment of deposits of money from the public repayable on demand, order or otherwise and withdrawable by cheque, draft, order or otherwise.' Thus, according to this definition accepting of deposits from the public for lending or investment is the main function of a banking company. However, under Section 6 of the Banking Regulation Act, a banking company can also carry on some other businesses, such as acting as agents for any government or local authority or any other person, carrying on every kind of guarantee and indemnity business, undertaking and executing of trust etc.

12.1 OBJECTIVES

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

- Understand the important provisions relating to final accounts of banking companies
- Get familiar with the prescribed formats of the Profit and Loss Account and Balance Sheet of a banking company

- Understand the concept of Capital Adequacy Ratio
- Describe the mode of disclosure of accounting policies adopted by a banking company in the preparation of its financial statements

NOTES

12.2 BANKING COMPANY ACCOUNTS: MEANING AND IMPORTANT PROVISIONS OF THE BANKING COMPANIES ACT, 1949

Banking business in India is largely governed by the Banking Regulation Act, 1949. According to Section 5(*b*) of this Act, banking means "the acceptance for the purpose of lending or investment of deposits of money from the public repayable on demand, order or otherwise and withdrawable by cheque, draft, order or otherwise." Thus, according to this definition accepting of deposits from the public for lending or investment is the main function of a banking company. However, under Section 6 of the Banking Regulation Act, a banking company can also carry on some other businesses, such as acting as agents for any government or local authority or any other person, carrying on every kind of guarantee and indemnity business, undertaking and executing of trust etc.

The Act has been amended from time to time. The major amendments have been in 1994, 2007, 2012 and most in recently in 2017 by The Banking Regulation (Amendment) Act, 2017. The basic provisions of the Amendment Act, 2017 are as under:

1. **Power of Central Government to authorize Bank for issuing directions to banking companies to initiate insolvency resolution process (Sec. 35AA):** The Central government may by order authorize the Reserve Bank to issue directions to any banking company or banking companies to initiate insolvency resolution process in respect of a *Default*, under the insolvency and Bankruptcy Code, 2016.

   According to the Insolvency and Bankruptcy Code 2016, the term *Default* means "non-payment of debt when whole or any part of instalment of the amount of debt has become due and is not repaid by the debtor or the corporate debtor, as the case may be".

2. **Power of Reserve Bank to issue directions in respect of stressed assets (Sec. 35AB):** Without prejudice to the provisions of section 35A, the Reserve Bank may, from time to time, issue directions to the banking companies for resolution of stressed assets.

   The Reserved bank may specify one or more authorities or committees with such members as the Reserve Bank may appoint or approve for appointment to advise banking companies on resolution of stressed assets.

Stressed Assets: Stressed assets are a powerful indicator of the health of the banking system. Stressed assets comprise of :

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NPAs + Restructured Assets + Written off Assets.

Nonperforming Assets (NPAs) include advances whose interest or principal remain overdue for a period of 90 days. While *Restructured Assets* include those advances where the defaulting borrowers have been given another opportunity to repay the advances. This opportunity may in the form of charging interest at a reduced rate, extended time period for repayment *written off assets* are those advances which the bank does not count its assets though the borrower owes it. It does not mean that the borrower is pardoned or got exempted from payment.

The sections given in this unit are of The Banking Regulation Act, 1949 unless stated otherwise.

In this unit, we are concerned mainly with the technique of preparing the final accounts of banking companies.

12.3 PREPARATION OF FINAL ACCOUNTS OF BANKING COMPANIES

Let us study the procedure for preparation of final accounts of banking companies.

12.3.1 Profit and Loss Account

The Profit and Loss Account of a banking company has to be prepared in Form *B* of Schedule *III*, attached to the Banking Regulation Act. As stated earlier the form has been revised *w.e.f.* 1st April 1991 and the Profit and Loss Account of a banking company for the year ending March 31, 1992, and onwards has to be prepared in the prescribed new form as given follows:

Form 'B'
THIRD SCHEDULE
FORM OF PROFIT AND LOSS ACCOUNT
Profit and Loss Account for the year ended 31st March, 19...

		Schedule Number	*Year ended (₹)*
I	INCOME:		
	Interest earned	13	......
	Other income	14	......
	Total		......
II	EXPENDITURE:		
	Interest expended	15	......
	Operating expenses	16	......
	Provisions and contingencies		......
	TOTAL		......
III	PROFIT/LOSS:		......
	Net Profit/(Loss) for the year		
	TOTAL		......
IV	APPROPRIATIONS:		
	Transfer to statutory reserves		......
	Transfer to other reserves		......
	Transfer to Govt./proposed dividend		......
	Balance carried over to balance sheet		......
	TOTAL		......

NOTES

Schedules to be annexed with Profit and Loss Account

SCHEDULE 13: INTEREST EARNED

		₹
I	Interest/Discount on advances/Bills	......
II	Income on investments	......
III	Interest on balances with RBI and other inter-bank funds	......
IV	Other	......
	TOTAL	......

SCHEDULE 14: OTHER INCOME

		₹
I	Commission, exchange and brokerage	......
II	Profit on sale of investments	......
	Less: Loss on sale of investments	
III	Profit on revaluation of investments	......
	Less: Loss on revaluation of investments	
IV	Profit on sale of land/building and other assets	......
	Less: Loss on sale of land, Bldg. and other assets	
V	Profit on exchange transactions	......
	Less: Loss on exchange transactions	
VI	Income earned by way of dividends etc. from subsidiaries/ companies and/or joint ventures abroad/in India	......
VII	Misc. Income	
	TOTAL	......

Note: Under Items *II* to *V* loss figures may be shown in brackets.

SHEDULE 15: INTEREST EXPENDED

		₹
I	Interest on deposits	.....
II	Interest on RBI/Inter-Bank borrowings	.....
III	Others	.....
	TOTAL	.....

SCHEDULE 16: OPERATING EXPENSES

		₹
I	Payments to and provisions for employees	.....
II	Rent, taxes and lighting	.....
III	Printing and stationery	.....
IV	Advertisement and publicity	.....
V	Depreciation on Bank's property	.....
VI	Directors' fees, allowances and expenses	.....
VII	Auditors' fees and expenses (including branch auditors)	.....
VIII	Law charges	.....
IX	Postages, telegrams, telephones etc.	.....
X	Insurance	.....
XI	Other expenditure	.....
	TOTAL	.....

Note: Corresponding figures for the immediately preceding financial year should be shown in separate columns.

Comments on Profits and Loss Account Items

Interest Earned (Schedule 13)

(1) *Interest/Discount on Advances/Bills*: Includes interest and discount on all types of loans and advances like cash credit, demand, loans, overdrafts, export loans, term loans, domestic and foreign bills

purchased and discounted (including those rediscounted), overdue interest and also interest subsidy, if any, relating to such advances/ bills.

(2) *Income on Investments*: Includes all income derived from the investment portfolio by way of interest and dividend.

(3) *Interest on Balances with Reserve Bank of India and other Inter-bank Funds*: Includes interest on balance with Reserve Bank and other banks, call loans, money market placements, etc.

(4) *Others*: Includes any other interest/discount income not included in the above heads.

NOTES

Other Income (Schedule 14)

(1) *Commission, Exchange and Brokerage*: Includes all remuneration on services such as commission on collections, commission/exchange on remittances and transfers, commission on letters of credit, letting out of lockers and guarantees, commission on government business, commission on other permitted agency business including consultancy and other services, brokerage, etc. on securities. It does not include foreign exchange income.

(2) *Profit on Sale of Investments*; *Less*: —Loss on Sale of Investments;

(3) *Profit on Revaluation of Investments*; *Less*: —Loss on Revaluation of Investments;

(4) *Profit on Sale of Land, Buildings and Other Assets*; *Less*: —Loss on sale of land, buildings and other assets.

Includes profit/loss on sale of securities, furniture, land and buildings, motor vehicle, gold, silver, etc. Only the net position should be shown. If the net position is a loss, the amount should be shown as a deduction. The Net Profit/Loss on revaluation of assets may also be shown under this item.

(5) *Profit on Exchange transactions*; *Less*: —Loss on Exchange Transactions: Includes profit/loss on dealing in foreign exchange, all income earned by way of foreign exchange, commission and charges on foreign exchange transactions excluding interest which will be shown under interest. Only the net position should be shown. If the net position is a loss, it is to be shown as a deduction.

