DMC 8303

MASTER OF
COMPUTER APPLICATION

ACCOUNTING AND FINANCIAL MANAGEMENT FOR APPLICATION DEVELOPMENT

CENTRE FOR DISTANCE AND ONLINE EDUCATION

ANNA UNIVERSITY

CHENNAI - 600 025

ACCOUNTING AND FINANCIAL MANAGEMENT FOR APPLICATIONDEVELOPMENT

SYLLABUS

OBJECTIVES:

- Understand the basic principles of Double entry system and preparation of cash book.
- Learn how to prepare final accounts and balance sheet.
- Acquire knowledge about partnership accounts
- Understand the process of estimating the depreciation of a particular asset.
- Learn single and double entry accounting.

UNIT I INTRODUCTION TO ACCOUNTING

Meaning and scope of Accounting, Basic Accounting Concepts and Conventions – Objectives of Accounting – Accounting Transactions – Double Entry Book Keeping – Journal, Ledger, Preparationof Trial Balance – Preparation of Cash Book.

UNIT II FINAL ACCOUNTS

Preparation of Final Accounts of a Sole Trading Concern – Adjustments Receipts and Payments Account, Income & Expenditure Account and Balance Sheet of Non Trading Organizations.

UNIT III PARTNERSHIP ACCOUNTS

Partnership Accounts-Final accounts of partnership firms – Basic concepts of admission, retirement and death of a partner including treatment of goodwill - rearrangement of capitals. (Simple problems on Partnership Accounts).

UNIT IV DEPRECIATION

Depreciation – Meaning, Causes, Types – Straight Line Method – Written Down Value Method, Insurance Policy Method, Sinking Fund Method & Annuity Method. Insurance claims – Average Clause (Loss of stock & Loss of Profit)

UNIT V SINGLE ENTRY ACCOUNTING

Single Entry – Meaning, Features, Defects, Differences between Single Entry and Double Entry System – Statement of Affairs Method – Conversion Method

OUTCOMES:

- Able to understand the basics of accounting
- Able to understand balance sheet preparation and do analysis
- Able to understand the partnership accounts
- Able to appreciate and depreciate the assets of an organization in accounting
- Able to understand Single Entry Accounting

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DMC 6303: ACCOUNTING AND FINANCIAL MANAGEMENT FOR APPLICATION DEVELOPMENT

UNIT-I
INTRODUCTION TO ACCOUNTING

STRUCTURE

1.0 OBJECTIVES

After going through this lesson, you will be able to- ·

Understand the meaning and nature of accounting.·

Differentiate between various types of accounting.

· Know development of accounting principle.

· Explain the importance of accounting.

1.1 INTRODUCTION

Over the centuries, accounting has remained confined to the financial record-keeping functions of the accountant. But, today's rapidly changing business environment has forced the accountants to reassess their roles and functions both within the organisation and the society. The role of an accountant has now shifted from that of a mere recorder of transactions to that of the member providing relevant information to the decision-making team. Broadly speaking, accounting today is much more than just book¬keeping and the preparation of financial reports. Accountants are now capable of working in exciting new growth areas such as: forensic accounting (solving crimes such as computer hacking and the theft of large amounts of money on the internet); e¬commerce (designing web-based payment system); financial planning, environmental accounting, etc.

This realisation came due to the fact that accounting is capable of providing the kind of information that managers and other interested persons need in order to make better decisions.

This aspect of accounting gradually assumed so much importance that it has now been raised to the level of an information system. As an information system, it collects data and communicates economic information about the organisation to a wide variety of users whose decisions and actions are related to its performance. This introductory chapter therefore, deals with the nature, need and scope of accounting in this context.

Accounting is a system meant for measuring business activities, processing of information into reports and making the findings available to decision-makers. The documents, which communicate these findings about the performance of an organisation in monetary terms, are called financial statements. Usually, accounting is understood as the Language of Business. However, a business may have a lot of aspects which may not be of financial nature. As such, a better way to understand accounting could be to call it The Language of Financial Decisions. The better the understanding of the language, the better is the management of financial aspects of living. Many aspects of our lives are based on accounting, personal financial planning, investments, income-tax, loans, etc. We have different roles to perform in life-the role of a student, of a family head, of a manager, of an investor, etc. The knowledge of accounting is an added advantage in performing different roles. However, we shall limit our scope of discussion to a business organisation and the various financial aspects of such an organisation.

When we focus our thoughts on a business organisation, many questions (is our business profitable, should a new product line be introduced, are the sales sufficient, etc.) strike our mind. To answer questions of such nature, we need to have information generated through the accounting process. The people who take policy decisions and frame business plans use such information. All business organisations work in an ever-changing dynamic environment. Any new programme of the organisation or of its competitor will affect the business. Accounting serves as an effective tool for measuring the financial pulse rate of the company. It is a continuous cycle of measurement of results and reporting of results to decision¬makers. Just like arithmetic is a procedural element of mathematics, book keeping is the procedural element of accounting. Figure 1 shows how an accounting system operates in business and how the flow of information occurs.

Objectives of Accounting

As an information system, the basic objective of accounting is to provide useful information to the interested group of users, both external and internal. The necessary information, particularly in case of external users, is provided in the form of financial statements, viz., profit and loss account and balance sheet. Besides these, the management is provided with additional information from time to time from the accounting records of business. Thus, the primary objectives of accounting include the following:

Maintenance of Records of Business Transactions

Accounting is used for the maintenance of a systematic record of all financial transactions in book of accounts. Even the most brilliant executive or manager cannot accurately remember the numerous amount of varied transactions such as purchases, sales, receipts, payments, etc. that takes place in business every day. Hence, proper and complete records of all business transactions are kept regularly. Moreover, the recorded information enables verifiability and acts as evidence.

Calculation of Profit and Loss

The owners of business are keen to have an idea about the net results of their business operations periodically, i.e. whether the business has earned profits or incurred losses. Thus, another objective of accounting is to ascertain the profit earned or loss sustained by a business during an accounting period which can be easily workout with help of record of incomes and expenses relating to the business by preparing a profit or loss account for the period. Profit represents excess of revenue (income), over expenses. If the total revenue of a given period is ` 6,00,000 and total expenses are ` 5,40,000 the profit will be equal to ` 60,000(` 6,00,000 – ` 5,40,000). If however, the total expenses exceed the total revenue, the difference reflects the loss.

Depiction of Financial Position

Accounting also aims at ascertaining the financial position of the business concern in the form of its assets and liabilities at the end of every accounting period. A proper record of resources owned by business organisation (Assets) Qualitative Characteristics of Accounting Information Decision Makers
(Users of Accounting Information).

- Understandability
- Decision Usefulness
- Relevance Reliability
- Timeliness
- Dedicative Feedback Verifiability Faithfulness
- Value Value
- Neutrality

Comparability and claims against such resources (Liabilities) facilitates the preparation of a statement known as balance sheet position statement.

Providing Accounting Information to its Users

The accounting information generated by the accounting process is communicated in the form of reports, statements, graphs and charts to the users who need it in different decision situations. As already stated, there are two main user groups, viz. internal users, mainly management, who needs timely information on cost of sales, profitability, etc. for planning, controlling and decision-making and external users who have limited authority, ability and resources to obtain the necessary information and have to rely on financial statements (Balance Sheet, Profit and Loss account). Primarily, the external users are interested in the following:

- Investors and potential investors-information on the risks and return on investment;
- Unions and employee groups-information on the stability, profitability and distribution of wealth within the business;
- Lenders and financial institutions-information on the creditworthiness of the company and its ability to repay loans and pay interest;
- Suppliers and creditors-information on whether amounts owed will be repaid when due, and on the continued existence of the business;
- Customers-information on the continued existence of the business and thus the probability of a continued supply of products, parts and after sales service.

1.2 DEVELOPMENT OF ACCOUNTING DISCIPLINE

The history of accounting can be traced back to ancient times. According to some beliefs, the very art of writing originated in order to record accounting information. Though this may seem to be an exaggeration, but there is no denying the fact that accounting has a long history. Accounting records can be traced back to the ancient civilizations of China, Babylonia, Greece and Egypt. Accounting was used to keep records regarding the cost of labour and materials used in building great structures like the Pyramids. During 1400s, accounting grew further because the needs for information of merchants in the Venis City of Italy increased. The first known description of double entry book keeping was first published in 1994 by Lucas Pacioli. He was a mathematician and a friend of Leonardo Ileda Vinci.

The onset of the industrial revolution necessitated the development of more sophisticated accounting system, rather than pricing the goods based on guesses about the costs. The increase in competition and mass production of goods led to the rise of accounting as a formal branch of study. With the passage of time, the corporate world grew. In the nineteenth century, companies came up in many areas of infrastructure like the railways, steel, communication, etc. It led to a rapid growth in accounting. As the complexities of business grew, ownership and management of business was divorced. As such, managers had to come up with well-defined, structured systems of accounting to report the performance of the business to its owners. Government also has had a lot to do with more accounting developments. The Income Tax brought about the concept of ‘income’. Government takes a host of other decisions, relating to education, health, economic planning, for which it needs accurate and reliable information. As such, the government demands stringent accountability in the corporate sector, which forces the accounting process to be as objective and formal as possible.

Meaning of Accounting

In 1941, The American Institute of Certified Public Accountants (AICPA) had defined accounting as the art of recording, classifying, and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of financial character, and interpreting the results thereof'. With greater economic development resulting in changing role of accounting, its scope, became broader. In 1966, the American Accounting Association (AAA) defined accounting as 'the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of information'.

ACCOUNTING CYCLE

After taking decisions such as selecting a business, selecting the form of organisation of business, making decision about the amount of capital to be invested, selectingsuitable site, acquiring equipment & supplies, selecting staff, getting customers & selling the goods etc. a business man finally resorts to record keeping. For all types of business organisations, transactions such as purchases, sales, manufacturing & selling expenses, collection from customers & payments to suppliers do take place. These business transactions are recorded in a set of ruled books such as journal, ledger, cash book etc. Unless these transactions are recorded properly he will not be in a position to know where exactly he stands.

The following is the complete cycle of Accounting

- The opening balances of accounts from the balance sheet & day to day business transaction of the accounting year are first recorded in a book known as journal.
- Periodically these transactions are transferred to concerned accounts known as ledger accounts.
- At the end of every accounting year these accounts are balanced & the trial balance is prepared.
- Then the final accounts such as trading & profit & loss accounts are prepared.
- Finally, a balance sheet is made which gives the financial position of the business at the end of the period.

FUNCTIONS OF FINANCIAL ACCOUNTING

An analysis of the above definition brings out the following functions of accounting:

1. Recording: This is the basic function of accounting. It is essentially concerned with not only ensuring that all business transactions of financial character are in fact recorded but also that they are recorded in an orderly manner. Recording is done in the book "Journal". This book may be further sub-divided into various subsidiary books such as Cash Journal (for recording cash transaction), Purchases Journal (for recording credit purchases of goods), Sales Journal (for recording credit sales of goods), etc. The number of subsidiary books to be maintained will be according to the nature and size of the business.

2. Classifying: Classification is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature at one place. The work of classification is done in the book termed as “Ledger”. This book contains on different pages individual’s account heads under which all financial transactions of similar nature are collected. For example, there may be separate account heads for Travelling Expenses, Printing and Stationery, Advertising, etc. All expenses under these heads after being recorded in the Journal will be classified under separate heads in the Ledger. This will help in finding out the total expenditure incurred under each of the above heads.

3. Summarising: This involves presenting the classified data in a manner which is understandable and useful to the internal as well as external end –users of accounting statements. This process leads to the preparation of the following statements, viz. Trial Balance, Income Statement and Balance Sheet.

4. Interpretation: This is the final function of accounting. The recorded financial data are interpreted in a manner that the end-users can make a meaningful judgment about the financial condition and profitability of the business operations. The data are also used for preparing the future plans and framing of policies for executing such plans.

PARTIES INTERESTED IN FINANCIAL ACCOUNTING INFORMATION

Accounting is of primary importance to the proprietors and the managers. However, the following other persons 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, they, therefore, act both as managers, since either some or all the partners participate in the management of the business and 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 suppliers 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 they 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 enterprises 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 employees.

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.

BOOK-KEEPING AND ACCOUNTING

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 only of a minor segment, such as a portion of the Customers' accounts in a departmental store. A substantial portion of the Book-Keeper's work is of a clerical nature and is increasingly being accomplished through the use of mechanical and electronic devices.

Accounting is primarily concerned with designing the systems for recording, classifying and summarizing the recorded data and interpreting them for internal and external end users. Accountants often direct and review the work of the book-keepers. 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.

LIMITATIONS OF FINANCIAL ACCOUNTING

The financial accounting is mainly concerned with the preparation of final accounts i.e Profit and Loss Account and Balance Sheet. The modern business has become so complex that mere final accounts information is not sufficient in meeting information needs. The management needs information for planning, controlling and co-ordinating business activities. It is because of the limitations of financial accounting that cost accounting and management accounting have developed. Some of the limitations of financial accounting are discussed below:

1. **Historical Nature:** Financial accounting is historical in nature in the sense that is a record of all those transactions which have taken place in the business during a particular period of time. The impact of future uncertainties has no place in financial accounting. As management needs information for future planning, the financial accounting can only give information about what has happened and not about what will happen. It does not suggest what should be done to increase the efficiency of the concern.

2. **Provides Information about the concern as a whole:** In financial accounting, information is recorded for the whole concern. One can find information about total expenses total receipts only. The information is not recorded product-wise, department-wise or any other line of activity. It is essential to record information activity-wise so as to be helpful for cost determination and cost control purposes.

3. Not helpful in Price Fixation: Financial accounting is not helpful in fixing prices of products. The cost of product can be obtained only when all expenses have been incurred. It is not possible to determine the price in advance. The concern may be required to quote a price for the supply of goods in the near future (for submitting tenders, etc.) Financial accounting cannot supply all this information, so it is not helpful in price determination. Price fixation requires information about variable and fixed costs, direct and indirect costs. Indirect expenses are estimated on the basis of past records for price determination purposes.

4. **Cost Control Not Possible:** Cost control is not possible in financial accounting. The cost figures are known only at the end of a can be done to control it. There is no technique in financial accounting which can help to ascertain whether the cost is more or less while the expenses are being incurred. There is no procedure, to assign responsibility for higher costs, if any. The costing process requires a constant
review of actual costs from time to time and this is not possible in financial accounting.

5. **Appraisal of Policies not Possible:** It is not possible to evaluate various policies and programmes in financial accounting. There is no technique for comparing actual performance with budgeted targets. Whether the work is going on as per schedule or not, cannot be determined. The only criterion for determining efficiency is to see the profits at the end of a financial period. The profitability is the only yardstick for evaluating managerial performance. Profits of an enterprise are influenced by a number of outside factors also. So it is not a reliable test for ascertaining efficiency of the management.

6. Only Actual Costs Recorded: Financial accounting records only actual cost figures. The amount paid for purchasing materials, property or other assets is recorded in account books. The prices of goods and assets go on varying from time to time. The present prices of assets may be absolutely different from the recorded costs. Financial accounts do not record price level changes. The recorded costs cannot provide correct information or exact values of assets.

7. **Not Helpful in taking Strategic Decisions:** Management is to take strategic decisions like replacement of labour by machinery, introduction of a new product, discontinuation of an existing line of production, expansion of capacity, etc. The impact of these decisions and cost involved will have to be ascertained in anticipation. Various alternative suggestions are to be studies before taking a final decision. Financial accounts cannot provide necessary information for taking important decisions because information is recorded for the whole concern and it is available only when the event has taken place.

8. **Technical subject**: Financial accounting is a technical subject. The recording of transactions and making their use requires knowledge of accounting principles and conventions. A person who is not conversant with accounting subject has little utility of financial accounts.

9. **Quantitative Information:** Financial accounting records only that information which can b quantitatively measured. Anything which cannot be quantitatively measured will not form a part of financial accounting even though it is important for the business. The policies and plans of the government have a direct bearing on the working of the business. It is essential to determine the impact of government decisions on the entrepreneurial policies. Financial accounts will avoid qualitative factors because they cannot be quantitatively measured.

10. Lack of Unanimity about Accounting Principles: Accountants differ on the use of accounting principles. Despite the efforts of International Accounting Standards Committee, there is a lack of unanimity on the use of accounting principles and procedures. The methods of valuing inventory and methods of charging depreciation are the most controversial issues on which unanimity has not been possible. The preference for the use of different accounting principles brings in an element of subjectivity and human basic needs. The use of different accounting methods reduces the usefulness and reliability of accounts.