(6) *Income earned by way of dividends etc.* from subsidiaries, companies, joint ventures abroad/in India.

(7) *Miscellaneous Income*: Includes recoveries from constituents for godown rents, income from bank's properties, security charges, insurance etc. and any other miscellaneous income. In case any item under this head exceeds one percentage of the total income, particulars may be given in the notes.

Interest Expended (Schedule 15)

(1) *Interest on Deposits*: Includes interest paid on all types of deposits including deposits from banks and other institutions.

(2) *Interest on RBI/Inter-Bank Borrowings*: Includes discount/interest on all borrowings and refinance from Reserve Bank of India and other banks.

(3) *Others*: Includes discount/interest on all borrowings/refinance from financial institutions. All other payments like interest on participation certificates, penal interest paid, etc. may also be included here.

Operating Expenses (Schedule 16)

(1) *Payments to and Provisions for Employees*: Includes staff salaries/wages, allowances, bonus, other staff benefits like provident fund, pension, gratuity, liveries to staff, leave fare concessions, staff welfare, medical allowance to staff, etc.

(2) *Rent, Taxes and Lighting*: Including rent paid by the bank on building and other municipal and other taxes paid (excluding income tax and interest tax) electricity and other similar charges and levies. House rent allowance and other similar payments to staff should appear under the head "Payments to and Provisions for Employees."

(3) *Printing and Stationery*: Includes books and forms and stationery used by the bank and other printing charges which are not incurred by way of publicity expenditure.

(4) *Advertisement and Publicity*: Includes expenditure incurred by the bank for advertisement and publicity purposes including printing charges of publicity matter.

(5) *Depreciation on Bank's Property*: Includes depreciation on bank's own property, motor cars and other vehicles, furniture, electric fittings, vaults, lifts, leasehold properties, non-banking assets, etc.

(6) *Directors' Fees, Allowances and Expenses*: Includes sitting fees and all other items of expenditure incurred on behalf of directors. The daily allowance, hotel charges, conveyance charges, etc. which though in the nature of reimbursement of expenses incurred may be included under this head. Similar expenses of Local Committee members may also be included under this head.

(7) *Auditors' Fees and Expenses (including branch auditors' fee and expenses)*: Includes the fees paid to the statutory auditors and branch auditors for professional services rendered and all expenses for performing their duties, even though they may be in the nature of reimbursement of expenses. If external auditors have been appointed by banks themselves for internal inspection and audits and other services, the expenses incurred in that context including

fees may not be included under this head but shown under 'other expenditure'.

(8) *Law Charges*: All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here.

(9) *Postage, Telegrams, Telephones, etc.*: Includes all postal charges like stamps, telegram, telephones, teleprinter, etc.

(10) *Repairs and Maintenance*: Includes insurance charges on bank's property, maintenance charges, etc.

(11) *Insurance*: Includes insurance charges on bank's property, insurance premia paid to DICGC etc. to the extent they are not recovered from the concerned parties.

(12) *VRS Expenditure*: In case a banking company has not expensed Voluntary Retirement Expenditure in full in the same year, the entire ex-gratia amount shall be treated as an extra-ordinary item and a deferred revenue expenditure. The period of deferment would be restricted to maximum of 5 years including the year of acceptance of VRS. While allocating the deferred revenue expenditure, it should be recognised that the tax benefits for the whole expenditure will arise in the first year itself. Hence the basis of allocation should be:

(*i*) for the first year the charge should be equal to the firm of tax benefit obtained + 1/5 of the balance, and

(*ii*) in each of the others 4 years, the charge should be equal to 1/5 of the net amount i.e. the gross amount less the tax benefit obtained for the first year.

(13) *Other Expenditure*: All expenses other than those included in any of the other heads, like licence fees, donations, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. may be included under this head. In case any particular item under this head exceeds one percentage of the total income particulars may be given in the notes.

Provisions and Contingencies: Includes provisions made for bad and doubtful debts, provisions for taxation, provisions for dimunition in the value of investments, transfers to contingencies and other similar items.

12.3.2 Preparation of Balance Sheet

The Balance Sheet of a banking company has to be prepared in Form A of Schedule *III*, attached to the Banking Regulation Act. The form of balance sheet, as stated earlier, has been revised *w.e.f.* April 1, 1991. The Balance Sheet of a banking company has to be prepared in the prescribed new form for the year ending 31st March 1992, and onwards as given as follows:

The Third Schedule: Form 'A'

FORM OF BALANCE SHEET

Balance Sheet as on 31st March...

	Schedule	₹
CAPITAL AND LIABILITIES:		
Capital	1	.....
Reserves and surplus	2	.....
Deposits	3	.....
Borrowings	4	.....
Other liabilities and provisions	5	.....
	Total:	.....
ASSETS:		
Cash and balance with RBI	6	.....
Balance with banks and money at call and short notice	7	.....
Investments	8	.....
Advances	9	.....
Fixed assets	10	.....
Other assets	11	.....
	Total:	.....
Contingent liabilities:		
Bills for collection	12	.....

The following schedules are required to be furnished with the Balance Sheet:

SCHEDULE 1: CAPITAL

			₹
I	FOR NATIONALISED BANKS:		
	Capital (Fully owned by Central Government)		.....
II	FOR BANKS INCORPORATED OUTSIDE INDIA		
	(*i*) Capital (the amount brought in by banks by way of start-up capital as prescribed by *RBI* should be shown under this head)		.....
	(*ii*) Amount of deposit kept with *RBI* under Section 11(2) of the Banking Regulation Act, 1949		.....
	Total	.....	
III	FOR OTHER BANKS:		
	Authorised capital (...shares of ₹ ...each)		.....
	Issued capital (...shares of ₹ ...each)		.....
	Subscribed capital (...shares of ₹ ...each)		.....
	Called up capital (...shares of ₹ ...each)		.....
	Less: calls unpaid		.....
	Add: Forfeited shares		.....

SCHEDULE 2: RESERVES AND SURPLUS

			₹
I	Statutory reserves:		
	Opening balance	.....	
	Additions during the year	.....	
	Deductions during the year	.....	.....
II	Capital reserves:		
	Opening balance	.....	
	Additions during the year	.....	
	Deductions during the year	.....	......
III	Share premium:		
	Opening balance	.....	
	Additions during the year	.....	
	Deductions during the year	.....	.....
IV	Revenue and other reserves:		
	Opening balance	.....	
	Additions during the year	.....	
	Deductions during the year	.....	......
V	Balance in profit and loss A/c:		.....
		Total (*I, II, III, IV and V*)	.....

SCHEDULE 3: DEPOSITS

				₹
A	*I*	Demand deposits:		
		(*i*) From banks	.....	
		(*ii*) From others	.....	.....
	II	Savings bank deposits		
	III	Term deposits:		
		(*i*) From banks	.....	
		(*ii*) From others	.....	.....
		Total (*I, II and III*)		
B	(*i*)	Deposits of branches in India	.....	.....
	(*ii*)	Deposits of branches outside India	.....	.....
		Total		.....

SCHEDULE 4: BORROWINGS

			₹
I	Borrowings in India:		
	(*i*) Reserve Bank of India	.....	
	(*ii*) Other banks	.....	
	(*iii*) Other institutions and agencies		
	....		
II	Borrowings outside India		.....
	Total (*I and II*)		.....
	Secured borrowing in *I* and *II* above	₹	.....

SCHEDULE 5: OTHER LIABILITIES and PROVISIONS

		₹
I	Bills payable	.....
II	Inter-office adjustments (net)	.....
III	Interest accrued	.....
IV	Others (including provisions)	.....
	Total	.....

SCHEDULE 6: CASH AND BALANCES WITH RBI

			₹
I	Cash in hand (including foreign currency notes)	.....	
II	Balances with RBI in:		
	(*i*) Current A/c		.....
	(*ii*) Other A/c		.....
	Total (*I & II*)		.....

SCHEDULE 7: BALANCE WITH BANKS & MONEY AT CALL AND SHORT NOTICE

			₹
I	In India		
	(*i*) Balance with banks:		
	(*a*) in Current A/c	.....	
	(*b*) in Other deposit A/c	.....	.....
	(*ii*) Money at call and short notice		
	(*a*) With banks	.....	
	(*b*) With other institutions	.....	.....
	Total (*i*) *and* (*ii*)		.....
II	Outside India		
	(*i*) In Current A/c		.....
	(*ii*) In Other deposit A/c		
	(*iii*) Money at call and short notice		.....
	Total (*i*), (*ii*) *and* (*iii*)		.....
	GRAND TOTAL (*I and II*)		.....

NOTES

SCHEDULE 8: INVESTMENTS

		₹
I Investments in India in		
(*i*) Govt. securities		.....
(*ii*) Other approved securities		.....
(*iii*) Shares		.....
(*iv*) Debentures and bonds		.....
(*v*) Subsidiaries and/or joint ventures		.....
(*vi*) Others (to be specified)		.....
	Total:	.....
II Investments outside India in		
(*i*) Govt. securities (incl. local authorities)		.....
(*ii*) Subsidiaries and/or joint ventures abroad		.....
(*iii*) Other investment (to be specified)		.....
	Total	.....
Grand Total (*I and II*)		.....

SCHEDULE 9: ADVANCES

		₹
A (*i*) Bills discounted and purchased		.....
(*ii*) Cash credits, overdrafts and loans payable on demand		.....
(*iii*) Term loans		.....
	Total	.....
B (*i*) Secured by tangible assets		.....
(*ii*) Covered by Bank/Govt. guarantees		.....
(*iii*) Unsecured		.....
	Total	.....
C *I* Advances in India:		
(*i*) Priority sectors		.....
(*ii*) Public sectors		.....
(*iii*) Banks		.....
(*iv*) Others		.....
	Total	.....
II Advances outside India:		.....
(*i*) Due from banks		.....
(*ii*) Due from others:		
(*a*) Bills purchased and discounted	.....	
(*b*) Syndicated loans	.....	
(*c*) Others	.....	.....
	Total:	.....
Grand Total (*CI and CII*)		.....

SCHEDULE 10: FIXED ASSETS

		₹
I Premises:		
At cost as on 31st March of the preceding year	.....	
Additions during the year	.....	
Deductions during the year	.....	
Depreciation to date	.....	.....
II Other fixed assets (Incl. furniture and fixture):		
At cost as on 31st March of the preceding year	.....	
Additions during the year	.....	
Deductions during the year	.....	
Depreciation to date	.....	.....
Total (*I and II*)		.....

SCHEDULE 11: OTHER ASSETS

		₹
Inter-office adjustments (net)		.....
Interest accrued		.....
Tax paid in advance/tax deducted at source		.....
Stationery and stamps		.....
Non-banking assets acquired in satisfactions of claims		.....
Others*		.....
	Total	.....

*In case there is any unadjusted balance of loss (*i.e.* when the loss exceeds the aggregate of capital, reserves and surplus), the same may be shown under this item under appropriate footnote.

SCHEDULE 12: CONTINGENT LIABILITIES

			₹
I	Claims against the bank not acknowledged as debts		.....
II	Liability for party paid investments		.....
III	Liability on account of outstanding forward exchange contracts		.....
IV	Guarantees given on behalf of constituents:		
	(*i*) In India	.....	
	(*ii*) Outside India	.....	.....
V	Acceptances, endorsements and other obligations		.....
VI	Other items for which the bank is contingently liable		.....
		Total	.....

Illustration

The following are the ledger balance of X Bank Ltd. Prepare the Profit and Loss Account and Balance Sheet as on 31st March 1998, as per the requirements of the Banking Regulation Act.

	₹
Share capital 20,000 shares or ₹ 1,000 each ₹ 100 paid	20,00,000
Reserve Fund Investments	10,00,000
General Expense	1,82,000
Current Accounts	2,20,44,000
Interest paid	1,61,000
Savings Banks Accounts	29,20,000
Fixed Deposits	40,00,000
Profit and Loss Account, balance brought forward	2,30,000
Discount received	1,80,000
Rebate on bills discounted	64,000
Commission, exchange and brokeage	44,000
Cash	2,27,000
Interest received	5,32,000
Cash with RBI	20,12,000
Owing by foreign Correspondents	2,00,000
Short Loans	64,82,000
Loans and advances to customers	1,55,85,000
Investments	92,83,000
Bills discounted	62,28,000
Premises	22,18,000

Note:
1. Provision for bad and doubtful debts required ₹ 1,29,000.
2. The bank had bills for collection for nits Constituents ₹ 5,00,000 and Acceptances, endorsements, and guarantees. ₹ 16,00,000.
3. The Profit and Loss Account balance is the balance of left on that account after the payment of interim dividend amounting to ₹ 2,00,000.

NOTES

Solution:

X Bank Ltd.
Balance Sheet as on 31st March, 1998

(000's omitted)

	Schedule	Year ended 31-3-1998 ₹	Year ended 31-3-1997 ₹
Captial & Liabilities			
Capital	1	2000	
Reserve & Surplus	2	1514	
Deposits	3	2,71, 64	
Borrowings	4	64,82	
Other Liabilities and provisions	5	1,93	
Total		37,353	
Assests			
Cash and Balances with Reserve Bank of India	6	2,239	
Balances with Banks and money at call and short notice	7	200	
Investments	8	10,883	
Advances	9	21,813	
Fixed Assest	10	2,218	
Other Assest	11	---	
Total		37,353	
Contingent liabilites	12	1,600	
Billis for Collection		500	
I. Income			
Interest Earned	13	712	
Other income	14	44	
Total		756	
II. Expenditure			
Interest expended	15	161	
Operating expenses	16	182	
Provision and contingencies		129	
Total		472	
III. Profit/Loss			
Net profit for the year		284	
Profit brought forward		430	
Total		714	
IV. Appropriations			
Transfer to Statutory resaves (20% for Rs. 2,84,000) (rounded of the nearest thousand repees)		57	
Interim dividend paid		200	
Balance carried over to balance sheet		457	
Total		714	
Schedula 1 Capital			
Authorized Capital:			
Issued, Subscribed and Called up capital:			
20,000 shares of Rs. 1,000 each, Rs. 100 per share Called up and paid up		2000	
Total		2000	
Schedule 2- Reserve & Surplus			
Statutory Reserves			
Opening balnace	1,000		
Additions during the year	57	1057	
Balance in Profit and Loss Account		457	
Total		1514	
Schedule 3- Deposits			
Demand deposits		20,244	
Savings Bank Deposits		2,920	
Term Deposits		4,000	
Total		27,164	

NOTES

Schedule 4-Borrowings		
Borrowing in India		
From other banks, against short Loans		6,482
Total		6,482
Schedule 5- Other Liabilities and Provisions		
Other (including provisions)		
Rebate on bills discounted	64	
Provisions	129	193
Schedule 6 Cash and Balances with Reserve Bank of India		
I (Cash in hand including foreign currency note)		227
II Balances with Reserve Bank of India		2012
Total		2239
Schedule 7-Balances with Banks & money at call and short notice		
I In India		
II Outside India		
i) In current Account (owing by foreign correspondents)		200
Total		200
Schedule 8-Investments		
Investments in India:		
Investments	9893	
Reserve Fund Investments	1000	10883
Total		10883
Schedule 9-Advances		
Bills purchased and discounted		228
Cash credits, overdrafts and loan repayable on demena		15,585
Total		21813
Schedule 10-Fixed Assets		
Premises		2218
Total		2218
Schedule 11-Other Assets		Nil
Total		Nil
Schedule 12-Contingent Liabilities		
Acceptances, endorsements and other obligations		1600
Total		1600
Schedule 13-Interest Earned		
Interest/discount on advance/bills:		
Interest	532	
Discount	180	712
Total		712
Schedule 15-Other Income		
Commission, exchange and brokerage		44
Total		44
Schedule 16-Interest Expended		
Interest on deposits		161
Total		161
Schedule 17-Operating Expenses		
General Expenses		182
Total		182

12.3.3 Accounting Policies for Banking Sector

On the recommendations of the Ghosh Committee, the Reserve Bank of India has issued a directive to all scheduled commercial banks to disclose the Accounting Policies adopted by them in the financial statements for the year ending 31st March, 1991, and later.