11. **Chances of Manipulation:** There are chances of using financial accounts to suit the whims of management. The over-valuation or under-valuation of inventory may change the figures of profits. More profits may be shown to get more remuneration, issue more dividends or to raise the prices of company's shares. Less profits may be shown to save takes or for not paying bonus to workers, etc. The possibility of manipulating financial accounts reduces their reliability.

1.3 AN ACCOUNTANT'S JOB PROFILE: FUNCTIONS OF ACCOUNTING

A man who is involved in the process of book keeping and accounting is called an accountant. With the coming up accounting as a specialised field of knowledge, an accountant has a special place in the structure of an organisation, because he performs certain vital functions.

The following paragraphs examine the functions of accounting and what role does an accountant play in discharging these functions. An accountant is a person who does the basic job of maintaining accounts as he is the man who is engaged in book keeping. Since the managers would always want to know the financial performance of the business. An accountant prepares profit and loss account which reports the profits/losses of the business during the accounting period, Balance Sheet, which is a statement of assets and liabilities of the business at a point of time, is also proposed by all accountants. Since both statements are called financial statements, the person who prepares them is called a financial accountant.

Accounting information serves many purposes. A part from revealing the level of performance, it throws light on the causes of weakness and deviation from plans (in any). In this way an accountant becomes an important functionary who plays a vital role in the process of management control, which is a process of diagnosing and solving a problem. Seen from this point of view, an accountant can be referred to as a management accountant. Tax planning is an important area as far as the fiscal management of a company is concerned. An accountant has a suggestive but very specific job to do in this regard by indicating ways to minimise the tax liability through his knowledge of concessions and incentives available under the existing taxation framework of the country. An accountant can influence a company even by not being an employee. He can act as a man who verifies and certifies the authenticity of accounts of a company by auditing the accounts. It is a strictly professional job and is done by persons who are formally trained and qualified for the purpose. They have an educational status and a prescribed code of conduct like the Chartered Accountants in India and Certified Public Accountants in USA. Information management is another area which keeps an accountant busy. He is the one who classifies the financial information into information for internal use (management accounting function); and information or external use (financial accounting function). Irrespective of the size and degree of automation of a business, information management is a key area and many organisations are known to have perished because they failed to recognise this as an important function of an accountant because information system is imperative for effective cost control, to forecast cash needs and to plan for future growth of the organisation.

1.4 UTILITY OF ACCOUNTING

The preceding section has just brought out the importance of information. Effective decisions require accurate, reliable and timely information. The need for quantity and quality of information varies with the importance of the decision that has to be taken on the basis of that information. The following paragraphs throw light on the various users of accounting information and what do they do with that information. Individuals may use accounting information to manage their routine affairs like operating and managing their bank accounts, to evaluate the worthwhileness of a job in an organization, to invest money, to rent a house, etc.

Business Managers have to set goals, evaluate progress and initiate corrective action in case of unfavourable deviation from the planned course of action. Accounting information is required for many such decisions—purchasing equipment, maintenance of inventory, borrowing and lending, etc. Investors and creditors are keen to evaluate the profitability and solvency of a company before they decide to provide money to the organisation. Therefore, they are interested to obtain financial information about the company in which they are contemplating an investment. Financial statements are the principal source of information to them which are published in annual reports of a company and various financial dailies and periodicals.

Government and Regulatory agencies are charged with the responsibility of guiding the socio-economic system of a country in such a way that it promotes common good. For example, the Securities and
Exchange Board of India (SEBI) makes it mandatory for a company to disclose certain financial information to the investing public. The government's task of managing the industrial economy becomes simplify if the accounting information such as profits, costs, taxes, etc. is presented in a uniform manner without any manipulation or 'window-dressing'.Central and State governments levy various taxes. The taxation authorities, therefore, need to know the income of a company to calculate
the amount of tax that the company would have to pay. The information generated by accounting helps them in such computations and also to detect any attempts of tax evasion.

Employees and trade unions use the accounting information to settle various issues related to wages, bonus, profit sharing, etc. Consumers and general public are also interested in knowing the amount of income earned by various business houses. Accounting information helps in finding whether or not a company is over charging or exploiting the customers, whether or not companies are showing improved business performance, whether or not the country is emerging from the economic recession, etc. All such aspects draw heavily on accounting information and are closely related to our standard of living.

1.5 TYPES OF ACCOUNTING

The financial literature classifies accounting into two broad categories, viz, Financial Accounting and Management Accounting. Financial accounting is primarily concerned with the preparation of financial statements whereas management accounting covers areas such as interpretation of financial statements, cost accounting, etc. Both these types of accounting are examined in the following paragraphs.

1.6 FINANCIAL ACCOUNTING

As mentioned earlier, financial accounting deals with the preparation of financial statements for the basic purpose of providing information to various interested groups like creditors, banks, shareholders, financial institutions, government, consumers, etc. Financial statements, i.e. the income statement and the balance sheet indicate the way in which the activities of the business have been conducted during a given period of time.

Financial accounting is charged with the primary responsibility of external reporting. The users of information generated by financial accounting, like bankers, financial institutions, regulatory authorities, government, investors, etc. want the accounting information to be consistent so as to facilitate comparison. Therefore, financial accounting is based on certain concepts and conventions which include separate business entity, going concern concept, money measurement concept, cost concept, dual aspect concept, accounting period concept, matching concept, realization concept and conventions of conservatism, disclosure, consistency, etc. All such concepts and conventions would be dealt with detail in subsequent lessons.

The significance of financial accounting lies in the fact that it aids the management in directing and controlling the activities of the firm and to frame relevant managerial policies related to areas like production, sales, financing, etc. However, it suffers from certain drawbacks which are discussed in the following paragraphs.

- The information provided by financial accounting is consolidated in nature. It does not indicate a break-up for different departments, processes, products and jobs. As such, it becomes difficult to evaluate the performance of different sub-units of the organisation.
- Financial accounting does not help in knowing the cost behaviour as it does not distinguish between fixed and variable costs.
- The information provided by financial accounting is historical in nature and as such the predictability of such information is limited.

The management of a company has to solve certain ticklish questions like expansion of business, making or buying a component, adding or deleting a product line, deciding on alternative methods of production, etc. The financial accounting information is of little help in answering these questions.

The limitations of financial accounting, however, should not lead one to believe that it is of no use. It is the basic foundation on which other branches and tools of accounting analysis are based. It is the source of information, which can be further analysed and interpreted according to the tailor-made requirements of decision-makers.

Management accounting

Management accounting is 'tailor-made' accounting. It facilitates the management by providing accounting information in such a way so that it is conducive for policy making and running the day-to-day operations of the business. Its basic purpose is to communicate the facts according to the specific needs of decision-makers by presenting the information in a systematic and meaningful manner. Management accounting, therefore, specifically helps in planning and control. It helps in setting standards and in case of variances between planned and actual performances, it helps in deciding the corrective action.An important characteristic of management accounting is that it is forward looking. Its basic focus is one future activity to be performed and not what has already happened in the past. Since management accounting caters to the specific decision needs, it does not rest upon any well-defined and set principles. The reports generated by a management accountant can be of any duration– short or long, depending on purpose. Further, the reports can be prepared for the organisation as a whole as well as its segments.

Cost accounting

One important variant of management accounting is the cost analysis. Cost accounting makes elaborate cost records regarding various products, operations and functions. It is the process of determining and accumulating the cost of a particular product or activity. Any product, function, job or process for which costs are determined and accumulated, are called cost centres. The basic purpose of cost accounting is to provide a detailed break-up of cost of different departments, processes, jobs, products, sales territories, etc., so that effective cost control can be exercised. Cost accounting also helps in making revenue decisions such as those related to pricing, product-mix, profit-volume decisions, expansion of business, replacement decisions, etc.

The objectives of cost accounting, therefore, can be summarized in the form of three important statements, viz, to determine costs, to facilitate planning and control of business activities and to supply information for short- and long-term decision. Cost accounting has certain distinct advantages over financial accounting. Some of them have been discussed succeedingly. The cost accounting system provides data about profitable and non-profitable products and activities, thus prompting corrective measures. It is easier to segregate and analyse individual cost items and to minimize losses and wastages arising from the manufacturing process. Production methods can be varied so as to minimize costs and increase profits. Cost accounting helps in making realistic pricing decisions in times of low demand, competitive conditions, technology changes, etc. Various alternative courses of action can be properly evaluated with the help of data generated by cost accounting. It would not be an exaggeration if it is said that a cost accounting system ensures maximum utilization of physical and human resources. It checks frauds and manipulations and directs the employer and employees towards achieving the organisational goal.

1.6 SUMMARY

Accounting can be understood as the language of financial decisions. It is an ongoing process of performance measurement and reporting the results to decision-makers. The discipline of accounting can be traced back to very early times of human civilization. With the advancement of industry, modern day accounting has become formalized and structured. A person who maintains accounts is known as the accountant. He is engaged in multifarious activities like preparing financial statements, facilitating the control process, tax planning, auditing and information management. The information generated by accountant is used by various groups like, individuals, managers, investors, creditors, government, regulatory agencies, taxation authorities, employees, trade unions, consumers and general public. Depending upon purpose and method, accounting can be of broadly two types– financial accounting and management accounting. Financial accounting is primarily concerned with the preparation of financial statements mainly for outsiders. It is based on certain well-defined concepts and conventions and helps in framing broad financial policies.

However, it suffers from certain limitations which are taken care of by the other branch of accounting, viz.; management accounting. Management accounting is meant to help in decision-making by analyzing and interpreting the information generated by financial accounting. As such, management accounting is futuristic and decision-oriented. The methods of management accounting are not very exact as they have to be varied according to the requirements of the decision. Cost accounting is an important aspect of management accounting. It emphasizes on cost determination, aiding the planning and control process and supplying information for short- and long-run decisions. The basic differences between financial and management accounting arises due to differences in users of information, differences in time frame and type of reports generated. The criterion for decision making and the behavioural implications of both types of accounting are also different.

1.7 KEYWORDS

Accrual	Recognition of revenues and costs as they are earned or incurred. It includes recognition of transaction relating to assets and liabilities as they occur irrespective of the actual receipts or payment.
Cost	The amount of expenditure incurred on or attributable to a specified article, product or activity.
Expenses	A cot relating to the operations of an accounting period.
Revenue	Total amount received from sales of goods/services.
Income	Excess of revenue over expenses.
Loss	Excess of expenses over revenue.
Capital	Generally refers to the amount invested in an enterprise by its owner.
Fund	An account usually of the nature of a reserve or provision which is represented by

	specifically Ear Market Assets.
Gain	A monetary benefit, profit or advantage resulting from a transaction or group of transactions.
Investment	Expenditure on assets held to earn interest, income, profit or other benefits.
Liability	The financial obligation of an enterprise other than owners' funds.
Net Profit	The excess of revenue over expenses during a particular accounting period.

1.8 SELF ASSESSMENT QUESTIONS

1. Define accounting. What purpose is served by accounting?
2. Discuss the role and activities of an accountant.
3. What are the various interested parties which use accounting information? How is such information used?
4. Explain the different types of accounting.
5. Differentiate Financial Accounting and Management Accounting in detail.

1.9 REFERENCES/SUGGESTED READINGS

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LESSON-2

BASIC ACCOUNTING CONCEPTS AND CONVENTIONS

STRUCTURE

2.0 OBJECTIVES

After studying this lesson, you should be able to- • Appreciate the need for a conceptual framework of
accounting.

• Understand and describe the generally accepted accounting principles (GAAP).

• Know the importance and advantages of uniformity in accounting policies and practices.

2.1 INTRODUCTION

Accounting is often called the language of business because the purpose of accounting is to communicate or report the results of business operations and its various aspects to various users of accounting information. In fact, today, accounting statements or reports are needed by various groups such as shareholders, creditors, potential investors, columnist of financial newspapers, proprietors and others. In view of the utility of accounting reports to various interested parties, it becomes imperative to make this language capable of commonly understood by all. Accounting could become an intelligible and commonly understood language if it is based on generally accepted accounting principles. Hence, you must be familiar with the accounting principles behind financial statements to understand and use them properly.

2.2 MEANING AND FEATURES OF ACCOUNTING PRINCIPLES

For searching the goals of the accounting profession and for expanding knowledge in this field, a logical and useful set of principles and procedures are to be developed. We know that while driving our vehicles, follow a standard traffic rules. Without adhering traffic rules, there would be much chaos on the road. Similarly, some principles apply to accounting. Thus, the accounting profession cannot reach its goals in the absence of a set rules to guide the efforts of accountants and auditors. The rules and principles of accounting are commonly referred to as the conceptual framework of accounting.

Accounting principles have been defined by the Canadian Institute of Chartered Accountants as "The body of doctrines commonly associated with the theory and procedure of accounting serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternatives exists. Rules governing the formation of accounting axioms and the principles derived from them have arisen from common experience, historical precedent statements by individuals and professional bodies and regulations of Governmental agencies".

According to Hendriksen (1997), Accounting theory may be defined as logical reasoning in the form of a set of broad principles that (i) provide a general frame of reference by which accounting practice can be evaluated, and (ii) guide the development of new practices and procedures. Theory may also be used to explain existing practices to obtain a better understanding of them. But the most important goal of accounting theory should be to provide a coherent set of logical principles that form the general frame of reference for the evaluation and development of sound accounting practices.

The American Institute of Certified Public Accountants (AICPA) has advocated the use of the word "Principle" in the sense in which it means "rule of action". It discuses the generally accepted accounting principles as follows:
Financial statements are the product of a process in which a large volume of data about aspects of the economic activities of an enterprise are accumulated, analysed and reported. This process should be carried out in conformity with generally accepted accounting principles. These principles represent the most current consensus about how accounting information should be recorded, what information should be disclosed, how it should be disclosed, and which financial statement should be prepared. Thus, generally accepted principles and standards provide a common financial language to enable informed users to read and interpret financial statements.

Generally accepted accounting principles encompass the conventions, rules and procedures necessary to define accepted accounting practice at a particular time....... generally accepted accounting principles include not only broad guidelines of general application, but also detailed practices and procedures (Source: AICPA Statement of the Accounting Principles Board No. 4, "Basic Concepts and Accounting Principles underlying Financial Statements of Business Enterprises ", October, 1970, pp 54-55)

According to 'Dictionary of Accounting' prepared by Prof. P.N. Abroal, "Accounting standards refer to accounting rules and procedures which are relating to measurement, valuation and

disclosure prepared by such bodies as the Accounting Standards Committee (ASC) of a particular country". Thus, we may define Accounting Principles as those rules of action or conduct which are adopted by the accountants
universally while recording accounting transactions. Accounting principles are man-made. They are accepted because they are believed to be useful. The general acceptance of an accounting principle usually depends on how well it meets the following three basic norms: (a) Usefulness; (b) Objectiveness; and (c) Feasibility.
A principle is useful to the extent that it results in meaningful or relevant information to those who need to know about a certain business. In other words, an accounting rule, which does not increase the utility of the records to its readers, is not accepted as an accounting principle. A principle is objective to the extent that the information is not influenced by the personal bias or Judgement of those who furnished it. Accounting principle is said to be objective when it is solidly supported by facts.

Objectivity means reliability which also means that the accuracy of the information reported can be verified. Accounting principles should be such as are practicable. A principle is feasible when it can be implemented without undue difficulty or cost. Although these three features are generally found in accounting principles, an optimum balance of three is struck in some cases for adopting a particular rule as an accounting principle. For example, the principle of making the provision for doubtful debts is found on feasibility and usefulness though it is less objective. This is because of the fact that such provisions are not supported by any outside evidence.

2.3 KINDS OF ACCOUNTING PRINCIPLES

In dealing with the framework of accounting theory, we are confronted with a serious problem arising from differences in terminology. A number of words and terms have been used by different authors to express and explain the same idea or notion. The various terms used for describing the basic ideas are: concepts, postulates, propositions, assumptions, underlying principles, fundamentals, conventions, doctrines, rules, axioms, etc. Each of these terms is capable of precise definition. But, the accounting profession has served to give them lose and overlapping meanings. One author may describe the same
idea or notion as a concept and another as a convention and still another as postulate. For example, the separate business entity idea has been described by one author as a concept and by another as a convention. It is better for us not to waste our time to discuss the precise meaning of generic terms as the wide diversity in these terms can only serve to confuse the learner.