A specimen form based on the published accounts of IDBI Bank, for the year ending 31 March, 2017 in which accounting policies may be disclosed in the financial statements is given as:

NOTES

Significant Accounting Policies

1. Basis of Preparation

The financial statements have been prepared in accordance with requirements prescribed under the Third Schedule of the Banking Regulation Act, 1949. The accounting policies used in the preparation of these financial statements, in all material aspects, conform to Generally Accepted Accounting Principles in India (Indian GAAP), the guidelines issued by Reserve Bank of India (RBI) from time to time, the Accounting Standards (AS) issued by the Institute of Chartered Accountants of India (ICAI) and prescribed under Section 133 of Companies Act, 2013 (â Actâ) read with Rule 7 of the Companies (Account) Rules, 2014, the provisions of the Act (to the extent notified) and practices generally prevalent in the banking industry in India. The Bank follows the accrual method of accounting, except where otherwise stated, and the historical cost convention.

2. Use of Estimates

The preparation of financial statements requires the management to make estimates and assumptions that affect the reported amount of assets, liabilities, expenses, income and disclosure of contingent liabilities as at the date of the financial statements. Management believes that these estimates and assumptions are reasonable and prudent. However, actual results could differ from estimates. Any revision to accounting estimates is recognized prospectively in current and future periods.

3. Revenue Recognition

Revenue is recognized to the extent it is probable that the economic benefits will flow to the Bank and the revenue can be reliably measured

(i) Interest income is recognized on accrual basis except in the case of nonperforming assets where it is recognized upon realization as per the prudential norms of the RBI.

(ii) Commissions on Letter of Credit (LC)/ Bank Guarantee (BG) are accrued over the period of LC/ BG.

(iii) Fee based income are accrued on certainty of receipt and is based on milestones achieved as per terms of agreement with the client.

(iv) Income on discounted instruments is recognized over the tenure of the instrument on a constant yield basis.

(v) Dividend is accounted on an accrual basis when the right to receive the same is established.

(vi) In case of Non-performing advances, recovery is appropriated as per the policy of the bank.

4. Advances and Provisions

(i) Advances are classified into Standard, Sub-standard, Doubtful and Loss assets and provisions are made in accordance with the prudential norms prescribed by RBI and additional provisions as decided by

the management. Advances are stated net of provisions towards non-performing advances.

(ii) Advances are classified as Secured by Tangible Assets when security of at least 10% of the advance has been stipulated/created against tangible security including book debts. Security in the nature of escrow, guarantee, comfort letter, charge on brand, license, patent, copyright etc are not considered as Tangible Assets.

(iii) Amounts recovered against debts written-off in earlier years and provisions no longer considered necessary in the context of the current status of the borrower are recognized as income in the Profit and Loss account.

(iv) The Bank does not make any floating provision for bad and doubtful advances and investments.

(v) Provision on loans and advances restructured/rescheduled is made in accordance with the applicable RBI guidelines on restructuring of loans and advances by Banks.

(vi) The Bank had made countercyclical provisioning buffer as required by RBI guidelines, amended from time to time, with the approval of the Board, which can be utilized within the limits and in the circumstances permitted by Reserve Bank of India (RBI).

5. Investment

A. Classification

In terms of extant guidelines of the RBI on investment classification and valuation, the entire investment portfolio is categorized as

(i) Held To Maturity, (ii) Available For Sale and (iii) Held For Trading.

Investments under each category are further classified as

(i) Government Securities (ii) Other Approved Securities

(iii) Shares (iv) Debentures and Bonds (v) Subsidiaries/Joint Ventures

(vi) Others (Commercial Paper, Mutual Fund Units, Security Receipts, Pass through Certificate).

B. Basis of Classification

(a) Investments that the Bank intends to hold till maturity are classified as Held to Maturity.

(b) Investments that are held principally for sale within 90 days from the date of purchase are classified as Held for Trading.

(c) Investments, which are not classified in the above two categories, are classified as Available for Sale.

(d) An investment is classified as Held To Maturity Available For Sale or Held For Trading at the time of its purchase and subsequent shifting amongst categories and its valuation is done in conformity with RBI guidelines.

(e) Investments in subsidiaries, joint venture are classified as Held To Maturity.

C. Valuation

(i) In determining the acquisition cost of an investment:

(a) Brokerage, commission, stamp duty, and other taxes paid are included in cost of acquisition in respect of acquisition of equity instruments from the secondary market whereas in respect of other investments, including treasury investments, such expenses are charged to Profit and Loss Account.

(b) Broken period interest paid/received is excluded from the cost of acquisition/ sale and treated as interest expense/income.

(c) Cost is determined on the weighted average cost method.

(ii) Investments Held To Maturity are carried at acquisition cost unless it is more than the face value, in which case the premium is amortized on straight line basis over the remaining period of maturity. Diminution, other than temporary, in the value of investments in subsidiaries/ joint venture under this category is provided for each investment individually.

(iii) Investments Held For Trading and Available For Sale are marked to market scrip- wise and the resultant net depreciation, if any, in each category is recognized in the Profit and Loss Account, while the net appreciation, if any, are ignored.

(a) Treasury Bills, commercial papers and certificates of deposit being discounted instruments are valued at carrying cost.

(b) In respect of traded/quoted investments, the market price is taken from the trades/quotes available on the stock exchanges.

(c) The quoted Government Securities are valued at market prices and unquoted/nontraded government securities are valued at prices declared by Primary Dealers Association of India (PDAI) jointly with Fixed Income Money Market and Derivative Association of India (FIMMDA).

(d) The unquoted shares are valued at break-up value or at Net Asset Value if the latest balance sheet is available, else, at ₹ 1/- per company and units of mutual fund are valued at repurchase price as per relevant RBI guidelines.

(e) The unquoted fixed income securities (other than government securities) are valued on Yield to Maturity (YTM) basis with appropriate mark-up over the YTM rates for Central Government securities of equivalent maturity. Such mark-up and YTM rates applied are as per the relevant rates published by FIMMDA.

(f) Security receipts issued by the asset reconstruction companies are valued in accordance with the guidelines applicable to such instruments, prescribed by RBI from time to time. Accordingly, in cases where the cash flows from security receipts issued by the asset reconstruction companies are limited to the actual realisation of the financial assets assigned to the instruments in the concerned

scheme, the Bank reckons the net asset value obtained from the asset reconstruction company from time to time, for valuation of such investments at each reporting period end.

(g) Quoted Preference shares are valued at market rates and unquoted/ non-traded preference shares are valued at appropriate yield to maturity basis, not exceeding redemption value as per RBI guidelines.

Profit or Loss on sale of investments is credited/debited to Profit and Loss Account. However, profits on sale of investments in Held to Maturity category is first credited to Profit and Loss Account and thereafter appropriated, net of applicable taxes to the Capital Reserve Account at the year/period end. Loss on sale is recognized in the Profit and Loss Account. Investments are shown net of provisions.

6. Fixed Assets (Property, Plant & Equipment) and depreciation

(i) Fixed assets other than Premises are stated at cost less accumulated depreciation. Premises are revalued in accordance with the Bank policy and RBI guidelines and the same are stated at revalued amount less accumulated depreciation.

(ii) Cost of asset includes purchase cost and all expenditure incurred on the asset before put to use. Subsequent expenditure incurred on assets put to use is capitalized only when it increases the future benefits from such assets or their functioning capability.

(iii) The appreciation on revaluation, if any, is credited to Revaluation Reserve.

(iv) Depreciation in respect of fixed assets is calculated on Straight Line Method with reference to cost or revalued amounts, in case of assets revalued and the same is charged to Profit and Loss account.

(v) In respect of revalued assets, the additional depreciation consequent to revaluation is transferred from revaluation reserve to general reserve in the balance sheet.

(vi) Fixed assets individually costing less than ₹5000 are fully depreciated in the year of addition.

(vii) Depreciation on tangible assets is allocated over useful life of the asset as prescribed under Part C of Schedule II of the Companies Act 2013. The useful lives and residual values are reviewed periodically. If the management estimate useful lives of an asset at the time of acquisition of the asset or of remaining useful life on subsequent review is shorter, depreciation is provided at a higher rate based on management estimate of useful life *I* remaining useful life.

(viii) Depreciation on additions/ sale of fixed assets during the year is provided for the period for which assets were actually held.

(ix) The useful lives of Fixed assets are as follows:

(x) Leasehold land is amortized over the period of lease.

(xi) Computer Software (non-integral) individually costing more than ₹ 2.50 Lacs is capitalised and depreciated in 6 years.

7. Foreign Currency Transactions

(i) Foreign currency transactions, on initial recognition are recorded at the exchange rate prevailing on the date of transaction. Monetary foreign currency assets and liabilities are translated at the closing rates prescribed by Foreign Exchange Dealers Association of India (FEDAI) and the resultant gain or loss is recognized in the Profit and Loss account. Exchange differences arising on the settlement of monetary items are recognized as income or expense in the period in which they arise.

(ii) Premium or discount arising at the inception of Forward Exchange Contracts which are not intended for trading is amortized as expense or income over the life of the contract. Premium or discount on other Forward Exchange Contracts is not recognized.

(iii) Outstanding Forward Exchange Contracts which are not intended for trading are revalued at closing FEDAI rates. Other outstanding Forward Exchange Contracts are valued at rates of exchange notified by FEDAI for specified maturities or at interpolated rates for in-between maturities. The resultant profit/ losses are recognized in the Profit and Loss Account.

(iv) Profit/ losses arising on premature termination of Forward Exchange Contracts, together with unamortized premium or discount, if any, is recognized on the date of termination.

(v) Contingent liability in respect of outstanding forward exchange contracts is calculated at the contracted rates of exchange and in respect of guarantees; acceptances, endorsements and other obligations are calculated at the closing FEDAI rates.

(vi) Operations of foreign branch are classified as Integral Foreign Operations. Assets and Liabilities are translated at the closing rates prescribed by Foreign Exchange Dealers Association of India (FEDAI) Income and Expenditure items are translated at quarterly average rates. The resultant gain or loss is recognized in the Profit and Loss Account.

8. Employee Benefits

(i) Payments to defined contribution schemes are charged to Profit and Loss Account of the year when contribution are due.

(ii) For defined benefit schemes, the cost of providing benefits is determined using the Projected Unit Credit Method, with actuarial valuations being carried out at each Balance Sheet date. Actuarial gains or losses are recognized in the profit and loss account for the period in which they occur.

(iii) The undiscounted amount of short-term employee benefits expected to be paid in exchange for the services rendered by employees is recognized during the period when the employee renders the service.

9. Segment Reporting

The Bank operates in three segments wholesale banking, retail banking and treasury services. These segments have been identified in line with AS-17 on segment reporting after considering the nature and risk profile of the products

and services, the target customer profile, the organization structure and the internal reporting system of the Bank.

Segment revenue, results, assets, and liabilities include the amounts identifiable to each of the segments as also amounts allocated, as estimated by the management. Assets and liabilities that cannot be allocated to identifiable segments are grouped under unallocated assets and liabilities.

10. Income Tax

(i) Tax expense comprises of current and deferred tax.

Current tax is the amount of Income tax determined to be payable (recoverable) in respect of taxable income (tax loss) for a period calculated in accordance with the provisions of the Income Tax Act, 1961 and the Income Computation and Disclosure Standards (ICDS).

(ii) Deferred tax for timing differences between the book and tax profits for the year is accounted for, using the tax rates and laws that have been substantively enacted as of the balance sheet date. Deferred tax assets arising from timing differences are recognized to the extent there is reasonable certainty that these would be realized in future.

(iii) Deferred tax assets in case of unabsorbed depreciation/ losses are recognized only if there is virtual certainty that such deferred tax asset can be realized against future taxable profits.

(iv) Disputed taxes not provided for including departmental appeals are included under Contingent Liabilities.

11. Earnings Per Share

(i) The Bank reports basic and diluted Earnings Per Share in accordance with AS 20. Basic Earnings per Share is computed by dividing the net profit after tax by the weighted average number of equity shares outstanding at the year end.

(ii) Diluted Earnings per Share reflect the potential dilution that could occur if securities or other contracts to issue equity shares were exercised or converted during the period. Diluted Earnings per Share is computed by dividing the net profit after tax by the sum of the weighted average number of equity shares and dilutive potential equity shares outstanding at the year end.

12. Impairment of Assets

Fixed Assets are reviewed for impairment whenever events or changes in circumstances warrant that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the estimated current realizable value and value in use. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds estimated current realizable value of the asset or value in use.

13. Provisions, Contingent Liabilities and Contingent Assets

(i) In conformity with AS 29, Provisions, Contingent Liabilities and Contingent Assets, the Bank recognizes provisions only when it has a present obligation as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and when a reliable estimate of the amount of the obligation can be made.

(ii) Provisions are not discounted to its present value and are determined based on best estimate required to settle the obligation at the balance sheet date.

(iii) Reimbursement expected in respect of expenditure required to settle a provision is recognized only when it is virtually certain that the reimbursement will be received.

(iv) Contingent Assets are neither recognized nor disclosed.

Application of Indian Accounting Standards

In line with the global trends Indian Companies are also being required, in phases, by the Government to adopt International Financial Reporting Standards (IFRS). Indian Accounting Standards (Ind ASs) are largely based on International Financial Reporting Standards (IFRSs). The schedule for application of Ind ASs to banking and non-banking finance companies, as per Reserve Bank of India's directives, is as under.

Banking Companies

All scheduled commercial banks have to comply with the Indian Accounting Standards (Ind ASs) for accounting period beginning on or after 1st April, 2018 with comparatives for periods ending on or after 31st March, 2018. Ind ASs would be applicable on or after the aforesaid date to both standalone financial statements and consolidated financial statements.

Non-banking Finance Companies (NBFCs)

Phase I: For accounting periods beginning on or after the 1st April, 2018, with comparatives for the periods ending on 31st March, 2018, or thereafter-

(A) NBFCs having net worth of rupees five hundred crore or more;

(B) Holding, subsidiary, joint venture or associate companies of companies covered under item (A), other than those already covered under clauses (i), (ii) and (iii) of sub-rule (1) of rule 4.

Phase II: For accounting periods beginning on or after the 1st April, 2019, with comparatives for the periods ending on 31st March, 2019, or thereafter-

(A) NBFCs whose equity or debt securities are listed or in the process of listing on any stock exchange in India or outside India and having net worth less than rupees five hundred crore;

(B) NBFCs, that are unlisted companies, having net worth of rupees two-hundred and fifty crore or more but less than rupees five hundred crore; and

(C) Holding, subsidiary, joint venture or associate companies of companies covered under item (A) or item (B) of sub-clause (b), other than those already covered in clauses (i), (ii) and (iii) of sub-rule (1) or item (B) of sub-clause (a) of clause (iv).

Check Your Progress

1. What is the meaning of banking under the Banking Regulation Act, 1949?
2. Name the Form attached to the Banking Regulation Act in which the Profit and Loss Account of a banking company has to be prepared.
3. Name the Form attached to the Banking Regulation Act in which the Balance Sheet of a banking company has to be prepared.

12.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. According to Section 5 (*b*) of this Act, banking means "the acceptance for the purpose of lending or investment of deposits of money from the public repayable on demand, order or otherwise and withdrawable by cheque, draft, order or otherwise."
2. The Profit and Loss Account of a banking company has to be prepared in Form B of Schedule III, attached to the Banking Regulation Act.
3. The Balance Sheet of a banking company has to be prepared in Form A of Schedule III, attached to the Banking Regulation Act.

12.5 SUMMARY

- The final accounts of a banking company include the Profit & Loss Account and the Balance Sheet. It may be noted that no Profit & Loss Appropriation Account is prepared in case of a banking company.
- The Third Schedule to the Banking Regulation Act, gives the formats of the Profit & Loss Account and the Balance Sheet. The formats have been revised *w.e.f.* 1st April, 1991.
- The Profit and Loss Account of a banking company has to be prepared in Form B of Schedule III, attached to the Banking Regulation Act.
- Premises wholly or partly owned by the banking company for the purpose of business including residential premises should be shown against 'Premises'. In the case of premises and other fixed assets, the previous balance, additions thereto and deductions therefrom during the year as also the total depreciation written off should be shown.
- An asset becomes non-performing when the interest and/or instalment of principal is delayed and not received before a stipulated time. In other words, an asset becomes non-performing when it ceased to generate income for banks.