We do feel, however, that some of these terms/ideas have a better claim to be called 'concepts' while the rest should be called 'conventions'. The term 'Concept' is used to connote the accounting postulates, i.e., necessary assumptions and ideas which are fundamental to accounting practice. In other words, fundamental accounting concepts are broad general assumptions which underline the periodic financial statements of business enterprises. The reason why some of these terms should be called concepts is that they are basic assumptions and have a direct bearing on the quality of financial accounting information. The term 'convention' is used to signify customs or tradition as a guide to the preparation of accounting statements.

2.4 ACCOUNTING CONCEPTS

The more important accounting concepts are briefly described as follows:

1. Separate Business Entity Concept: In accounting we make a distinction between business and the owner. All the books of accounts records day to day financial transactions from the view point of the business rather than from that of the owner. The proprietor is considered as a creditor to the extent of the capital brought in business by him. For instance, when a person invests Rs. 10 lakh into a business, it will be treated that the business has borrowed that much money from the owner and it will be shown as a 'liability' in the books of accounts of business. Similarly, if the owner of a shop were to take cash from the cash box for meeting certain personal expenditure, the accounts would show that cash had been reduced even though it does not make any difference to the owner himself. Thus, in recording a transaction the important question is how does it affects the business? For example, if the owner puts cash into the business, he has a claim against the business for capital brought in. In so-far as a limited company is concerned, this distinction can be easily maintained because a company has a legal entity like a natural person it can engage itself in economic activities of buying, selling, producing, lending, borrowing and consuming of goods and services. However, it is difficult to show this distinction in the case of sole proprietorship and partnership. Nevertheless, accounting still maintains separation of business and owner. It may be noted that it is only for accounting purpose that partnerships and sole proprietorship are treated as separate from the owner (s), though law does not make such distinction. In fact, the business entity concept is applied to make it possible for the owners to assess the performance of their business and performance of those whose manage the enterprise. The managers are responsible for the proper use of funds supplied by owners, banks and others.

2. Money Measurement Concept: In accounting, only those business transactions are recorded which can be expressed in terms of money. In other words, a fact or transaction or happening which cannot be expressed in terms of money is not recorded in the accounting books. As money is accepted not only as a medium of exchange but also as a store of value, it has a very important advantage since a number of assets and equities, which are otherwise different, can be measured and expressed in terms of a common denominator. We must realise that this concept imposes two severe limitations. Firstly, there are several facts which though very important to the business, cannot be recorded in the books of accounts because they cannot be expressed in money terms. For example, general health condition of the Managing Director of the company, working conditions in which a worker has to work, sales policy pursued by the enterprise, quality of product introduced by the enterprise, though exert a great influence on the productivity and profitability of the enterprise, are not recorded in the books. Similarly, the fact that a strike is about to begin because employees are dissatisfied with the poor working conditions in the factory will not be recorded even though this event is of great concern to the business. You will agree that all these have a bearing on the future profitability of the company.

Secondly, use of money implies that we assume stable or constant value of rupee. Taking this assumption means that the changes in the money value in future dates are conveniently ignored. For example, a piece of land purchased in 1990 for Rs. 2 lakh and another bought for the same amount in 1998 are recorded at the same price, although the first purchased in 1990 may be worth two times higher than the value recorded in the books because of rise in land prices. In fact, most accountants know fully well that purchasing power of rupee does change but very few recognise this fact in accounting books and make allowance for changing price level.

3. Dual Aspect Concept: Financial accounting records all the transactions and events involving financial element. Each of such transactions requires two aspects to be recorded. The recognition of these two aspects of every transaction is known as a dual aspect analysis. According to this concept every business transactions has dual effect. For example, if a firm sells goods of Rs. 5,000 this transaction involves two aspects. One aspect is the delivery of goods and the other aspect is immediate receipt of cash (in the case of cash sales). In fact, the term 'double entry' book keeping has come into vogue and in this system the total amount debited always equals the total amount credited. It follows from 'dual aspect concept' that at any point of time owners' equity and liabilities for any accounting entity will be equal to assets owned by that entity. This idea is fundamental to accounting and could be expressed as the following equalities:

Assets = Liabilities + Owners Equity …(1)

Owners Equity = Assets- Liabilities …(2)

The above relationship is known as the 'Accounting Equation'. The term 'Owners Equity' denotes the resources supplied by the owners of the entity while the term 'liabilities' denotes the claim of outside parties such as creditors, debenture-holders, bank against the assets of the business. Assets are the resources owned by a business. The total of assets will be equal to total of liabilities plus owners capital because all assets of the business are claimed by either owners or outsiders.

4. Going Concern Concept: Accounting assumes that the business entity will continue to operate for a long time in the future unless there is good evidence to the contrary. The enterprise is viewed as a going concern, that is, as continuing in operations, at least in the foreseeable future. In other words, there is neither the intention nor the necessity to liquidate the particular business venture in the predictable future. Because of this assumption, the accountant while valuing the assets does not take into account forced sale value of them. In fact, the assumption that the business is not expected to be liquidated in the foreseeable future establishes the basis for many of the valuations and allocations in accounting. For example, the accountant charges depreciation on fixed assets. It is this assumption which underlies the decision of investors to commit capital to enterprise. Only on the basis of this assumption accounting process can remain stable and achieve the objective of correctly reporting and recording on the capital invested, the efficiency of management, and the position of the enterprise as a going concern. However, if the accountant has good reasons to believe that the business, or some part of it is going to be liquidated or that it will cease to operate (say within six-month or a year), then the resources could be reported at their current values. If this concept is not followed, International Accounting Standard requires the disclosure of the fact in the financial statements together with reasons.

5. Accounting Period Concept: This concept requires that the life of the business should be divided into appropriate segments for studying the financial results shown by the enterprise after each segment. Although the results of operations of a specific enterprise can be known precisely only after the business has ceased to operate, its assets have been sold off and liabilities paid off, the knowledge of the results periodically is also necessary. Those who are interested in the operating results of business obviously cannot wait till the end. The requirements of these parties force the businessman 'to stop' and 'see back' how things are going on. Thus, the accountant must report for the changes in the wealth of a firm for short time periods. A year is the most common interval on account of prevailing practice, tradition and government requirements. Some firms adopt financial year of the government, some other calendar year. Although a twelve month period is adopted for external reporting, a shorter span of interval, say one month or three month is applied for internal reporting purposes.

This concept poses difficulty for the process of allocation of long term costs. All the revenues and all the cost relating to the year in operation have to be taken into account while matching the earnings and the cost of those earnings for the any accounting period. This holds good irrespective of whether or not they have been received in cash or paid in cash. Despite the difficulties which stem from this concept, short term reports are of vital importance to owners, management, creditors and other interested parties. Hence, the accountants have no option but to resolve such difficulties.

6. Cost Concept: The term 'assets' denotes the resources land building, machinery etc. owned by a business. The money values that are assigned to assets are derived from the cost concept. According to this concept an asset is ordinarily entered on the accounting records at the price paid to acquire it. For example, if a business buys a plant for Rs. 5 lakh the asset would be recorded in the books at Rs. 5 lakh, even if its market value at that time happens to be Rs. 6 lakh. Thus, assets are recorded at their original purchase price and this cost is the basis for all subsequent accounting for the business. The assets shown in the financial statements do not necessarily indicate their present market values. The term 'book value' is used for amount shown in the accounting records.

The cost concept does not mean that all assets remain on the accounting records at their original cost for all times to come. The asset may systematically be reduced in its value by charging 'depreciation', which will be discussed in detail in a subsequent lesson. Depreciation has the effect of reducing profit of each period. The prime purpose of depreciation is to allocate the cost of an asset over its useful life and not to adjust its cost. However, a balance sheet based on this concept can be very misleading as it shows assets at cost even when there are wide difference between their costs and market values. Despite this limitation you will find that the cost concept meets all the three basic norms of relevance, objectivity and feasibility.

7. The Matching concept: This concept is based on the accounting period concept. In reality we match revenues and expenses during the accounting periods. Matching is the entire process of periodic earnings measurement, often described as a process of matching expenses with revenues. In other words, income made by the enterprise during a period can be measured only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue. Broadly speaking revenue is the total amount realised from the sale of goods or provision of services together with earnings from interest, dividend, and other items of income. Expenses are cost incurred in connection with the earnings of revenues. Costs incurred do not become expenses until the goods or services in question are exchanged. Cost is not synonymous with expense since expense is sacrifice made, resource consumed in relation to revenues earned during an accounting period. Only costs that have expired during an accounting period are considered as expenses. For example, if a commission is paid in January, 2002, for services enjoyed in November, 2001, that commission should be taken as the cost for services rendered in November 2001. On account of this concept, adjustments are made for all prepaid expenses, outstanding expenses, accrued income, etc, while preparing periodic reports.

8. Accrual Concept: It is generally accepted in accounting that the basis of reporting income is accrual. Accrual concept makes a distinction between the receipt of cash and the right to receive it, and the payment of cash and the legal obligation to pay it. This concept provides a guideline to the accountant as to how he should treat the cash receipts and the right related thereto. Accrual principle tries to evaluate every transaction in terms of its impact on the owner's equity. The essence of the accrual concept is that net income arises from events that change the owner's equity in a specified period and that these are not necessarily the same as change in the cash position of the business. Thus it helps in proper measurement of income.

9. Realisation Concept: Realisation is technically understood as the process of converting non-cash resources and rights into money. As accounting principle, it is used to identify precisely the amount of revenue to be recognised and the amount of expense to be matched to such revenue for the purpose of income measurement. According to realisation concept revenue is recognised when 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 implies that revenue is generally realised when goods are delivered or services are rendered. The rationale is that delivery validates a claim against the customer. However, in case of long run construction contracts revenue is often recognised on the basis of a proportionate or partial completion method. Similarly, in case of long run instalment sales contracts, revenue is regarded as realised only in proportion to the actual cash collection. In fact, both these cases are the exceptions to the notion that an exchange is needed to justify the realisation of revenue.

2.5 ACCOUNTING CONVENTIONS

1. Convention of Materiality: Materiality concept states that items of small significance need not be given strict theoretically correct treatment. In fact, there are many events in business which are insignificant in nature. The cost of recording and showing in financial statement such events may not be well justified by the utility derived from that information. For example, an ordinary calculator costing Rs. 100 may last for ten years. However, the effort involved in allocating its cost over the ten year period is not worth the benefit that can be derived from this operation. The cost incurred on calculator may be treated as the expense of the period in which it is purchased. Similarly, when a statement of outstanding debtors is prepared for sending to top management, figures may be rounded to the nearest ten or hundred.

This convention will unnecessarily overburden an accountant with more details in case he is unable to find an objective distinction between material and immaterial events. It should be noted that an item material for one party may be immaterial for another. Actually, there are no hard and fast rules to draw the line between material and immaterial events and hence, It is a matter of judgement and common sense. Despite this limitation, It is necessary to disclose all material information to make the financial statements clear and understandable. This is required as per IAS-1 and also reiterated in IAS-5. As per IAS-1, materiality should govern the selection and application of accounting policies.

2. Convention of Conservatism: This concept requires that the accountants must follow the policy of ''playing safe" while recording business transactions and events. That is why, the accountant follow the rule anticipate no profit but provide for all possible losses, while recording the business events. This rule means that an accountant should record lowest possible value for assets and revenues, and the highest possible value for liabilities and expenses. According to this concept, revenues or gains should be recognised only when they are realised in the form of cash or assets (i.e. debts) the ultimate cash realisation of which can be assessed with reasonable certainty. Further, provision must be made for all known liabilities, expenses and losses, Probable losses regarding all contingencies should also be provided for. 'Valuing the stock in trade at market price or cost price whichever is less', 'making the provision for doubtful debts on debtors in anticipation of actual bad debts', 'adopting written down value method of depreciation as against straight line method', not providing for discount on creditors but providing for discount on debtors', are some of the examples of the application of the convention of conservatism. The principle of conservatism may also invite criticism if not applied cautiously. For example, when the accountant create secret reserves, by creating excess provision for bad and doubtful debts, depreciation, etc. The financial statements do not present a true and fair view of state of affairs. American Institute of Certified Public Accountant have also indicated that this concept need to be applied with much more caution and care as over conservatism may result in misrepresentation.

3. Convention of Consistency: The convention of consistency requires that once a firm decided on certain accounting policies and methods and has used these for some time, it should continue to follow the same methods or procedures for all subsequent similar events and transactions unless it has a sound reason to do otherwise. In other worlds, accounting practices should remain unchanged from one period to another. For example, if depreciation is charged on fixed assets according to straight line method, this method should be followed year after year. Analogously, if stock is valued at 'cost or market price whichever is less', this principle should be applied in each subsequent year.

However, this principle does not forbid introduction of improved accounting techniques. If for valid reasons the company makes any departure from the method so far in use, then the effect of the change must be clearly stated in the financial statements in the year of change. The application of the principle of consistency is necessary for the purpose of comparison. One could draw valid conclusions from the comparison of data drawn from financial statements of one year with that of the other year. But the inconsistency in the application of accounting methods might significantly affect the reported data.

Accounting standards

The accounting concepts and conventions discussed in the foregoing pages are the core elements in the theory of accounting. These principles, however, permit a variety of alternative practices to co-exist.

On account of this the financial results of different companies can not be compared and evaluated unless full information is available about the accounting methods which have been used. The lack of uniformity among accounting practices have made it difficult to compare the financial results of different companies. It means that there should not be too much discretion to companies and their accountants to present financial information the way they like. In other words, the information contained in financial statements should conform to carefully considered standards. Obviously, accounting standards are needed to:

- provide a basic framework for preparing financial statements to be uniformly followed by all business enterprises,
- make the financial statements of one firm comparable with the other firm and the financial statements of one period with the financial statements of another period of the same firm,
- make the financial statements credible and reliable, and d) create general sense of confidence among the outside users of financial statements.

In this context unless there are reasonably appropriate standards, neither the purpose of the individual investor nor that of the nation as a whole can be served. In order to harmonise accounting policies and to evolve standards the need in the USA was felt with the establishment of Securities and Exchange Commission (SEC) in 1933. In 1957, a research oriented organisation called Accounting Principles Boards (APB) was formed to spell out the fundamental accounting principles. After this the Financial Accounting Standards Board (FASB) was formed in 1973, in USA. At the international level, the need for standardisation was felt and therefore, an International Congress of accountants was organised in
Sydney, Australia in 1972 to ensure the desired level of uniformity in accounting practices. Keeping this in view, International Accounting Standards Committee (IASC) was formed and was entrusted with the responsibility of formulating international standards.

In order to harmonise varying accounting policies and practices, the Institute of Chartered Accountants of India (ICAI) formed the Accounting Standards Board (ASB) in April, 1977. ASB includes representatives from industry and government. The main function of the ASB is to formulate accounting standards. This Board of the Institute of Chartered Accountants of India has so far formulated around 27 Accounting Standards, the list of these accounting standards is furnished. Regarding the position of Accounting standards in India, it has been stated that the standards have been developed without first establishing the essential theoretical framework. As a result, accounting standards lack direction and coherence. This type of limitation also existed in UK and USA but it was remedied long back. Hence, there is an emergent need to make an attempt to develop a conceptual framework and also revise suitably the Indian Accounting Standards to reduce the number of alternative treatments.

2.6 SUMMARY

Accounting principles may be defined as rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. Accounting principles are accepted because they are believed to be useful. The general acceptance of an accounting principle usually depends on how well it meets the three basic norms i.e., usefulness, objectiveness and feasibility. The accounting principles broadly classified into two categories namely accounting concepts and accounting conventions. The term concept is used to cannot the accounting postulates, i.e., necessary assumptions and ideas which are fundamental to accounting practice. Accounting concepts are separate business entity concepts, money measurement concept, dual aspect concept, accounting period concept, cost concept, matching concept, accrual concept, and realisation concept. The term convention is used to signify customs or tradition as a guide to the preparation of accounting statement, main conventions of accounting are- (i) convention of materiality, convention of conservatism.

2.7 KEYWORDS

Creditor: Amount owned by an enterprise on account of goods purchased or services received.

Debtor: Persons from whom amounts are due for goods sold or services rendered.

Reserve: The portion of earnings of an enterprise appropriated by the management for a general or specific purpose.

Provision: Amount retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy.

Net Realisable Value: Actual selling price of an asset in the ordinary course of business less cost incurred in order to make the sale.

Inventory: Tangible property held for sale in the ordinary course of business or in the process of production for such sale.

Interim Report: The information provided with reference to a date before the close of the accounting period to owners or other interested persons concerning its operations/financial position.

Depreciation: Decrease in the value of fixed assets.

Balance Sheet: A statement of the financial position of an enterprise as at a given date.

Capital: Generally refers to the amount invested in an enterprise by its owners.