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- Interest earned by a banking company on doubtful debts can be treated in any of the following ways in the accounts of a banking company:
    - o Interest Suspense Method: The interest earned may be credited to Interest Suspense Account opened for this purpose.
    - o Cash Method: No entry is passed for such interest till it is actually received.
    - o Accrual Method: Interest Account may be credited with the full amount of interest due on doubtful.

12.6 KEY WORDS

- **Inter office (or branch) adjustments:** It represents the difference on account of incomplete recording of transactions between one branch and another branch or between the branch and the head office.
- **Non-banking asset:** It refers to an asset charged in the favour of the banking company and taken in its possession in case of failure the debtor to repay the loan taken by him in time.

12.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Write a short note on revenue recognition.
2. State the two phases of non-banking finance companies (NBFCs).

Long Answer Questions

1. Explain the legal provisions relating to the final accounts of a banking company.
2. Draft a specimen accounting policy concerning the advances of a bank.

12.8 FURTHER READINGS

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

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

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UNIT 13 PRUDENTIAL ACCOUNTING: MEANING AND SCOPE

NOTES

Structure

13.0 Introduction
13.1 Objectives
13.2 Meaning and Implementation
13.3 Prudential Accounting and Basel Committee on Banking Supervision (BCBS)
13.4 Answers to Check Your Progress Questions
13.5 Summary
13.6 Key Words
13.7 Self Assessment Questions and Exercises
13.8 Further Readings

13.0 INTRODUCTION

The term 'prudential norms' too often used particularly in relation to the non-performing assets of the commercial banks. In the light of the existence of huge non-performing asset in the balance sheets of the commercial banks leading to the erosion of their capital base the relevance of these prudential has acquired particular significance.

The main elements of prudential norms are income recognition, assets classification, provisioning for loans and advances and capital adequacy. In keeping with latest practices at the international levels, commercial banks are not supposed to recognize their incomes from non-performing assets on an accrual basis and these are to be booked only when these are actually received.

Prudential accounting norms/standards set by the Basel-3 are being implemented worldwide by the member countries. In India, Reserve Bank issued Guidelines based on the Basel III reforms on capital regulation on May 2, 2012, to the extent applicable to banks operating in India. The Basel III capital regulation has been implemented from April 1, 2013 in India in phases and it will be fully implemented as on March 31, 2019. Prudential norms issued by the RBI are discussed in the next unit.

13.1 OBJECTIVES

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

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- Understand what prudential norms are
- Discuss the role of the Basel Committee on Banking Supervision (BCBS) in prudential accounting

13.2 MEANING AND IMPLEMENTATION

Prudential norms, issued by Basel-3, are the guidelines and general norms issued by the regulating bank (the central bank) of the country for the proper and accountable functioning of bank and bank-like establishments. In other words, the norms are the practices that all banks are expected to follow. Most usually, these norms relate to cash reserves, overnight call rates, income recognition, asset classification, provisioning of non-performing assets, and capital adequacy ratios.

Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09. It was agreed upon by the members of the Basel Committee on Banking Supervision in 2010–11, and was scheduled to be introduced from 2013 until 2015; however, changes from 1 April 2013 extended implementation until 31 March 2018 and again extended to 31 March 2019. The measures aim to strengthen the regulation, supervision and risk management of banks. Like all Basel Committee standards, Basel III standards are minimum requirements which apply to internationally active banks. Members are committed to implementing and applying standards in their jurisdictions within the time frame established by the Committee. Basel III is intended to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage.

Basel III reforms strengthen the bank-level i.e. micro prudential regulation, with the intention to raise the resilience of individual banking institutions in periods of stress. Besides, the reforms have a macro prudential focus also, addressing system wide risks, which can build up across the banking sector, as well as the procyclical amplification of these risks over time. These new global regulatory and supervisory standards mainly seek to raise the quality and level of capital to ensure banks are better able to absorb losses on both a going concern and a gone concern basis, increase the risk coverage of the capital framework, introduce leverage ratio to serve as a backstop to the risk-based capital measure, raise the standards for the supervisory review process (Pillar 2) and public disclosures (Pillar 3) etc. The macro prudential aspects of Basel III are largely enshrined in the capital buffers. Both the buffers i.e. the capital conservation buffer and the

countercyclical buffer are intended to protect the banking sector from periods of excess credit growth.

13.3 PRUDENTIAL ACCOUNTING AND BASEL COMMITTEE ON BANKING SUPERVISION (BCBS)

The BCBS is the primary global standard setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability.

The BCBS seeks to achieve its mandate through the following activities:

- Exchanging information on developments in the banking sector and financial markets, to help identify current or emerging risks for the global financial system;
- Sharing supervisory issues, approaches and techniques to promote common understanding and to improve cross-border cooperation;
- Establishing and promoting global standards for the regulation and supervision of banks as well as guidelines and sound practices;
- Addressing regulatory and supervisory gaps that pose risks to financial stability;
- Monitoring the implementation of BCBS standards in member countries and beyond with the purpose of ensuring their timely, consistent and effective implementation and contributing to a “level playing field” among internationally active banks;
- Consulting with central banks and bank supervisory authorities which are not members of the BCBS to benefit from their input into the BCBS policy formulation process and to promote the implementation of BCBS standards, guidelines and sound practices beyond BCBS member countries;
- Coordinating and cooperating with other financial sector standard setters and international bodies, particularly those involved in promoting financial stability.

The BCBS sets standards for the prudential regulation and supervision of banks. The BCBS expects full implementation of its standards by its members and their internationally active banks. However, BCBS standards constitute minimum requirements and BCBS members may decide to go beyond them. The Committee expects standards to be incorporated into local legal frameworks through each jurisdiction’s rule-making process within the pre-defined timeframe established by the Committee. If deviation from literal

transposition into local legal frameworks is unavoidable, members should seek the greatest possible equivalence of standards and their outcome.

The BCBS guidelines elaborate the standards in areas where they are considered desirable for the prudential regulation and supervision of banks, in particular international active banks. They generally supplement BCBS standards by providing additional guidance for the purpose of their implementation.

Check Your Progress

1. What are prudential norms?
2. State the importance of Basel-III reforms.
3. State the role of BCBS guidelines.

13.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Prudential norms, issued by Basel-3, are the guidelines and general norms issued by the regulating bank (the central bank) of the country for the proper and accountable functioning of bank and bank-like establishments.
2. Basel III reforms strengthen the bank-level i.e. micro prudential regulation, with the intention to raise the resilience of individual banking institutions in periods of stress.
3. The BCBS guidelines elaborate the standards in areas where they are considered desirable for the prudential regulation and supervision of banks, in particular international active banks.

13.5 SUMMARY

- The main elements of prudential norms are income recognition, assets classification, provisioning for loans and advances and capital adequacy.
- In keeping with latest practices at the international levels, commercial banks are not supposed to recognize their incomes from non-performing assets on an accrual basis and these are to be booked only when these are actually received.
- Prudential norms, issued by Basel-3, are the guidelines and general norms issued by the regulating bank (the central bank) of the country for the proper and accountable functioning of bank and bank-like establishments.

- The BCBS is the primary global standard setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability.
- Basel III reforms strengthen the bank-level i.e. micro prudential regulation, with the intention to raise the resilience of individual banking institutions in periods of stress. Besides, the reforms have a macro prudential focus also, addressing system wide risks, which can build up across the banking sector, as well as the procyclical amplification of these risks over time.
- The BCBS sets standards for the prudential regulation and supervision of banks. The BCBS expects full implementation of its standards by its members and their internationally active banks. However, BCBS standards constitute minimum requirements and BCBS members may decide to go beyond them.

13.6 KEY WORDS

- **Prudential norms:** These are the guidelines and general norms issued by the regulating bank (the central bank) of the country for the proper and accountable functioning of bank and bank-like establishments.
- **Basel III (or the Third Basel Accord or Basel Standards):** This is a global, voluntary regulatory framework on bank capital adequacy, stress testing, and market liquidity risk

13.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. When were the basel-III reforms agreed upon and when were they scheduled to be introduced?
2. Write a short note on BCBS standards.

Long Answer Questions

1. How does the BCBS seeks to achieve its mandate? Discuss.
2. Discuss the meaning and implication of prudential accounting.