2.8 SELF ASSESSMENT QUESTIONS

1. State whether the following statements are true or false:

a) The ‘materiality concept’ refers to the state of ignoring small items and values from accounts.

b) Accounting principles are rules of action or conduct which are adopted by the accountants universally while recording accounting transactions.

c) The ‘separate entity concept’ of accounting is not applicable to sole trading concerns and partnership concerns.

d) The ‘dual aspect’ concept result in the accounting equation: Capital+Liabilities = Assets.
e) The ‘conservatism concept’ leads to the exclusion of all unrealised profits.
f) The balance sheet based on ‘Cost concept’ is of no use to a potential investor.
g) Accounting standards are statements prescribed by government regulatory bodies.
h) Accounting statements are statements prescribed by professional accounting bodies.
i) Accounting concepts are broad assumptions.

2. Choose the correct answer from the alternations given:

(I) Accounting standards are statements prescribed by
a) Law
b) Bodies of shareholders
c) Professional accounting bodies
(II) Accounting Principles are generally based on
a) Practicability
b) Subjectivity
c) Convenience in recording
(III) The Policy of ‘anticipate no profit and provide for all possible losses’ arises due to convention of
a) Consistency
b) Disclosure
c) Conservatism
(IV) Which is the accounting concept that requires the practice of crediting closing stock to the trading account
a) Going concern
b) Cost
c) Matching
(V) The convention of conservatism, when applied to the balance sheet, results in
a) understatement of assets liabilities
b) understatement of
c) understatement of capital.

3. Examine the role of accounting concepts in the preparation of financial statements. Do you find any of the accounting concepts conflicting with each other? Give examples.

4. Discuss briefly the basic concepts and conventions of accounting?

5. Write short notes on

a) Going concern concept
b) Dual aspect concept
c) Business entity concept
d) Convention of materiality
e) Convention of conservatism.

6. Why accounting practices should be standardised? Explain.
7. What progress has been made in India regarding standardisation of accounting practices?

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LESSON-3
DOUBLE ENTRY SYSTEM OF BOOK-KEEPING

Structure

After going through this lesson, you will be able to-

- Know the meaning, types of accounting systems and steps of accounting process.
- Understand the meaning and importance of book keeping.
- Know the standards of accounting systems and advantages.

3.1 OBJECTIVES OF ACCOUNTING

The following are the main objectives or utility of accounting:

(**1) To keep systematic record of business transactions:** The main objective of accounting is to keep complete record of business transactions accordingspecified rules. Complete record of business transactions possibility of omission and fraud. For this purpose, all the business transactions are first of all recorded in Journal or Subsidiary Books and then posted into Ledger.

(2) To calculate profit or loss: The second main objective of accounting is to ascertain the net profit earned or loss suffered on account of business transactions during a particular period. For this purpose Trading and Profit &Loss Account of the business is prepared at the end of each accounting period.

All the items relating to purchases, sales, expenses and revenues (incomes) of the business are recorded in Trading and Profit & Loss Account. If the amount of revenue exceeds the expenditure incurred in earning that revenue, there is said to be a profit. In case the expenditure exceeds the revenue, there is said tobe a loss. In addition, a businessman is able to get the following information by preparing a Trading and Profit & Loss Account.

I.How much goods have been purchased during a particular period?

II. How much goods have been sold during a particular period?

III. How much goods have remained unsold and what is its value?

IV. How much amount has been spent on various heads of expenditure and how much amount has been earned by various heads of revenues?

By attaining these information a businessman can keep effective control on expenditure.

(3) To know the exact reasons leading to net profit or net loss.

(4) To ascertain the financial position of the business - For a businessman merely ascertaining profit or loss of the business is not sufficient. The businessmust also know the financial health of the business. For this purpose, after prepar the Profit & Loss Account a statement called 'Balance Sheet' is prepared which the assets and their values on the one hand and the liabilities and capital on the ouk hand. A Balance Sheet is actually a screen picture of the financial position business. At one glance, one would know the following by looking at the Blade Sheet

(i) How much the business has to recover from Debtors?

(ii)How much the business has to pay to Creditors?

(iii) How much the business has in the form of

(a) Cash in hand,

(b) Cash at Bank,

(c) Closing Stock, and

(d) Fixed Assets?

(5) To ascertain the progress of the business from year to year.

(6) To prevent and detect errors and frauds.

(7) To provide information's to various parties: - Another main objective of accounting is to communicate the accounting information to various interested parties like owners, investors, creditors, banks, employees and government authorities etc. The information helps them in taking sound and judicious decisions about the business entity.

3.2 ACCOUNTING TRANSACTIONS

What are Accounting Transactions?

Accounting Transaction is an event that has an impact on entity's financial statements. In this tutorial, we are going to learn how basic transactions move through the accounting equation. What we need to remember is that because the accounting equation always balances, every movement in the equation must be countered by another movement of the same amount. Accounting transactions refer to any business activity those results in a direct effect on the financial status and financial statements of the business. Such transactions come in many forms, including:

- Sales in cash and credit to customers
- Receipt of cash from a customer by sending an invoice
- Purchase of fixed assets and movable assets
- Borrowing funds from a creditor

- Paying off borrowed funds from a creditor
- Payment of cash to a supplier from a sent invoice.

It is imperative to remember that every transaction should show the balance between the assets and the liabilities, or the debit and the credit, such that a receipt of cash from a customer equals an increase in revenue or that a purchase from a supplier equals an increase in expenses and a decrease in cash.

Types of Accounting Transactions based on Institutional Relationship

The types of accounting transactions may be based on various points of view. The first one that we will discuss is the types of accounting transactions according to institutional relationships, namely external and internal transactions.

1. External transactions: These involve the trading of goods and services with money. Therefore, it can be said that any transaction that is entered into by two persons or two organizations with one buying and the other one selling is considered an external transaction. It is also called a business transaction.

Example: If Company A buys raw materials for its production from Company B, then this is called an external transaction.

An external transaction, also known as a business transaction, is a trade of goods and services for money. One party is buying a product or service while the other party is selling it. This transaction can be between two people, two organizations, or a person and an organization. For example, a customer purchasing a hammer from a hardware store or a business purchasing equipment from a supplier are external transactions.

2. Internal transactions: They don’t involve any sales but rather other processes within the organization. This may include computing the salary of the employees and estimating the depreciation value of a certain asset. An internal transaction is any financial activity that occurs within an organization rather than with a third party. It is typically an exchange of finances between departments or the company and its employees. Internal transactions aren't sales like external transactions are, but they affect the company's finances. An employee receiving their salary or a department giving office supplies to another department are examples of internal transaction.

Types of Accounting Transactions based on the Exchange of Cash

Based on the exchange of cash, there are three types of accounting transactions, namely cash transactions, non-cash transactions, and credit transactions.

1. Cash transactions

They are the most common forms of transactions, which refer to those that are dealt with cash. For example, if a company purchases office supplies and pays for them with cash, a debit card, or a check, then that is a cash transaction. Cash transactions are one of the most common types of transactions that businesses make. They refer to any transaction that involves the exchange of cash. It doesn't have to be physical money, it can include debit transactions or cheques as well. A cash transaction is a type of external transaction, so an example is a restaurant purchasing ingredients from their supplier and paying them in cash. Another example is a customer purchasing a coffee from a cafe and paying with their debit card.

2. Non-cash transactions

They are unrelated to transactions that specify if cash's been paid or if it will be paid in the future. For example, if Company A purchases a machine from Company B and sees that it is defective, returning it will not entail any cash spent, so it falls under non-cash transactions. In other words, transactions that are not cash or credit are non-cash transactions. A non-cash transaction is any type of financial transaction that doesn't involve the exchange of cash or credit. Businesses still record these transactions in their financial statements as they impact the company's income or expenditure. An example of a non-cash transaction is a company that takes over a loan from another company in exchange for an asset, such as a share. Another example of a non-cash transaction is a company converting their bonds to another type of asset of equal value.

3. Credit transactions

They are deferred cash transactions because payment is promised and completed at a future date. Companies often extend credit terms for payment, such as 30 days, 60 days, or 90 days, depending on the product or service being sold or industry norms. Credit transactions occur when a creditor or lender supplies a company with goods, services, money, or securities in exchange for a deferred payment. Both parties agree to a payment plan, which typically includes a date the borrower needs to complete their payment. Some credit transactions include interest the borrower needs to pay on top of the original amount they borrowed.

An example of a credit transaction is a customer purchasing a bed from a mattress store and paying for their purchase every month for 18 months, rather than paying the total amount upfront. Another example is a business taking out a loan from a bank and paying it back over five years while also paying a 10% interest rate.

Types of Accounting Transactions based on Objective

There are two types of accounting transactions based on objective, namely business or non-business.

1. Business transactions: These are everyday transactions that keep the business running, such as sales and purchases, rent for office space, advertisements, and other expenses. Business transactions are day-to-day transactions that companies make to keep the business running. This can include sales and purchases, such as the external transactions we discussed, but also rent for office space, money spent on advertising, and other expenses. An example of a business transaction is a company hiring an external consultant to improve their marketing strategies. Another example of a business transaction is a company buying new kitchen equipment for their restaurant.

2. Non-business transactions: These are transactions that don't involve a sale or purchase but may involve donations and social responsibility. Non-business transactions are transactions that companies make that don't involve a sale or purchase, such as giving donations or fulfilling social responsibilities. A company hosting a charity event and donating the money they make is an example of a non-business transaction. Another example of a non-business transaction is a company sending their employees to volunteer for a cause instead of working for a day.

3. Personal transactions: Personal transactions are those that are performed for personal purposes such as birthday expenditures. Personal transactions occur when employees or businesses spend money for personal reasons. For example, a department throwing a birthday party for one of their employees is a personal transaction. Some companies require employees to pay for their own personal transactions, while others offer a certain amount of money for personal use.

Ways to record these transactions

If you work in the finance department, you may be responsible for recording and monitoring the business' accounting transactions. There are typically procedures and processes laid out by the senior management team. If you're working for a startup or trying to make the existing processes more efficient, here are some ways you can do so:

1. **Journal entries:** This is the most common method of recording transactions, as you simply need to enter the debit or credit for each transaction in a journal. It can be a physical journal or ledger, but many companies use digital versions to streamline the accounting process.
2. **Issuance of an invoice:** Using accounting software, you can automatically create journal entries whenever you issue an invoice to a customer. Include relevant

information, such as the price of the product or service you sold, the unit quantity, and any sales tax. Then, send this invoice to your customers and the information will go to the company's accounts receivable account.

3. **Receipt of an invoice:** Similarly, when you receive an invoice from a supplier or another business, record this information in an expense or accounts payable account. Keep a copy of both types of invoices for your own records.
4. **Issuance of pay checks**: As paying employees is a large, reoccurring expense, it's important to keep track of the issuance of these paychecks. Enter the employees' pay rates, hours worked, and deductions in a payroll account.

Double-entry Bookkeeping of Accounting Transactions

When recording accounting transactions, the double-entry method is a system bookkeeping where every entry to an account requires an opposite entry to a different account producing balanced journal entries. The double-sided journal entry comprises two equal and corresponding sides, known as a debit (left) and a credit (right). It will ensure that total debits will always equal total credits.

3.3 DOUBLE ENTRY SYSTEM OF BOOK-KEEPING

Book-Keeping – Introduction: Book-keeping is the art of recording business transactions in appropriate set of account note-books. If you turn a dictionary the meaning of book-keeping is given as the "art of keeping accounts in a regular and systematic manner'. Definitions: R.N. Carter defines Book-Keeping as follows: "Book-keeping is the science and art of correctly recoding in books of account all those business transactions that results in the transfer of money or money's worth".

According to L.C. Cropper, Book-keeping may be described as the science of recording transactions in money or money's worth in such a manner that at any subsequent date their nature and effect may be clearly understood and that when required a combined statement of their result may be prepared.

BOOK-KEEPING AND ACCOUNTING

The task of recording business transactions is described as the art of book-keeping. But, to be useful for a businessman, the information contained in the books of accounts must be classified, analysed and properly interpreted. He must know whether his financial position is sound. On a particular date he would also like to know what his assets are and what his liabilities are. Accounting is the task of preparing appropriate statements for the purposes noted above. It also provides analysis and interpretation of the figures available out of book-keeping. That is why accounting is known as the language of the businessman. In short, book-keeping is the art of maintaining the books of accounts of a business whereas accounting is the science of converting figures contained in the books into information useful for a businessman.

OBJECTIVES OF BOOK-KEEPING

The important objectives of Book-Keeping may be summarized as follows:

i) To have a permanent record of all the business transactions;
ii) To ensure the accurate recording of all financial transactions; and
iii) To know the effect of each transaction and to know the total effect of all the transactions.

3.4 ADVANTAGES OF BOOK-KEEPING

A number of advantages will be available if a proper system of Book-Keeping is followed. It will be understood that these advantages will accrue only if the Double Entry System is adopted.

1. A firm can know whenever it wants, how much profit it has earned or how much loss it has incurred in a particular period. This knowledge is naturally essential in order to know whether one is on the right path or not; otherwise one will merely grope in the dark.
2. The exact reasons leading to the profit or loss can also be ascertained. This knowledge will enable the firm to take the necessary action to increase profits and to convert losses into profits.
3. At the end of every trading period (usually a year), a Balance Sheet can be prepared which will disclose the financial state of affairs. Thus it will be known whether the firm is fully solvent or not. A comparative study of the balance sheets for various years shows a firm's progress.
4. Through accounts properly kept, losses of assets will be apparent without delay. This will help in avoiding such losses.
5. Reminders can be sent regularly to those customers who fail to pay in time. This will reduce bad debts.
6. A strict watch can be kept on the amount owing to outsiders, so that the firm will know what amounts are to be paid and when.
7. Accurate recording of transactions can be assured under the Double Entry System. Existence of errors is revealed by the preparation of what is known as "Trial Balance" – a statement containing balances in various accounts.
8. Proper accounting not only prevents and discovers errors, it also prevents and discovers frauds.
9. Management derives good guidance from accounts properly kept for the purpose of making decisions.
10. From the income tax and sales tax points of view, it is essential to follow a good accounting system; otherwise the authorities may impose heavy tax liabilities.

3.5 SYSTEMS OF BOOK-KEEPING

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 business 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 aspects of the transaction. This has been, to some extent, explained while discussing the 'dual aspect concept' in an earlier chapter. The system recognizes that every transaction has a twofold effect. If someone 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. The accounting equation very well explains the working of this system. This has been further explains below :

Assets = Equities

The properties owned by a 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 represents debts of the business and is called liabilities. The equity of the owners is called capital, or proprietorship of owner's equity. Thus:

Assets = Liabilities + Capital

Assets – Liabilities = Capital

3.6 SYSTEM OF ACCOUNTING

There are basically two systems of accounting:

(i) 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 receipt 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.

(ii**) 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 receipts. This system recognizes the face that if a transaction or an event has occurred, its consequences cannot be avoided and therefore should be brought into book 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 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 Rs.700 has become due for payment on account of rent for the year 1994. The amount has, however, been paid in January, 1995.

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 1994. The entry will be made only in January 1995 when the rent is actually paid. However, if the firm is following mercantile system of accounting, two entries will be made: (i) on 31stDecember, 1994, rent account will be debited while the landlord's account will be credited by the amount of outstanding rent; (ii) In January, 1995 landlord's account will be debited while the cash account will be credited with the amount of the rent actually paid. (This has been discussed in detail later while dealing with adjustments relating to final accounts). The 'mercantile system' is considered to be better, since it takes into account the effects of all transactions already entered into. This system is followed by most of the industrial and commercial firms.

3.7 ANALYSIS OF TRANSACTIONS

Every commercial transaction involves an exchange. An exchange has two sides. You cannot receive unless somebody gives. When goods come into your godown it has to come out from the godown of some other businessman. The income you get is the expenditure of the other man. Therefore in every business transaction there are two aspects. From the point of view of a businessman one may call it the benefit gaining aspect and benefit losing aspect. Technically they are called the "debit" aspect and the "credit" aspect of the transaction.

Consider the following transaction: -

Kumar purchases a Radio for cash from a shop'. This transaction involves an exchange. The two aspects in this transaction are (1) Kumar gets a Radio and (2) Cash goes out from Kumar's pocket. The first is the debit aspect and the second is the credit aspect. It is fundamental to note that every commercial transaction contains a debit as well as a credit aspect. Under the double entry system of book keeping, both the debit and credit aspects are taken into account and recorded.