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13.8 FURTHER READINGS

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

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UNIT 14 PRUDENTIAL ACCOUNTING NORMS

NOTES

Structure

14.0 Introduction
14.1 Objectives
14.2 Capital Adequacy
14.3 Accounting Treatment: Income Recognition, Asset Classification and Provisioning
14.4 Answers to Check Your Progress Questions
14.5 Summary
14.6 Key Words
14.7 Self Assessment Questions and Exercises
14.8 Further Readings

14.0 INTRODUCTION

In line with the international practices and as per the recommendations made by the Committee on the Financial System, the Reserve Bank of India (RBI) has introduced, in a phased manner, prudential norms for income recognition, asset classification and provisioning for the advances portfolio of the banks so as to move towards greater consistency and transparency in the published accounts.

The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, the classification of assets of banks has to be done on the basis of objective criteria which would ensure a uniform and consistent application of the norms. Also, the provisioning should be made on the basis of the classification of assets based on the period for which the asset has remained non-performing and the availability of security and the realisable value thereof. Banks are urged to ensure that while granting loans and advances, realistic repayment schedules may be fixed on the basis of cash flows with borrowers. This would go a long way to facilitate prompt repayment by the borrowers and thus improve the record of recovery in advances.

14.1 OBJECTIVES

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

- Describe capital adequacy ratio
- Explain the prescribed formats of the Profit and Loss Account and Balance Sheet of a banking company

- Differentiate between performing and non-performing assets
- Describe the process of a non-performing asset becoming a performing asset

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14.2 CAPITAL ADEQUACY

Capital Adequacy Ratio (CAR) is the ratio of a bank's capital in relation to its risk weighted assets and current liabilities. It is decided by central banks and bank regulators to prevent commercial banks from taking excess leverage and becoming insolvent in the process. For the purpose of capital adequacy, banks should assign 100% risk weights to the non performing financial assets purchased from other banks. In case the nonperforming asset purchased is an investment, then it would attract capital charge for market risks also. For NBFCs the relevant instructions on capital adequacy would be applicable.

The Basel III norms stipulated a capital to risk weighted assets of 8%. However, as per RBI norms, Indian scheduled commercial banks are required to maintain a CAR of 9% while Indian public sector banks are emphasized to maintain a CAR of 12%.

A bank shall comply with the capital adequacy ratio requirements at two levels:

- The consolidated ("Group") level capital adequacy ratio requirements, which measure the capital adequacy of a bank based on its capital strength and risk profile after consolidating the assets and liabilities of its subsidiaries / joint ventures / associates etc. except those engaged in insurance and any non-financial activities; and
- The standalone ("Solo") level capital adequacy ratio requirements, which measure the capital adequacy of a bank based on its standalone capital strength and risk profile. Accordingly, overseas operations of a bank through its branches will be covered in both the above scenarios.

All banking and other financial subsidiaries except subsidiaries engaged in insurance and any non-financial activities (both regulated and unregulated) should be fully consolidated for the purpose of capital adequacy. This would ensure assessment of capital adequacy at the group level, taking into account the risk profile of assets and liabilities of the consolidated subsidiaries. The insurance and non-financial subsidiaries / joint ventures / associates etc. of a bank should not be consolidated for the purpose of capital adequacy. The equity and other regulatory capital investments in the insurance and non-financial subsidiaries will be deducted from consolidated regulatory capital of the group.

Banks should ensure that majority owned financial entities that are not consolidated for capital purposes and for which the investment in equity and other instruments eligible for regulatory capital status is deducted, meet

their respective regulatory capital requirements. In case of any shortfall in the regulatory capital requirements in the unconsolidated entity, the shortfall shall be fully deducted from the Common Equity Tier 1 capital.

14.3 ACCOUNTING TREATMENT: INCOME RECOGNITION, ASSET CLASSIFICATION AND PROVISIONING

Accounting treatment of some specific items in the Profit and Loss Account and Balance Sheet is explained in the following pages.

Income Recognition

Assets of the banks are classified as performing assets and non-performing assets for the purpose of income recognition. Assets which are not non-performing are performing assets. An asset become non-performing when it ceases to generate income for banks. A non-performing asset would be an advance where:

- Interest and/or instalment of principal remain overdue for a period of more than 180 days, in in respect of a term loan;
- The account remains 'out of order' for a period of more than 180 days in respect of overdraft/cash credit;
- The bill remains overdue for a period of more than 180 days in case of bills purchased and discounted;
- Interest and or instalment of principal remains overdue for two harvest seasons but for a period not exceeding two and a half years in the case of an advance granted for agricultural purposes; and
- Any amount to be received remains overdue for a period of more than 180 days in respect of other accounts.

NPAs with effect from 31 March 2004

With a view to moving towards international best practices and to ensure greater transparency, it has been decided to adopt the '90 days' overdue norm for identification of NPAs, from the year ending March 31, 2004. Accordingly, with effect from March 31, 2004, a non-performing asset (NPA) shall be a loan or an advance where:

- Interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,
- The account remains 'our of order' for a period of more than 90 days, in respect of an Overdraft/Cash Credit (OD/CC),
- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

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- Interest and/or instalment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes, and
- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

As a facilitating measure for smooth transition to 90 days norm, banks have been advised to move over to charging of interest at monthly rests, by April 1, 2002. However, the date of classification of an advance as NPA should not be changed on account of charging of interest at monthly rests. Banks should, therefore, continue to classify an account as NPA only if the interest charged during any quarter is not serviced fully within 180 days from the end of the quarter with effect from April 1, 2002 and 90 days from the end of the quarter with effect from March 31, 2004.

The terms 'Out of Order' and 'Overdue' have been defined as under:

Out of Order: An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/ drawing power.

Overdue: Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

Banks have been advised by the Reserve Bank of India that they should identify the non-performing assets and ensure that interest on such non-performing assets is not recognised as income and taken to the profit and loss account. Banks are to recognise their income on Accrual Basis in respect of income on performing assets and on Cash Basis in respect of income on non-performing assets. Any interest accrued and credited to income account must be cancelled by a reserve entry once the credit facility comes under the category of non-performing assets.

A non-performing asset may become performing asset

An asset becomes non-performing when the interest and/or instalment of principal is delayed and not received before a stipulated time. In other words, an asset becomes non-performing when it ceased to generate income for banks. A term loan is treated as non-performing asset when interest and/or instalment of principal remains over due for a period of more than 90 days.

The identification of non-performing assets is to be done on the basis of the position as on the balance sheet data. If an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources (not by sanction of additional facilities or transfer of funds between accounts) the account need not be treated as non-performing assets. The bank should however ensure that the account remains in order subsequently.

Hence, non-performing assets, need not be permanently non-performing assets, it shall resume into performing assets, subject to the satisfaction of their norms at the discretion of banks.

NOTES

Illustration 14.1 Given below are details of inerest on advances of a Commercial Bank as on 31-3-2002.

	Interest Earned ₹ in lakhs	Interest Received ₹ in lakhs
Performing assets:		
Term loan	240	160
Cash credit and overdraft	1,500	1,240
Bills purchased and discounted	300	300
Non-performing assets:		
Term loan	150	10
Cash credit and overdraft	300	24
Bills purchased and discounted	200	40

Find out the income to be recognised for the year end 31-3-2002.

Solution:

Interest on performing assets should be recognised on accrual basis but interest on non-performing assets should be recognised on Cash basis as per directions given in various circulars issued by R.B.I.

	₹ in lakhs
Interest on Term loan (240 + 10)	250
Interest on cash credit and overdraft (1500 + 24)	1524
Income from bills purchased and discounted (300 + 40)	340
Income to be recognised:	2114

Bad Debts and Provisions for Doubtful Debts

The business of a banking company depends on public confidence. In order to ensure that this confidence is not impaired, the banks some years back were given a special privilege permitting them not to show in their published accounts bad debts and provisions for doubtful debts. They could show income after making deductions for such losses. In the Profit and Loss account the income from 'interest and discount' was usually shown after meeting such losses. In the Balance Sheet, the amount of advances was shown after deducting bad and doubtful debts.