For the purpose of double entry the business transactions should be analyzed. The debit and credit aspects of the transaction have to be located. Then they have to be entered in the proper set of accounting books. Understanding the debit and credit aspects is as fundamental as understanding the alphabet while learning a language. The first step in the process is to find out the two accounts which every transaction must contain. Let us see some examples.

Example I: Purchases Goods for cash.

The two accounts in the above transaction are a) goods account and b) cash account.

Example II: Received Cash from Rama

Here the two accounts are a) Cash account and b) Rama's account.

Example III: Paid Cash for Office Rent

a) Cash account and b) office rent account are the two accounts in the transaction.

3.8 SUMMARY

Book keeping and accounting systems following are key elements in the preparation of accounts of a company. The double entry system is a scientific system and helps to prepare accounts without any errors. The systems may change based on the need and size of the business.

3.9 QUESTIONS

1. Define Book-Keeping and explain the need for Book-Keeping.
2. State the objectives of Book-Keeping.
3. What do you mean by Double-Entry Book-Keeping? How is it different from Single Entry system of Accounting?
4. How are Accounts classified? Give three examples for each class of Accounts.
5. What is a Journal? Set forth the rules for journalising.

Exercises

1. Journalise the following transactions:

1993

January 1 Started business with cash Rs. 10,000

2 Opened a bank account with Rs. 9,750

5 Bought furniture by cheque Rs. 525

6 Purchase from Badsha Rs. 2.500

8 Sales to Ravikumar Rs. 1.785

11 Purchase by cheque Rs. 275

14 Bought goods from Basu Rs. 450

17 Cheque paid into bank Rs. 850

22 Sales to Roshan Rs. 775

24 Goods returned to Basu Rs.50

26 Goods returned to Roshan Rs. 75

28 Wages paid by cheque Rs. 20

29 Salaries paid by cheque Rs. 125

30 Sundry Expenses paid in cash Rs. 5. Received Rs. 950 by cheque from Ravikumar and allowed him discount Rs. 50

31 Paid Basu Rs.275 by cheque and was allowed discount Rs. 25

2. Show how the following transactions would be journalised in the books of the trader:

1994 May 1 Balances on date: Cash in hand Rs.175; Bank Rs.4,825; Stock in trade Rs.1.100; Furniture and fittings Rs.250; Debtors for goods: All Rs.650; Apte Rs.2,100; Creditors for goods: Baig Rs. 1,500; Balu Rs. 2,100; Capital Rs. 5,500.

1993 -

May 4 Purchases from Baig Rs. 1,500 and Apte Rs. 600

7 Sales to Ali Rs. 1,150 and Apte Rs. 600

10 Returns to Baig Rs. 500

12 Returns from Apte Rs. 100

15 Cash purchases Rs. 700 and sales Rs. 1,400

16 Wages paid by cash Rs.25

18 Cash paid into Bank Rs. 500

21 Drawings by cheque Rs. 100

24 Gave cheque to Balu Rs. 300 in settlement of Rs. 2,100

26 Received from Apte cheque for Rs. 2,400 and the same paid into Bank and discount allowed Rs.200

30 Bought land and building for Rs. 3,500 and paid from Bank 31 Salaries paid by cash Rs. 200

3. Journalise the following transactions: for the year 1993

January 1 Rajaram commenced business with Rs.7,500

2 He opened a Current Account with Rs.7,000 with State Bank of India

3 Bought by cheque goods worth Rs. 1,500 and furniture and fixtures Rs. 250

5 Purchases from David Rs. 500 and Daniel Rs. 1,700

7 Sales to Salim Rs. 550 and Samuel Rs. 1,775

9 Returns to Daniel Rs. 200

10 Wages paid in cash Rs. 25

12 Insurance premium paid by cheque Rs. 25

14 Samuel returned goods worth Rs. 275

15 Rent paid by cheque Rs. 100

18 Sales by cheque Rs. 250. The cheque was banked at once

20 David sold him goods worth Rs. 575

21 Sold damaged furniture by cheque Rs. 35

27 Carriage expenses paid by cash Rs. 30

28 Drew cheque for his personal use Rs. 170

29 Withdrew capital by cheque Rs. 1,000

30 Received cash towards commission Rs. 25 and also cheque Rs. 525 from Salim and was allowed discount Rs. 25

31 Remitted to Daniel by money order for Rs. 75, and a cheque for Rs. 1,925 in settlement of Rs. 2,075

LESSON-4

RECORDING OF TRANSACTIONS- VOUCHER SYSTEM, ACCOUNTING PROCESS, JOURNAL STRUCTURE

4.0 OBJECTIVES

After going through this lesson, you will be able to-

- Know the meaning and steps of accounting process.
- Understand the meaning and importance of journal.
- Know the rules of journalising.

4.1 INTRODUCTION

A business enterprise generally prepares the following two basic financial statements:
Profit and Loss Account to ascertain the profit earned or loss incurred during an accounting period.
Balance Sheet to ascertain the financial position of the business as on a particular date.

Generally, a business enterprise has numerous transactions every day during an accounting period. Unless the transactions are recorded and analysed, it is not possible to determine the impact of each transaction in the above two basic statements. Traditionally, accounting is a method of collecting, recording, classifying, summarising, presenting and interpreting financial data aspect of an economic activity. The series of business transactions occurring during the accounting period and its recording is referred to an accounting process/mechanism. An accounting process is a complete sequence of accounting procedures which are repeated in the same order during each accounting period. Therefore, accounting process involves the following steps or stages.

1. Identification of transaction

In accounting, only business transactions are recorded. A transaction is an event which can be expressed in terms of money and which brings change in the financial position of a business enterprise. An event is an incident or a happening which may or may not being any change in the financial position of a business enterprise. Therefore, all transactions are events but all events are not transactions. A transaction is a complete action, to an expected or possible future action. In every transaction, there is movement of value from one source to another. For example, when goods are purchased for cash, there is a movement of goods from the seller to the buyer and a movement of cash from buyer to the seller. Transactions may be external (between a business entity and a second party, e.g., goods sold on credit to Hari or internal (do not involve second party, e.g., depreciation charged on the machinery).

Illustration: State with reasons whether the following events are transactions or not to Mr. K. Mondal, Proprietor.

(i) Mr. Mondal started business with capital (brought in cash)Rs. 40,000.

(ii) Paid salaries to staff Rs. 5,000.

(iii) Purchased machinery for Rs. 20,000 in cash.

(iv) Placed an order with Sen & Co. for goods for Rs. 5,000.

(v) Opened a Bank account by depositing Rs. 4,000.

(vi) Received pass book from bank.

(vii) Appointed Sohan as Manager on a salary of Rs. 4,000 per month.

(viii) Received interest from bank Rs. 500.

(ix) Received a price list from Lalit.

Solution: Here, each event is to be considered from the view point of Mr. Mondal's business. Those events which will change the financial position of the business of Mr. Mondal, should be regarded as

transaction.

(i) It is a transaction, because it changes the financial position of Mr. Mondal's business. Cash will increase by Rs. 40,000 and Capital will increase by Rs. 40,000.

(ii) It is a transaction, because it changes the financial position of Mr. Mondal's business. Cash will decrease by Rs. 5,000 and Salaries (expenses) will increase by Rs. 5,000

(iii) It is a transaction, because it changes the financial position of Mr. Mondal's business. Machinery comes in and cash goes out.

(iv) It is not a transaction, because it does not change the financial position of the business.

(v) It is a transaction, because it changes the financial position of the business. Bank balance will increase by Rs. 4,000 and cash will decrease by Rs. 4,000.

(vi) It is also not a transaction, because it does not change the financial position of Mr. Monal.

(vii) It is also not a transaction, because it does not change the financial position of Mr. Monal.

(viii) It is a transaction, because it changes the financial position of Mr. Mondal's business. Bank interest will increase by Rs. 500 and cash will increase by the same amount.
(ix) It is not a transaction, because it does not change the financial position of the business of Mr. Mondal.

2. Recording the transaction

Journal is the first book of original entry in which all transactions are recorded event wise and date-wise and presents a historical record of all monetary transactions. It may further be divided into sub-journals as well which are also known subsidiary books.

3. Classifying

Accounting is the art of classifying business transactions. Classification means statement setting out for a period where all the similar transactions relating to a person, a thing, expense, or any other subject are grouped together under appropriate heads of accounts.

4. Summarising

Summarising is the art of making the activities of the business enterprise as classified in the ledger for the use of management or other user groups i.e. Sundry debtors, Sundry creditors etc. Summarisation helps in the preparation of Profit and Loss Account and Balance sheet for a particular fiscal year.

5. Analysis and Interpretation

The financial information or data as recorded in the books of a account must further be analysed and interpreted so to draw useful conclusions. Thus, analysis of accounting information will help the management to assess in the performance of business operation and forming future plans also.

6. Presentation or reporting of financial information

The end users of accounting statements must be benefited from analysis and interpretation of data as some of them are the 'stock holders' and other one the 'stake holders'. Comparison of past and present statement and reports, use of ratio and trend analysis are the different tools of analysis and interpretation. From the above discussion one can conclude that accounting is a art which starts and includes steps right from recording of business transactions of monetary character to the communicating or reporting the results thereof to the various interested parties.

4.2 VOUCHER

Each transaction is recorded in books of accounts providing all the required information of the transaction. Since each transaction has an effect on the financial position of the business, there should be a documentary evidence to establish the monetary accounts at which transactions are recorded and also the transactions are properly authorised. The common documents that are generally used are as under:

(i) Payment voucher;
(ii) Receipt voucher; and
(iii) Transfer voucher.

(i) A Payment voucher usually on a printed standard form, is a record of payment. When payment is made for an expense, generally a bills is prepared to record full particulars of the claim by the person or organisation receiving payment. From the bill, the accounting department prepares a voucher for each payment to be made, no matter whether the amount that is paid for the goods purchased, or to pay employee's salaries, or to pay for services or to pay for any other asset acquisition.

(ii) A Receipt voucher is a document which is issued against cash receipts. It may also be a printed standard form. This document shows that a certain sum of money was received from a person or organisation and also, contains information of the purpose for which the money is received. It is signed by a responsible employee, authorised by the management to receive the money.

(iii) A Transfer voucher is used to record the residuary transactions. An internal transaction or a transaction not involving any cash payment or cash receipt, is recorded in the transfer voucher. Examples are: Goods purchased on credit; depreciation of assets, outstanding expenses, accrued income, etc.

4.3 JOURNAL

Journal is a historical record of business transaction or events. The word journal comes from the French word "Jour" meaning "day". It is a book of original or prime entry. Journal is a primary book for recording the day to day transactions in a chronological order i.e. the order in which they occur. The journal is a form of diary for business transactions. This is called the book of first entry since every transaction is recorded firstly in the journal.

Journal Entry

Journal entry means recording the business transactions in the journal. For each transaction, a separate entry is recorded. Before recording, the transaction is analysed to determine which account is to be debited and which account is to be credited. The performa of journal is shown as follows:

JOURNAL OF M/S CHOUDARY ENTERPRISES

Date	Particulars	Ledger Folio No	Debit amount in Rs	Credit amount in Rs

Each business transaction should be entered in to journal in a chronological order. For each entre there should be a date, transaction details, ledger folio number in which it was posted and the ledger account number and the amount of transaction in both debit and credit column. Each entry should be followed by a narration explaining the detailed description about the transaction.

Column 1 (Date): The date of the transaction on which it takes pale is written in this column.
Column 2 (Particulars): In this column, the name of the accounts to the debited is written first, then the names of the accounts to be credited and lastly, the narration (i.e. a brief explanation of transaction) are entered.
Column 3 (L.F.): L.F. stands for ledger folio which means page of the ledger. In this column are entered the page numbers on which the various accounts appear in the ledger.
Column 4 (Dr. Amount): In this column, the amount to be debited against the 'Dr.' Account is written along with the nature of currency.
Column 5 (Cr. Amount): In this column the amount to be credited against the 'Cr.' Account is written along with the nature of currency.

Advantages of Using Journal

Journal is used because of the following advantages:

(i) A journal contains a permanent record of all the business transactions.
(ii) The journal provides a complete chronological (in order of the time of occurrence) history of all business transactions and the task of later tracing of some transactions is facilitated.
(iii) A complete information relating to one single business transaction is available in one place with all its aspects.
(iv) The transaction is provided with an explanation technically called a narration.
(v) Use of the journal reduces the possibility of an error when transactions are first recorded in this book.
(vi) The journal establishes the quality of debits and credits for a transaction and reconciles any problems. If a business purchases a bicycle, it is necessary to decide whether the bicycle represents ordinary goods or machinery. Further any amount paid is debited to bicycle account and credited to cash account.

(vii) The use of journals avoids omission or duplication of transactions or parts of transaction. Without the journal the accountant would be forced to got to the individual account to enter debits and credits. Therefore it is possible for accountant to miss part of a transaction, duplicate all or part of a transaction or incorrectly record debits and credits. Even with the Journal, it is still possible to omit transactions and make other errors. However, the Journal reduces these problems.

(viii) Once a transaction is recorded in the journal, it is not necessary to post it immediately in the ledger accounts. In this, way, the journal allows the delayed posting. In connection with the journal, the following points are to be remembered:

(ix) For each transaction, the exact accounts should be debited and credited. For that, the two accounts involved must be identified to pass a proper journal entry.

(x) Sometimes, a journal entry may have more than one debit or more than one credit. This type of journal entry is called compound journal entry. Regardless of how many debits or credits are contained in a compound journal entry, all the debits are entered before any credits are entered. The aggregate amount of debits should be equal to the aggregate amount of credits.

· For a business, journal entries generally extend to several pages. Therefore, the total are cast at the end of each page, against the debit and credit columns, the following words and written in the particular column, which indicates, carried forward (of the amount on the next page) "Total c/f". The debits and credits totals of the page are then written on the next page in the amount columns; and opposite to that on the left, the following words are written in the particulars column to indicate brought forward (of the amount of the previous page) "Total b/f". This process is repeated on every page and on the last page, "Grand Total" is casting.

4.3.1Classification of Accounts

1. Personal Accounts

Personal Accounts: Accounts recording transactions relating to individuals or firms or company are known as personal accounts. Personal accounts may further be classified as:

(i) Natural Person's personal accounts: The accounts recording transactions relating to individual human beings e.g., Anand's a/c, Ramesh's a/c, Pankaj a/c are classified as natural persons' personal accounts.

(ii) Artificial Persons' Personal accounts: The accounts recording transactions relating to limited companies, bank, firm, institution, club, etc., Delhi Cloth Mill; M/s Sahoo & Sahoo; Hans Raj College; Gymkhana Club are classified as artificial persons' personal accounts.

(iii) Representative Personal Accounts: The accounts recording transactions relating to the expenses and incomes are classified as nominal accounts. But in certain cases (due to the matching concept of accounting) the amount, on a particular date, is payable to the individuals or recoverable from individuals. Such amount (i) relates to the particular head of expenditure or income and (ii) represent persons to whom it is payable or from whom it is recoverable. Such accounts are classified as representative personal accounts e.g., "wages outstanding account", pre-paid Insurance account, etc.

Accounts which are related with accounts of individuals, firms, companies are known as personal accounts. The personal accounts may further be classified into three categories:
(i) Natural Personal Accounts: Accounts of individuals relating to natural persons such as Akhil's A/c, Rajesh's A/c, Sohan's A/c are natural personal accounts.
(ii) Artificial Personal Accounts: Accounts of companies, institutions such as Reliance Industries Ltd; Lions Club, M/s Sham & Sons, National College account are artificial personal accounts. These exist only in the eyes of law.
(iii) Representative Personal Accounts: The accounts which represent some person such as wage outstanding account, prepaid insurance account, accrued interest account are considered as representative personal accounts.

2. Real Accounts

Real accounts are the accounts related to assets/properties. These may be classified into tangible real account and intangible real account. The accounts relating to tangible assets such as building, plant, machinery, cash, furniture etc. are classified as tangible real accounts. Intangible real accounts are the accounts related to intangible assets such as goodwill, trademarks, copyrights, franchisees, Patents etc.

3. Nominal Accounts

The accounts relating to income, expenses, losses and gains are classified as nominal accounts. For example Wages Account, Rent Account, Interest Account, Salary Account, Bad Debts Accounts.

Golden Rules of Accounting

Type of account	**Debit is given to**	**Credit is given to**
Personal accounts	Debit the Receiver	Credit the Giver
Real Accounts	Debit what comes in	Credit what goes out
Nominal Accounts	Debit all expenses and losses	Credit all incomes and gains

Illustration: How will you classify the following into personal, real and nominal accounts?