However, with effect from April 1, 1991 this practice has undergone a change. The amount of bad debts and provision for bad debts has to be charged under the heading "Provisions and Contingencies" in the Profit and Loss Account. In the Balance Sheet, the advances are shown after deducting the both, bad debts and provision for bad debts. It may be noted that the banks collect from their branches information regarding bad and doubtful debts also. The Schedule of Advances to be filled in by the branches contains a separate column regarding doubtful debts in respect of bills purchased and discounted, cash-credits and overdrafts, and unsecured loans. However, while consolidating the Schedule of Advances at the Head Office level for Balance Sheet purposes the advances are shown net of any bad or doubtful debts.

Any surplus provision for doubtful debts has not to the deducted from advances but to be shown under the heading other liabilities and provisions in the Balance Sheet.

NOTES

Assets Classification and Provisions for Doubtful Debts

As per the present guidelines of the Reserve Bank the assets classification and the requisite provision for doubtful debts is as under.

Assets Classification

Banks are required to classify the loan assets (advances) into four categories viz.:

(*i*) Standard Assets; (*ii*) Sub-standard Assets; (*iii*) Doubtful Assets; and (*iv*) Loss Assets.

(*i*) *Standard Assets*: Standard asset is one which does not disclose any problem and which does not carry more than normal risk attached to the business. Such asset is considered as performing asset.

(*ii*) *Sub-standard Assets*: With effect from 31st March, 2005 sub-standard asset is one which has been classified as a non-performing asset (NPA) for a period not exceeding 12 months. In such cases, the current net worth of the borrowers/ guarantors or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such assets will have well-defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

An asset where the terms of the loan agreement regarding interest and principal have been re-negotiated or rescheduled after commencement of production, should be classified as sub-standard and should remain in such category for at least 12 months of satisfactory performance under the re-negotiated or rescheduled terms. In other words, the classification of an asset should not be upgraded merely as a result of rescheduling, unless there is satisfactory compliance of this condition.

(*iii*) *Doubtful Assets*: A doubtful asset is one which has remained in sub-standard category for a peiod exceeding 12 months.

(*iv*) *Loss Assets*: A loss asset is one where loss has been identified by the bank or internal or external auditors or the co-operative Department or the RBI inspection but the amount has not been written off, wholly or partly. Such an asset is not realisable, although there may be some salvage or recovery value.

Provisions The purpose of classifications of bank assets is to make adequate provisions on the basis of quality of assets, the realisation of the security and the erosion in the value of security. It has been directed that the banks should make provision against the various assets on the following basis:

NOTES

(*i*) *Standard Assets:* Banks should make general provision for standard assets at 40%[1] except in case of direct advances to agriculture and SME sectors where only 0.25% provision is to be made.

(*ii*) *Doubtful Assets*:

(*a*) To the extent the debt is not covered by realisable value of the security, 100% provision is to be made.

(*b*) In addition to the above (*a*), for the secured portion of the doubtful assets, provision is required to be make between 20% and 100% depending upon the period for which the asset has remained doubtful as given below:

Period for which the advances have been considered doubtful	Percentage of provision
Upto one year	20
More than one year but upto three years	30
Above three years	100

(*iii*) *Loss Assets*: The entire assets should be written off or if the assets are to be retained in the books for any reason 100% provision is required to be made.

Note:

Provision towards standard assets should not be deducted from advanced but shown separately as contingent provisions against standard assets under "Other Liabilities and Provisions" — 'Others' in Schedule *V* of the Balance Sheet.

Illustration 14.2 Compute the amount of provision for doubtful debts from the following details of advances of National Bank Ltd.

(₹ in lakhs)

1.	Total loans and advances	50
2.	Fully secured advances without any default by the borrowers	30
3.	Advances overdue for 15 months	10
4.	Advances overdue for more than 30 months but less than 36 months (secured by mortgage of plant worth Rs 3 lakhs)	5
5.	Non-recoverable unsecured advances	3
6.	Small advances not exceeding ₹ 25,000 to each borrower (unsecured)	2

Solution:

COMPUTATION OF PROVISION FOR DOUBTFUL DEBTS

S. No.	*Category of advances*	*Rs lakhs*	*Provision for doubtful debts* %	*Provision for doubtful debts* *Rs*
1.	Standard assets	30	.40	12,000
2.	Sub-standard assets	10	10	1,00,000
3.	Doubtful assets	5	Unsecured portion + 30% of secured portion	2,90,000
4.	Loss assets	3	100	3,00,000
5.	Small advances (sub-standard)	2	20	40,000
		50		8,50,000

[1] Raised from 0.25% w.e.f. November 4, 2005.

NOTES

Illustration 14.3 From the following details, compute the amount of provision required to be made in the profit and loss account of Evergreen Bank Ltd. for the year 2005-06:

Assets		₹ in Lakhs
Standard		16,000
Sub-standard		12,000
Doubtful:		
—	One year (secured)	4,800
—	For two to three years (secured)	3,600
—	For more than 3 years (secured by mortgage of machinery worth ₹ 1,000 lakhs)	1,800
Non-recoverable assets		3,000

Solution:

COMPUTATION OF PROVISION AGAINST ADVANCES

Classification of Assets	*Amount (Rs in lakhs)*	*%age of Provision*	*Provision (Rs in lakhs)*
Standard	16,000	0.40%	64
Sub-standard	12,000	10%	1,200
Doubtful for 1 year	4,800	20%	960
Doubtful 2 to 3 years	3,600	30%	1,080
Doubtful more than 3 years	1,800	100% of unsecured	1,800
Non-recoverable Assets	3,000	100%	3,000
	41,200		8,104

Check Your Progress

1. Define capital adequacy ratio.
2. Differentiate between performing and non-performing assets.
3. What is an out of order account?
4. Do non-performing assets become performing assets?

14.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Capital Adequacy Ratio (CAR) is the ratio of a bank's capital in relation to its risk weighted assets and current liabilities.
2. Assets which are not non-performing are performing assets. An asset becomes non-performing when it ceases to generate income for banks.

3. An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.
4. Non-performing assets need not be permanently non-performing assets, it shall resume into performing assets subject to the satisfaction of their norms at the discretion of banks.

14.5 SUMMARY

- The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, the classification of assets of banks has to be done on the basis of objective criteria which would ensure a uniform and consistent application of the norms.
- Banks are urged to ensure that while granting loans and advances, realistic repayment schedules may be fixed on the basis of cash flows with borrowers. This would go a long way to facilitate prompt repayment by the borrowers and thus improve the record of recovery in advances.
- Capital Adequacy Ratio (CAR) is the ratio of a bank's capital in relation to its risk weighted assets and current liabilities. It is decided by central banks and bank regulators to prevent commercial banks from taking excess leverage and becoming insolvent in the process.
- The Basel III norms stipulated a capital to risk weighted assets of 8%. However, as per RBI norms, Indian scheduled commercial banks are required to maintain a CAR of 9% while Indian public sector banks are emphasized to maintain a CAR of 12%.
- Assets of the banks are classified as performing assets and non-performing assets for the purpose of income recognition. Assets which are not non-performing are performing assets. An asset become non-performing when it ceases to generate income for banks.
- With a view to moving towards international best practices and to ensure greater transparency, it has been decided to adopt the '90 days' overdue norm for identification of NPAs, from the year ending March 31, 2004.
- An asset becomes non-performing when the interest and/or instalment of principal is delayed and not received before a stipulated time. In other words, an asset becomes non-performing when it ceased to generate income for banks. A term loan is treated as non-performing asset when interest and/or instalment of principal remains over due for a period of more than 90 days.

NOTES

- Banks are required to classify the loan assets (advances) into four categories viz.:
  (i) Standard Assets; (ii) Sub-standard Assets; (iii) Doubtful Assets; and (iv) Loss Assets.

14.6 KEY WORDS

- **Non-performing asset:** A non-performing asset (NPA) is a loan or advance for which the principal or interest payment remained overdue for a period of 90 days.
- **Performing Asset:** It is something that you own that pays you a flow of money on a regular basis.

14.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the two levels in which a bank shall comply with the capital adequacy ratio?
2. What are basel-III norms?
3. What do you understand by the following terms:
   (i) Standards Assets (ii) Sub-standard Assets
   (iii) Doubtful Assets (iv) Loss Assets.

Long Answer Questions

1. Describe capital adequacy ratio with the help of examples.
2. Analyse the accounting treatment of some specific items in the profit and loss account and balance sheet.
3. With the help of illustrations, describe how a non-performing asset may become a performing asset.

14.8 FURTHER READINGS

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

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