(i) Investments

(ii) Freehold Premises

(iii) Accrued Interest

(iv) Punjab Agro Industries Corporation

(v) Janata Allied Mechanical Works

(vi) Salary Accounts

(vii) Loose Tools Accounts

(viii) Purchases Account

(ix) Indian Bank Ltd.

(x) Capital Account

(xi) Brokerage Account

(xii) Toll Tax Account

(xiii) Dividend Received Account

(xiv) Royalty Account

(xv) Sales Account

Solution: Real Account: (i), (ii), (vii), (viii), (xv).; Nominal Account: (vi), (ix), (xi), (xii), (xiii), (xiv); and

Personal Account: (iii), (iv), (v), (x)

Journalizing

Journalism is the process of recording journal entries in the Journal. It is a systematic act of entering the transaction in a day book in order of their occurrence i.e., date-wise or event-wise. After analysing the business transactions, the following steps in journalising are followed:

(i) Find out what accounts are involved in business transaction.

(ii) Ascertain what is the nature of accounts involved?

(iii) Ascertain the golden rule of debit and credit is applicable for each of the accounts involved.

(iv) Find out what account is to be debited which is to be credited.

(v) Record the date of transaction in the "Date Column".

(vi) Write the name of the account to be debited very near to the left hand side in the 'Particulars Column' along with the word 'Dr' on the same line against the name of the account in the 'Particulars Column' and the amount to be debited in the 'Debit Amount column' against the name of the account.

(vii) Record the name of the account to be credited in the next line preceded by the word 'To' at a few space towards right in the 'Particulars Column' and the amount to be credited in the 'Credit Amount Column' in front of the name of the account.

(viii) Record narration (i.e. a brief explanation of the transaction) within brackets in the following line in 'Particulars Column'.

(ix) A thin line is drawn all through the particulars column to separate one Journal entry from the other and it shows that the entry of a transaction has been completed.

Ex-2: Analyse the following transactions.

(a) Ramesh started his business with cash

(b) Borrowed from Nikhil

(c) Purchased furniture

(d) Purchased furniture from Mohan on credit

(e) Purchased goods for cash

(f) Purchased goods from Ram on credit

(g) Sold goods for cash

(h) Sold goods to Hari on credit

(i) Received cash from Hari

(j) Paid cash to Ram

(k) Deposited into bank

(l) Withdrew cash for personal use

(m) Withdrew from bank for office use

(n) Withdrew from bank for personal use

(o) Received cash from a customer, Shyam

(p) Paid salary by cheque

(q) Received donation in cash

(r) Paid to Ram by cheque

(s) Paid salary

(t) Paid rent by cheque

(u) Goods withdrawn for personal use

(v) Paid an advance to suppliers of goods

(w) Received an advance from customers

(x) Paid interest on loan

(y) Paid instalment of loan

(z) Interest allowed by bank.

Opening Entry

In case of going concern at the beginning of the new year, new books of accounts are opened and the balances relating to personal and real Accounts appearing in the books at the close of the previous year are brought forward in new books. The entry for this purpose in the books is called opening entry. The opening entry is passed by debiting all assets and crediting all liabilities including capital. If the amount of capital is not given then this can be found out with the help of the accounting equation:

Assets = Liabilities + capital

Capital = Assets- Liabilities

Ex-3: On 1st April 1998, Singh's assets and liabilities stood as follows:
Assets: Cash Rs. 6,000, Bank Rs. 17,000, Stock Rs. 3,000; Bills receivable 7,000; Debtors 3,000; Building 70,000; Investments 30,000; Furniture 4,000.
Liabilities: Bills payable 5000, Creditors 9000, Ram's loan 13,000
Pass on opening Journal entry.

Journal of Mr.Singh

Date	Particulars	Lf.No	Dr. amt.Rs	Cr.amt.Rs
1998	Cash A/c Dr		6000	
April-1	Bank a/c Dr		17000	
	Stock a/c Dr		3000	
	Bills receivable A/C Dr		7000	
	Debtors A/c Dr		3000	
	Building A/c Dr		70000	
	Investments A/c Dr		30000	
	Furniture A/c Dr		4000	
	To Bills payable A/c			5000
	To Creditors A/c			9000
	To Ramloan A/c			13000
	To Capital Account			113000
	Being the capital introduced into business)			

4.3.2 Important Considerations for Recording The Business Transactions

1. Trade Discount : Trade discount is usually allowed on the list price of the goods. It may be allowed by producer to wholesaler and by wholesaler to retailer for purchase of goods in large quantity. It is not recorded in the books of account and entry is made only with the net amount paid or received, for example, purchased goods of list price Rs. 8,000 at 15% trade discount from X. In this case the following entry will be passed:

Particulars	Dr.Amt.Rs	Cr.Amt.Rs
Purchases A/c Dr	6800	
To X A/c		6800
(Being goods purchased at 15% trade discount Less list price)		

2. Amount paid or received in full settlement or cash discount : Cash discount is a concession allowed by seller to buyer to encourage him to make early cash payment. It is a Nominal Account. The person who allows discount, treat it as an expenses and debits is his books and it is called discount allowed and the person who receives discount, treat as an income and it is called discount received and credits

in his books of account "Discount Received Account." For example, X owes Rs. 6,000 to Y. He pays Rs. 5,950 in full settlement against the amount due. In the books of X the journal entry will be:

Particulars	Dr.Amt.Rs	Cr.Amt.Rs
Y A/c Dr	6000	
To Cash Account		5950
To discount received A/c		50
(Being Cash paid and discount received)		

In the books of Y	Rs.	Rs.
Cash Account Dr.	5,950	
Discount Allowed Account Dr.	50	
To X		6,000
(Being cash received and discount allowed)		

3. Goods distributed as free samples : Some times business distributes goods as free samples for the

purpose of advertisement. In this case Advertisement Account is debited and Purchases Accounts is credited. For example, goods costing Rs. 8000 were distributed as free sample. to record this transactions following entry will be passed:

Advertisement Account Dr.	8,000
To Purchases Account	8,000

4. Interest on capital: Interest paid on capital is an expense. Therefore interest account should be debited. On the other hand the capital of the business is increases. So the capital account should be credited. The entry will be as follows:

Interest on Capital Account Dr.
To Capital Account

5. Interest charged on Drawings

If the interest is charged on drawings then it will be an increase in the income of business, so interest on drawings will be credited. On the other hand there will be increase in Drawings or decrease in Capital. So Drawings Account will be debited. To record this, following entry will be passed:

Drawing Account or Dr. XXX
Capital Account Dr. XXX
To Interest on Drawing Account XXX

6. Depreciation charged on Fixed Assets

Depreciation is the gradual, permanent decrease in the value of an assets due to wear and tear and many other causes. Depreciation is an expense so the following entry will be passed:

Depreciation Account Dr. XXX
To Asset Account XXX

7. Bad Debts

Sometimes a debtor of business fails to pay the amount due from him. Reasons may be many e.g. he may become insolvent or he may die. Such irrecoverable amount is a loss to the business. To record this following entry will be passed:

Bad Debts Account Dr. XXX
To Debtor's Account XXX

8. Bad Debts Recovered

When any amount becomes irrecoverable from any costumer or debtor his account is closed in the books. If in future any amount is recovered from him then his personal account will not be credited because that does not exist in the books. So the following entry is passed:

Cash Account Dr. XXX
To Bad Debts Recovered Account XXX

9. Purchase and Sale of investment

When business has some surplus money it may invest this amount is shares, debentures or other types of securities. When these securities are purchased, these are recorded at the purchase price paid. At the time of sale of investment the sale price of an investment is recorded in the books of accounts. The following entry is passed to record the purchase of investment:

Investment Account Dr. XXX
To Cash Account XXX

In case of sale of these securities the entry will be:

Cash Account Dr. XXX
To Investment Account XXX

10. Loss of Goods by Fire/Accident/theft

A business may suffer loss of goods on account of fire, theft or accident. It is a business loss and a nominal account. It also reduces the goods at cost price, and increases the loss/expenses of the business. The entry will be passed as:

Loss by fire/Accident/theft Account Dr (for loss)	XXX
Insurance Company Account Dr. (for insurance claim admitted)	XXX
To Purchases Account	XXX

11. Income Tax Paid

Income Tax paid should be debited to Capital Account or Drawings Account and credited to cash Account in case of sole proprietorship and partnership firms. The reason behind this is that income tax is a personal expense for the sole trader and partners because it is paid on income of proprietor. The entry will be as follows:

Capital Account Dr. XXX
Drawing Account Dr. XXX
To Cash Account XXX

12. Bank Charges

Bank provide various services to their customers. Bank deducts some charges by debiting the account of customers. It is an expenses for the business. To record this following entry will be passed in the books of businessman/customer:

Bank Charges Account Dr. XXX
To Bank Account XXX

13. Drawings Account

It is a personal account of the proprietor. When the businessman withdraws cash or goods form the business for his personal/domestic use it is called as 'drawings'. Drawings reduce the capital as well as

goods/cash balance of the business. The journal entry is:

Drawings Account Dr. XXX
To Cash Account XXX
To Purchases Account XXX

14. Personal expenses of the proprietor

When the private expenses such as life insurances premium, income tax, home telephone bill, tuition fees of the son of the proprietor etc. are paid out of the cash or bank account of business it should be debited to the Drawing Account of the proprietor. The journal entry is:

Capital/Drawings Account Dr. XXX
To Cash/Bank XXX

15. Sale of Asset/Property

When the asset of a business is sold, there may occur a profit or loss on its sale. It should be noted carefully that sales account is never credited on the sale of asset. The journal entry is:

(i) In case there is a profit on sale of Property/Assets

Cash/Bank Account Dr. XXX

To Asset/Property Account XXX

To Profit on sale of Asset Account XXX

(ii) In case of a loss on sale of asset

Cash/Bank Account Dr. XXx

Loss on sale of Asset Account Dr. XXX

To Asset Account XXX

16. Amount paid or Received on behalf of customer

(i) When the business entity pays the amount on behalf of old reputed customers such as carriage in anticipation of recovering the same later on, carriage account should not be opened because carriage is not the expense of the seller. It should be debited/charged to customer's Personal account. The journal entry is:

Customer/Debtor's Account Dr. XXX

To Cash/Bank Account XXX

(ii) When the business entity receives the amount on behalf of customers from the third party as mutually settled between the third party and the customer, the account of the third party/person making the payment should not be opened in the books of the receiving entity.

The journal entry in the books of the entity is:

Cash/Bank Account Dr. XXX

To Customer/Debtor's Account XXX

17. Amount paid on behalf of creditors

When the creditors/supplier instructs the business entity to make payment on their behalf, the amount so paid should be debited to creditors account and liability of the business will decrease accordingly.

The journal entry is:

Suppliers/Creditors Account Dr. XXX

To Cash/Bank Account XXX

18. The events affecting business but they do not involve any transfer/exchange of money for the time being, they would not be recorded in the financial books. Examples of them are:

(i) On 1st January 2006 placed on order to Geeta & Sons for the supply of goods worth Rs. 1,00,000.

(ii) Babanjot, a B.Com. graduate has been appointed Sales Assistant on a salary of Rs. 5,000 p.m. on Jan., 2006.

(iii) Raman, a proprietor contracted with Bahia Builders Ltd. for the renovation of the building at an estimated cost of Rs. 5,00,000.

(iv) A shop in Adalt Bazar Patiala contracted to be taken on a rent @ Rs. 4,000 pm.

19. Paid wages/installation charges for erection of machinery

Wages and installation charges are the expenses of nominal nature. But for erection of machinery no separate account should be opened for such expenses because these expenses are of capital nature and it will be merged/debited to the cost of assets i.e. machinery. The journal entry is:

Machinery Account Dr.XXX

To Cash/Bank Account XXX

(Being wages/installation charges paid for the erection of machinery)

Exercise-I: Journalise the following transactions for the month of January 2006:

2006

Jan.1 Invested in shares of Tata Cotton Mills Ltd. and paid for the same in cash Rs. 2,000.

2 Placed on order with Mr. Shah for goods to be received a month later Rs. 1,500.

3 Invoiced goods to Mr. Love worth Rs. 1,000 and allowed a trade discount of 2 per cent.

4 Carriage Rs. 25 and freight Rs. 70 were paid by the proprietor for the above goods but which are to be charged to Mr. Love Account.the above goods but which are to be charged to Mr. Love Account.

5 Paid rent to landlord of office premises- Rs. 150, which he spent on purchase of our goods.

6 Goods valued at Rs. 700 were delivered to Ahmedabad Merchants under instructions from Mr. Gobind. They were to be charged to the latter's Account.

7 Mr. Love paid Rs. 500 due from him, and the same was spent on purchasing goods from Mr. Deepu.

8 Sold one old motor car belonging to the proprietor for Rs. 5,000 and the amount was invested in the business.

9 The proprietor paid Rs. 180 in full settlement of Mr. Manpreet for goods worth Rs. 200 purchased by him for personal use.

10 Mr. Gobind was declared insolvent and paid Rs. 450 in full settlement. The balance Rs. 250 was written off as a bad debt.

11 Mohinder our debtors, on our advice, directly paid Narinder, our creditor Rs. 2,000.

4.5 SUMMARY

An accounting process is a complete sequence of accounting procedures which are repeated in the same order during each accounting period. Accounting process involves six steps or stages i.e. identification of transactions, recording the transaction, classifying, summarising, analysis and interpretation and reporting of financial information. In accounting, all the transactions are recorded on the basis of evidence/document which are mainly three– (i) payment voucher; (ii) receipt voucher; and (iii) transfer voucher. Recording the transaction is the first step in the process of accounting which is performed in the book called 'Journal'. Journal is a primary book for recording the day to day transactions in a chronological order, i.e., the order in which they occur. The process of recording journal entries in the journal is called journalising. For the

journalising, all the accounts are classified into three categories namely personal account; real account; and nominal account.

4.6 KEYWORDS

Bad Debt: Debt owned to an enterprise which is considered to be irrecoverable.

Capital: It refers to the interest of owners in the assets of an enterprise.

Depreciation: Decrease in the value of fixed assets.

Trade Discount: Reduction on print prices of goods.

Cash Discount: A reduction granted by a supplier from the invoiced price in consideration of payment with in a stipulated period.

4.7 SELF ASSESSMENT QUESTIONS

1. "Recording of transaction is an important step in accounting process" Comment.
2. What is Journal? Distinguish between Journal and Journalising.
3. How you will classify the accounts? State the rules of journalising with respect to each class of accounts.

PROBLEMS TO SOLVE AND UNDERSTAND

1. Record the following transactions in the Journal and post them into ledger and prepare a Trail Balance

Oct 1st	:	Neel started business with a capital of 80,000
3rd	:	Bought goods from Karl on credit 20,000
4th	:	Sold goods to Tarl 25,000
5th	:	Cash purchases 25,000
7th	:	Cash sales 15,000
9th	:	Goods retuned to Karl 2,000
10th	:	Bought furniture for 15,000
11th	:	Cash paid to Karl 12,000
12th	:	Goods returned by Tarl 3,000
14th	:	Goods taken by Neel for personal use 3,000
15th	:	Cash received from Tarl 12,000
16th	:	Took loan from Parl 30,000
17th	:	Salary paid 5,000
18th	:	Bought stationery for 1,000
19th	:	Amount paid to Parl on loan account 18,000
20th	:	Interest received 4,000

2. Enter the following transactions in the Journal and post them into ledger and from the information obtained prepare a Trail Balance.

Nov 10th : Mrs. Roy started business with 60,000
11th : Bought furniture from Modern Furniture for 10,000
12th : Purchased goods for cash 15,000
13th : Purchased goods from B. Sen & Co for 30,000
14th : Opened a bank account by depositing 16,000
16th : Sold goods for cash 15,000
17th : Purchased stationery for 1000 from Bharat Stationery Mart
18th : Sold goods to Zahir Khan for 10,000
19th : Bought machinery for 6,000 and payment made by cheque
20th : Goods returned by Zahir Khan for 2,000
21st : Payment to B.Sen & Co by cheque 5,000
22nd : Withdrew from bank for personal use 3,000
23rd : Interest paid through cheque 2,000
24th : Withdrew from bank for office expenses 10,000
26th : Cheque received from Zahir Khan 5,000
27th : Paid electricity bill for 100
29th : Cash sales for 6,000
30th : Commission received by cheque 5,000

Mr. Ramu has the following transactions in the month of July.

3. Record them into the journal and show postings in the ledger and balance the accounts.

July 1st : Ramu started business with a capital of 75,000
1st : Purchased goods from Manu on credit 25,000
2nd : Sold goods to Sonu 20,000
3rd : Purchased goods from Meenu 15,000
4th : Sold goods to Tanu for cash 16,000
5th : Goods retuned to Manu 2,000
6th : Bought furniture for 15,000
7th : Bought goods from Zenu 12,000
8th : Cash paid to Manu 10,000
9th : Sold goods to Jane 13,500
10th : Goods returned from Sonu 3,000
11th : Cash received from Jane 5,500
12th : Goods taken by Ramu for domestic use 3,000
13th : Returned Goods to Zenu 1,000
14th : Cash received from Sonu 12,000
15th : Bought machinery for 18,000
16th : Sold part of the furniture for 1,000

17th : Cash paid for the purchase of bicycle for Ramu's son 1,500
19th : Cash sales 15,000
20th : Cash purchases 13,500

4. Journalise the following transactions in the books of Moon and post them into the ledger for the month of August

Aug 10th : Moon commenced business with a capital of 1,50,000
11th : Cash deposited into bank 50,000
12th : Bought equipment for 15,000
13th : Bought goods worth 20,000 from Star and payment made by cheque
14th : Sold goods to Sun for 15,000 and payment received through cheque
16th : Paid rent by cheque 5,000
17th : Took loan from Mr. Storm 25,000
18th : Received commission from Mr. Air by cheque 5,000
19th : Wages paid 15,000
20th : Withdrew from bank for personal use 3,000
21st : Withdrew from bank for office use 10,000
22nd : Bought goods for 25,000
23rd : Cash paid into bank 30,000
24th : Interest paid through cheque 2,000
25th : Gave loan to Mr.Wind 10,000
26th : Amount paid to Mr. Storm on loan account 15,000
27th : Salary paid to Manager Mr. Liquid 5,000
28th : Postage paid 1,000
29th : Received cheque from Mr. Wind on loan account 3,000
30th : Sold part of the equipment for 2,000

5. Shah Garden Center is retail garden supplier. Record the transactions needed to journalize, post to respective ledger account and prepare Trial Balance of the following for October, 2011 of the current year:

Oct. 2 Purchased inventory on credit terms of 1/10 net 30. FOB shipping point, for Rs. 3,000. Freight charges on the purchase were Rs. 150.

Oct. 9 Sold garden supplies on credit terms 3/20 net 30, FOB shipping point, for Rs. 4,000. The cost of the supplies sold was Rs. 2,500.

Oct. 10 Paid the amount owed on account for the Oct. 2 inventory purchase.

Oct. 15 Received merchandise that was returned as defective, originally sold for Rs. 500 on Oct. 9. The original cost of the supplies returned was Rs. 275.

Oct. 25 Received payment on account for the Oct. 9 sale less the appropriate sales discount.

Oct. 28 Inventory lost by fire of cost Rs. 350.

6. Post transactions to appropriate T-account & make Trial Balance for ABC Ltd as on June 30th, 2008:

Owner investment in Cash Rs. 10,000

Borrowing Rs. 1,000 from a local bank on a Note due in three months

Purchase Equipment of Rs. 500, paid Rs. 100 Cash and promising the rest on a Note Payable

Paid Rs. 150 for Stationery

Lent Rs. 200 to an employee who signed a Note promising to repay within 60 days

Service Revenue received during the period is Rs. 5,800

Paid Insurance for three year at start of this accounting period Rs. 1,800

Service Revenue of worth Rs. 1,200 earned but not received

Insurances expired recorded as Insurance Expense of Rs. 600

Personal withdrawal of owner of Rs. 700

7. Post transactions to appropriate T-account & make Trial Balance with Totals and Trial Balance with Balances and Totals for ABC Ltd as on March 30th, 2008:

Ahmed Bajwa, an interior decorator, completed the following transactions during the month of March 2008.

Begun his business with Equipment valued at Rs. 80,000 and placed Cash Rs. 100,000 in a business Bank Account.

Purchase a used Motor Car costing Rs. 50,000 and paid by check.

Completed painting a two-story house and billed the customer, Rs. 24,800 (Account Receivable Dr).

Received cash for painting two rooms, Rs. 5,000. It was kept in cash till.

Hired assistant to work with him, to be paid Rs. 100 per day.

Purchase supplies for Rs. 14,600 and paid by check.

Paid assistant for six days work, Rs. 600 in Cash.

Received cheque for painting five room apartment Rs. 33,600 and check is not deposited.

Transfer Rs. 2,000 to Business Bank Account.

8. Prepare journal and ledger from the following information

Tina started her consulting business in September 2019. The following transactions occurred in the business during her first month of operation.

Sep 01: Tina invested cash $ 30,000 in the business.

Sep 2: Purchased office equipment for $ 4,000 on account

Sep 5: Provided Service to Nikita & co for $ 3,000 on account

Sep 10: Paid $ 4,000 cash for two-year insurance policy

Sep 12: Tina withdrew $ 600 cash for personal use

Sep 15: Received $ 2,000 cash for service provided

Sep 20: Paid $ 1,000 cash for office Rent for August

Sep 22: Received cash from Nikita & Co for service provided on Sep 5

Sep 28: Paid Bank charges $ 500

Sep 30: Paid $ 4,000 cash for Salary of August

9. Journalise the following transactions and post them in the ledger 2006

January 1 Commenced business with cash 50000

January 3 Paid into bank 25000

January 5 Purchased furniture for cash 5000

January 8 Purchased goods and paid by cheque 15000

January 8 Paid for carriage 500

January 14 Purchased Goods from K. Murthy 35000

January 18 Cash Sales 32000 January 20 Sold Goods to Ashok on credit 28000

January 25 Paid cash to K. Murthy in full settlement 34200

January 28 Cash received from Ashok 20000

January 31 Paid Rent for the month 2000

January 31 Withdrew from bank for private use 2500

10. Mr Robert commenced business on 1st January, 2011 with a capital of $100,000 in cash. On the same date he opened the bank account in ADCB and deposited $20,000. During the month of January 2011 the following transactions took place:

Jan 1 Bought goods for cash 70,000

2 Sold goods to Steve Co. (Credit) 38,000

15 Sold goods for cash 9,000

21 Steve Co. paid by cheque 35,000

22 Stationery bill paid by cheque 2,000

22 Telephone bill by cash 500

31 Paid rent by cash 2,000

Paid salaries by cash 3,000

Withdrew cash personal use 5,000, Record journal entries for the transactions and post them to ledgers.

4.8 REFERENCES/SUGGESTED READINGS

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Lesson-5

LEDGER POSTING AND TRIAL BALANCE STRUCTURE

5.0 OBJECTIVES

After going through this lesson, you should be able to-

- Know meaning and importance of ledger.
- Understand the rules regarding posting.
- Know balancing of an account.
- Know meaning and objectives of trial balance.

5.1 INTRODUCTION

It has already been discussed in earlier lesson that accounting involves recording, classifying and summarising the financial transactions. Recording is made in Journal, which has been explained in the preceding lesson. Classification of the recorded transactions is made in the ledger. This is being discussed in the present lesson. Ledger is a book which contains various accounts. In simple words, ledger is a set of accounts. It includes all accounts of the business enterprise whether Real, Nominal or Personal. Ledger may be kept in any of the following two forms:

- Bound Ledger; and
- Loose Leaf Ledger.

It is common to keep the ledger in the form of loose-leaf cards these days instead of keeping them in bounded form. This helps in posting transactions particularly when mechanised system of accounting is used. Interestingly, nowadays, mechanised system of accounting is preferred over the manual system of accounting.

5.2 POSTING

The term 'Posting' means transferring the debit and credit items from the Journal to their respective accounts in the ledger. It is important to note that the exact names of accounts used in the Journal should be carried to the ledger.

For example:

If in the Journal, Salary Account has been debited, it would not be correct to debit the Outstanding Salary Account in the Ledger. Therefore, the correct course would be to use the same account in both the Journal and Ledger.

Ledger posting may be done at any time. However, it must be completed before the annual financial statements are prepared. It is advisable to keep the more active accounts posted upto date. The examples of such accounts are the cash account, personal accounts of various parties, etc. The Ledger posting may be made by the book-keeper from the Journal to the Ledger by any of the following methods: He may take a particular side first. For example, he may take the debits first and make the complete postings of all debits from Journal to the Ledger. · He may take a particular account first and post all debits and credits relating to that account appearing on one particular page of Journal. He may then take some other account and follow the same procedure.He may complete posting of each journal entry before proceeding to the next entry.

It is advisable to follow the last method. Further, 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 made from the Journal. Thus, these are cross references in both the Journal and the Ledger. A proper index must be maintained in the Ledger giving the names of the accounts and the page number. A specimen of Ledger is given below:

LOKESH ACCOUNT

Dr. Cr.

Date	Particular	J.F.	Amount (Rs.)	Date	Particular	J.F.	Amount (Rs.)

All entries relating to Dalmia's A/c shall be posted in this specimen a/c and finally the balance either debit or credit may be drawn. All rules regarding the posting must strictly be followed.

5.2.1Rules Regarding Posting

The following rules must 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 has been credited in the Journal.

iii) The concerned account, which has been credited in the Journal; should also be credited in the Ledger, but reference should be given of the account, which has been debited in the Journal. For example, for salaries paid, Cash Account has been credited in the Journal. It will be credited in the Ledger also, but reference will be given of the Salaries Account in the Ledger. Thus, it may be concluded that while making posting in the Ledger, the concerned account which has been debited or credited in the Journal should also be debited or credited in the Ledger, but reference has to be given of the other account which has been credited or debited in the Journal, as the case may be. This will be clear with the following example:

Suppose salaries of Rs. 10,000 have been paid in cash, the following entry will be passed in the Journal:

Salaries Account Dr. 10,000

To Cash Account 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:

Sol:

SALARIES ACCOUNT

Dr.			Cr.
Cash A/c (i)	Rs. 10,000		

CASH ACCOUNT

Dr.			Cr.
		Salaries A/c (ii)	Rs. 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.

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 his 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 balance has been brought forward or brought down (b/f or b/d) from the previous period. This will be clear with the help of the following illustration.

Illustration 1: Journalise the following transactions, post them in the Ledger and balance the accounts as on 31st March, 2006.

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

Solution:

JOURNAL

Date	Particulars		L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
	Cash Account	Dr.		10,000	
	To Capital Account				10,000
	(Being commencement of business)				
	Purchase 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 good sold to Suresh)				
	Cash Account	Dr.		3,000	
	To Suresh				
	(Being cash received from Suresh)				3,000
	Purchases Account	Dr.		2,000	
	To Mohan				
	(Being purchase of goods from Mohan)			2,000	
	Mohan	Dr.		1,000	
	To Cash Account				
	(Being payment of cash to Mohan)				1,000
	Suresh	Dr.		2,000	
	To Sales Account				
	(Being goods sold to Suresh)				2,000
	Cash Account	Dr.		1,000	
	To Suresh				
	(Being cash received from Suresh)				1,000
				24,000	24,000

LEDGER

CASH ACCOUNT

Dr. Cr.

Date	Particular	Amount Rs.	Date	Particular	Amount Rs.
	To Capital A/c	10,000		By Mohan	1,000
	To Suresh	3,000		By Mohan	1,000
	To Suresh	1,00		By Balance c/d	12,000
		14,000	Mar. 31		14,000
April 1	To Balance b/d	12,000			

CAPITAL ACCOUNT

		Rs.			Rs.
Mar. 31	To Balance c/d	10,000		By Cash A/c	10,000
		10,000			10,000
			Apr. 1	By Balance b/d	10,000

PURCHASE ACCOUNT

		Rs.			Rs.
	To Mohan	2,000	March. 31	By Balance c/d	4,000
	To Mohan	2,000			
		4,000			4,000
April 1.	To Balance b/d	4,000			

MOHAN

		Rs.			Rs.
	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
			Apr. 1	By Balance b/d	2,000

SURESH

		Rs.			Rs.
	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

		Rs.			Rs.
Mar. 31	To Balance c/d	4,000		By Suresh	2,000
				By Suresh	2,000
		4,000			4,000
			April. 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 Rs. 12,000. It will be therefore said that Cash Account is showing a debit balance of Rs. 12,000. Similarly, the credit side of the Capital Account is greater than debit side by Rs. 10,000. It will be, therefore, said that the Capital Account is showing a credit balance of Rs. 10,000.

Illustration

1. Journalise the following transactions of M/s. Radha & Sons.

1.1.2000	**Business Started with Rs.2,50,000 and cash deposited with Bank – 1,50,000**
3.1.2000	**Purchasesd machinery on credit from Rangan – 50,000**
6.1.2000	**Bought furniture from Ramesh for cash – 25,000**
12.1.2000	**Goods sold to Yesodha – 22,500**
13.1.2000	**Goods returned by Yesodha – 2,500**
15.1.2000	**Goods sold for cash – 50,000**
17.1.2000	**Bought goods for cash – 25,000**
20.1.2000	**Cash received from Yesodha – 10,000**
21.1.2000	**Cash paid to Ramola – 20,000**
25.1.2000	**Cash withdrawn from bank – 50,000**
29.1.2000	**Paid advertisement expenses – 12,500**
30.1.2000	**Bought office stationery for cash – 5,000**
31.1.2000	**Cash withdrawn from bank for personal use of the proprietor – 6,250**
31.1.2000	**Paid salaries – 15,000**
31.1.2000	**Paid rent – 2,500**

Solution: **Books of M/s.Radha & Sons**

Journal

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
1.1.2000	Cash A/c Dr. To Capital A/c (Being cash brought in as capital)		**2,50,000**	 **2,50,000**
1.1.2000	Bank A/c Dr. To Cash A/c (Being cash deposited into bank)		**1,50,000**	 **1,50,000**
3.1.2000	Machinery A/c Dr. To Rangan's A/c (Being machinery bough on credit from Rangan)		**50,000**	 **50,000**
6.1.2000	Furniture A/c Dr. To Cash A/c (Being goods sold to Yesodha on credit)		**25,000**	 **25,000**
12.1.2000	Yesodha's A/c Dr. To Sales A/c (Being goods sold to Yesodha on credit)		**22,500**	 **22,500**

13.1.2000	Sales Returns A/c Dr. To Yesodha's A/c (Being goods returned by Yesodha)		**2,500**	**2,500**
15.1.2000	Cash A/c Dr. To Sales A/c (Being goods sold for cash)		**50,000**	**50,000**
17.1.2000	Purchases A/c Dr. To Cash A/c (Being goods purchased for cash)		**25,000**	**25,000**
20.1.2000	Cash A/c Dr. To Yesodha's A/c (Being cash received from Yesodha)		**10,000**	**10,000**
21.1.2000	Ramola A/c Dr. To Cash A/c (Being cash paid to Ramola)		**20,000**	**20,000**
25.1.2000	Cash A/c Dr. To Bank A/c (Being cash withdrawn from bank)		**50,000**	**50,000**
29.1.2000	Advertisement Expenses A/c Dr. To Cash A/c (Being advertisement expenses paid)		**12,500**	**12,500**
30.1.2000	Office stationery A/c Dr. To Cash A/c (Being stationery purchased for cash)		**5,000**	**5,000**
31.1.2000	Drawings A/c Dr. To Bank A/c (Being cash withdrawn from bank for personal use)		**6,250**	**6,250**
31.1.2000	Salaries A/c Dr. Rent A/c Dr. To Cash A/c (Being salaries and rent paid)		**15,000** **2,500**	**17,500**

Illustration

Suresh, Kanpur commenced business on 1st January, 2018 introducing capital in cash ₹ 1,00,000. His oth

2018		₹
Jan 1	Started business with cash	1,00,000
Jan 2	Bought goods for cash	20,000
Jan 3	Sold goods for cash	7,000
Jan 15	Sold goods to Shravan, Delhi	6,000
Jan 18	Bought goods on credit from Anurag, Kanpur	60,000
Jan 19	Goods returned to Anurag	5,000
Jan 20	Sold goods for cash	30,000
Jan 22	Paid electricity bill	1,000
Jan 28	Paid for telephone bill	500
Jan 29	Paid rent	800
Jan 31	Paid wages	3000

Enter the above transactions in his books of account.

Solution:

Journal

Date	Particulars		L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
2018 Jan 01	Cash A/c To Capital A/c (Started business with cash)	Dr.		1,00,000	1,00,000
Jan 02	Purchases A/c To Cash A/c (Goods purchased)	Dr.		20,000	20,000
Jan 03	Cash A/c To Sales A/c (Goods sold)	Dr.		7,000	7,000
Jan 15	Shravan A/c To Sales A/c (Goods sold)	Dr.		6,000	6,000
Jan 18	Purchases A/c To Anurag A/c (Goods purchased on credit)	Dr.		50,000	50,000
Jan 19	Anurag A/c To Purchases Return A/c (Goods returned)	Dr.		5,000	5,000
Jan 20	Cash A/c To Sales A/c (Goods sold)	Dr.		30,000	30,000
Jan 22	Electricity Expenses A/c To Cash A/c (Paid electricity bill)	Dr.		1,000	1,000
Jan 28	Telephone Expenses A/c To Cash A/c (Paid telephone bill)	Dr.		500	500
Jan 29	Rent A/c To Cash A/c (Paid rent)	Dr.		800	800
Jan 31	Wages A/c To Cash A/c (Paid wages)	Dr.		3,000	3,000

Cash Account

Dr.							Cr.
Date	**Particulars**	**J.F.**	**Amount (Rs.)**	**Date**	**Particulars**	**J.F.**	**Amount (Rs.)**
Jan 01	Capital A/c		1,00,000	Jan 02	Purchases A/c		20,000
Jan 03	Sales A/c		7,000	Jan 22	Electricity Expenses A/c		1,000
Jan 20	Sales A/c		30,000	Jan 28	Telephone Expenses A/c		500
				Jan 29	Rent A/c		800
				Jan 31	Wages A/c		3,000
				Jan 31	Balance c/d		1,11,700
			1,37,000				1,37,000

Wages Account

Dr.							Cr.
Date	**Particulars**	**J.F.**	**Amount (Rs.)**	**Date**	**Particulars**	**J.F.**	**Amount (Rs.)**
Jan 31	Cash A/c		3,000	Jan 31	Balance c/d		3,000
			3,000				3,000

Rent Account

Dr.							Cr.
Date	**Particulars**	**J.F.**	**Amount (Rs.)**	**Date**	**Particulars**	**J.F.**	**Amount (Rs.)**
Jan 29	Cash A/c		800	Jan 31	Balance c/d		800
			800				800

Electricity Expenses Account

Dr.							Cr.
Date	**Particulars**	**J.F.**	**Amount (Rs.)**	**Date**	**Particulars**	**J.F.**	**Amount (Rs.)**
Jan 22	Cash A/c		1,000	Jan 31	Balance c/d		1,000
			1,000				1,000

Telephone Expenses Account

Dr. Cr.

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
Jan 28	Cash A/c		500	Jan 31	Balance c/d		500
			500				500

Capital Account

Dr. Cr.

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
Jan 01	Cash A/c		1,00,000	Jan 31	Balance c/d		1,00,000
			1,00,000				1,00,000

Anurag Account

Dr. Cr.

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
Jan 19	Purchases Return A/c		5,000	Jan 18	Purchases A/c		50,000
Jan 31	Balance c/d		45,000				
			50,000				50,000

Shravan Account

Dr. Cr.

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
Jan 15	Sales A/c		6,000	Jan 31	Balance c/d		6,000
			6,000				6,000

QUESTIONS

1. Explain the meaning of 'posting'.
2. How are Ledgers classified?
3. Give four examples of Accounts that are found in each of the types of Ledgers.
4. Outline the procedure for posting Journal entries. Explain with suitable examples.
5. What is an opening Journal entry? How is it posted in the Ledgers?
6. Indicate how the Double Entry principle is observed in the course of Ledger postings.

EXERCISES

1. From the following information write up the Journal and make the postings there from into the Ledgers:

1994 July

1. Balances Assets: Cash in hand Rs. 500; Cash at Bank Rs. 5,750; Stock Rs.3,400; Fixtures and fittings Rs. 250; Debtors: Mohan Rs. 1,000; Mankekar Rs. 750; Masani Rs. 1,250. Liabilities: Loan from Roy Rs. 2,000: Creditors: David Rs. 1,400; Martin Rs. 1,750; Shroff Rs. 1,220; Capital Rs.6,650

3. Purchases from David Rs. 500

5. Sales to Mohan Rs. 450

7. Carriage paid Rs. 15

10 Cash sales by cheque Rs. 250

12 Above cheque paid into Bank

14 Returns from Mohan Rs. 150

15 Sundry expenses by cash Rs. 10

17 Purchases from Masani Rs. 175

19 Purchases from Masani Rs. 150

20 Electricity charges paid by cheque Rs. 22

22 Returns to Masani Rs. 150

24 Drawings by cheque Rs. 55

26 Cheque received from Mohan and paid into Bank Rs. 1,250 discount allowed Rs. 50

28 Gave cheque to David Rs. 1,825 in full settlement of his balance

29 Wages and salaries paid by cheque Rs. 125

31 Additional capital brought into business and banked Rs. 1,500

2. Journalise the following and post into the appropriate Ledgers:

1995

May 1. Debit balances: Cash at Bank Rs. 4,600; Stock in trade Rs. 1,250; Plant and machinery Rs. 12,000; Buildings Rs. 22,500; B. Babu Rs. 1,220; C. Charles Rs. 250; D. Darling Rs. 780; Cash in hand Rs. 900; Credit balances: Mortgage on buildings Rs. 7,500; R. Rao Rs. 2,000; M. Mardi Rs. 1,000

4. Sales to Babu Rs. 780

6. Purchases from Mardi Rs. 500

8. Freight paid in cash Rs. 5

10. Purchases from Mardi Rs. 250

12. Sales by cheque and paid into bank Rs. 225

14. Sales to Darling Rs. 220

16. Purchases from R. Rao Rs. 750; cash Rs. 57

18. Printing and stationery expenses paid cheque Rs. 45

20. Returns outwards Rao Rs. 150; M. Mardi Rs. 175

22. Returns inwards Babu Rs. 125; Darling Rs. 80

24. Insurance premium paid by cheque Rs. 124; advertising expenses paid by cash Rs. 50

26. Received from B.Babu Rs.1,650 and wrote off the balance as discount

29. Rent received from tenant Rs.180

30. Gave R. Rao cheque forRs. 2,550 in settlement of his balance of Rs. 2,600 alsopaid Mardi by cheque in full settlement of Rs. 1,825

31. Drawing by cheque Rs. 125; sundry expenses paid by cash Rs. 25

3. From the following particulars write up the Journal and Ledgers:

1994

June 1 Basu commenced business with cash Rs. 5,000 2 Opened a current account with the Bank of India Rs. 4,750 and bought furniture by cheque Rs. 100

3 Purchases from Kumar and Roy Rs. 1,250 and Rs. 875 respectively

5 Sales to Mohan and Charles Rs. 750 and Rs. 840 respectively

7 Sale by cheque Rs.125

9 Returns outwards Kumar Rs. 250; Roy Rs. 75

11 Returns inwards; Mohan Rs. 59 and Charles Rs. 40

13 Cheque banked Rs. 125

15 Wages paid in cash Rs. 75; rent by cheque Rs. 125

17 Cheque for private use Rs. 50

19 Purchases by cheque Rs. 175

22 Purchases from Roy Rs. 425

24 Sales to Mohan Rs. 750

26 Cheque paid to Roy Rs. 1,000 discount Rs. 225

27 Withdrew capital by cheque Rs. 1,000

28 Received from Mohan cheque for Rs. 1,400 in full settlement and paid the same into bank; sent Kumar cheque for Rs.478; Discount received Rs. 22

29 Cheque drawn for office use Rs. 225; received Charles' cheque for Rs. 490 and allowed Rs. 10 discount; the cheque was paid into bank on the same day

30 Purchases from Das Rs. 775 and by cheque Rs. 130; sales to Black Rs. 270 and cash sales Rs. 130; carriage expenses paid by cash Rs. 30; remitted Income Tax Rs. 100 by MO; MO commission Rs. 2.

5.3 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 1. The Trial Balance can be prepared as follows:

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

Introduction

The Journal Entries and the posting of the entries in the Ledger Accounts fulfill the fundamental needs for keeping accounts in a business. But a businessman should know the progress of his business at least once in a year. The profit or loss made during the previous year should be known before he commences his business operations for the next year. So also he should know whether he has enough assets to meet the liabilities incurred by him in his business.

From out of the ledger accounts, it is possible to build up the necessary accounts to show the profit or loss in a business and a statement showing the assets and liabilities of a business. Information regarding purchases, sales, expenses and gains of a business are readily available from ledger accounts. But before proceeding to ascertain the financial results of a business it is necessary to check whether the accounts are arithmetically accurate. The preparation of a Trial Balance serves this important purpose. It guarantees at the outset that the accounts are fairly accurate.

A Trial Balance is prepared from out of the ledger accounts. We have already noted that the double entry effect of the transitions is preserved in ledger also. That is to say, that for every debit posting there should be a corresponding credit posting. Therefore, the debit totals of all the ledger accounts put together should be equal to the credit totals of all the ledger accounts. The debit total should balance itself with the credit total, if there is no error in the postings and the totals are correctly made.

If, however, it does not do so, the existence of errors, is implied and efforts must be directed towards the detection of errors, and thereby setting right the Trial Balance. In certain cases, the time factor is likely to weigh heavily against the detection of errors and the agreement of the Trial Balance. In all such cases, the Trial Balance must be tallied for the time being, by including in the Ledgers and the Trial Balance, an account called the Suspense Account or Difference in the Books Account, having a balance equal to the deficit in the Trial Balance. As and when the errors are subsequently detected, this Suspense Account will be automatically written off.

A perusal of the Trail Balance will also show that some accounts always have debit balances, some credit balances, and yet some others debit or credit balances. Thus accounts involving properties like cash, furniture, machinery, land and building will always have only debit balances. Likewise, debtors and all items constituting losses and expenses will be debits. Thus, trade debtors, wages, salaries, rates and taxes, etc., will have debit balances. Similarly, items like discounts received and other incomes, profits and gains will have credit balances. Lastly, there are accounts which may have debit or credit balances. They are rent, discount,bank and interest. As far as nominal accounts are concerned, in the absence of any specific indication, they may be taken as debit balances, e.g., rent, interest, etc. Likewise, loan (without any clue) should be taken as liability and a credit balance, while the term bank implies always cash at bank, i.e., debit balance.

OBJECTIVES OF PREPARING A TRIAL BALANCE

I**. 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 the fact that the books of accounts are arithmetically accurate. Of course, there may be certain errors in the books of accounts in spite of an agreed Trial Balance. For example, if a transaction has been completely omitted, from the books of accounts, the two sides of the Trial Balance will tally, in spite of the books of accounts being wrong.

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.

ERRORS NOT DISCLOSED BY A TRIAL BALANCE

Before concluding the discussion on the Trial Balance, it is necessary to indicate as to what extent the Trial Balance is an index of the correctness of the accounts. The fact remains that the Trial Balance merely ensures the arithmetical accuracy of the books, subject to certain conditions. In short, it discloses only certain errors, but not all of them. This is mainly due to the fact that the Trial Balance is a device based on the Double Entry principle and that for every debit there should be a corresponding credit.

Errors not disclosed by the Trial Balances are:

- Errors of total omission from the Subsidiary Books.
- Errors in regard to the Subsidiary Book itself or the amount involved. In short, any error in a subsidiary book, other than the one involving wrong carry-forwards and totaling, will not affect the agreement of the Trial Balance.
- Postings to the right side of wrong accounts.

- Compensating errors which exist together without affecting the agreement of the Trial Balance.

Errors disclosed by the Trial Balance are:

- Errors by way of wrong postings, i.e., to wrong side or of wrong amounts.
- Duplication of postings.
- Omission to post.
- Mistakes in totaling and carry-forwards.
- Omission of an account in the Trial Balance.

5.4 SUMMARY

Ledger is a book which contains various accounts of the business enterprise whether real, nominal or personal. The term 'posting' means transferring the debit and credit items from the journal to their respective accounts in the ledger. At the end of a period, the businessman will be interested in knowing the position of a particular account. This means, he should total the debits and credits of his account separately and final out the net balance. This technique of finding out the net balance of an account is known as balancing the account. Before preparing the final accounts, the accountant prepares a trial balance to check arithmetical errors. The trial balance is a statement containing the various ledger balances on a particular date.

5.5 KEYWORDS

Assets: Tangible objects or intangible rights owned by an enterprise and carrying probable future benefits.Profits & Loss Account: A financial statement which represents the revenues and expenses of an enterprise and shows the excess of revenues over expenses or vice-versa. Balance Sheet: A statement of the financial position of an enterprise as at a given date.

5.6 SELF ASSESSMENT QUESTIONS

1. Explain the rules regarding posting of transactions into the Ledger.
2. What is a Trial Balance? Explain its objectives.
3. Discuss and differentiate between Journal and Ledger.

QUESTIONS

1. What is a Trial Balance and what purpose does it serve?
2. Explain the term 'Suspense Account'. What are the circumstances under which a Suspense Account is opened?
3. To what extent is the Trial Balance useful for detecting errors?
4. Set forth the errors that are not disclosed by the Trial Balance.

EXERCISES

1. From the following particulars pertaining to the Ledger Balances as on 31 December

1993, prepare a Trial Balance:

Capital account 25,000	Carriage outwards 1,300
Freight 5,000	Purchases 1,05,000
Rent paid 4,500	Office expenses 400
Motor lorry 7,000	Trade expenses 100
Petty expenses 520	Goodwill 10,000
Drawings 24,000	Cash on hand 250
Wages and salaries 8,500	Stock (1-1-63) 10,000
Trade debtors 9,500	Sales 1,60,000
Mortgage 1,320	Discounts received 5,750
Advertising 1,000	Building 10,000
Rates paid 2400	Bills payable 6,970
Commission received 4130	

2. A Novice has prepared the Trial Balance which does not agree. Scrutinize and rectify the errors:

Salaries	Rs.2,414	Repairs	328
Sales	18,205	Sundry creditors	664
Wages	6,116 196	Sundry debtors	3,445
Purchase returns	295	Stock at commencement	1,572
Furniture and fittings	720	Petty cash	13
Publicity expense	200	Cash at hand	390
Discount allowed	446	Drawings	900
Carriage on sale	163	Postal expense	37
Sundry expenses	86	Insurance	87
Capital	7,200	Loans	500
Machinery and plant	1,460	Rent received	200
Rates	175	Samples	100
Cash at bank	1,200	Bills payable	300
Repairs	328	Drawings	900
Sundry creditors	664	Postal expense	37
Sundry debtors	3,445	Insurance	87
Stock at commencement	1,572	Loans	500
Petty cash	13	Rent received	200
Cash at hand	390	Purchases	7,336

3. From the following Ledger Balances prepare a Trial Balance:

Bills receivable Rs. 1,500; Bad debts Rs. 140; Discounts earned Rs. 395; Rates, taxes and insurance Rs.370;General expenses Rs. 210; Sundry receipts Rs. 30; Coal Rs. 150; Manufacturing expenses Rs. 700; Sales Rs. 16, 500; Bills payable Rs. 400; Cash on deposit Rs. 300; Cash on Current Account Rs. 700; Sundry creditors Rs. 6,000; Patents Rs. 1,000; Office furniture Rs. 800; Plant and machinery Rs. 2,500; Drawings Rs. 1,500: Interest on deposit Rs. 100: Rents earned Rs.50; Travelling expenses Rs. 300; Discounts allowed Rs. 280;

Office salaries Rs. 1,200; Gas and water Rs. 180; Renewals and replacements Rs. 250; Purchases Rs. 9,600; Mortgage loan Rs. 800; Loan to Antonio Rs. 2,000; Cash on hand Rs. 95: Sundry debtors Rs. 7,500; Patterns and models Rs. 1,200; Stock in trade Rs. 4,500; Freehold property Rs. 2,000; Capital Rs. 15,000. (Ans: Trial Balance Totals Rs. 39,275)

4. Prepare trail balance from the follwoing

Balances	□
Cost of Goods Sold	5,20,000
Opening Stock	50,000
Closing Stock	50,000
Salary and Wages	50,000
Sales	8,00,000
Plant & Machinery	2,00,000
Drawing	50,000
Investment	4,30,000
Creditors	1,00,000
Capital	4,00,000

5. The following balances were extracted from the ledger of Mr.Sachin as on 31st March 2021. You are required to prepare a trial balance as on that date.

Balances	□
Drawings	60,000
Salaries	95,000
Capital	4,40,000
Sales return	10,000
Sundry creditors	2,30,000
Purchases return	11,000
Bills payable	40,000
Commission paid	1,000
Sundry debtors	5,00,000
Trading expenses	25,000
Bills receivable	52,000
Discount earned	5,000
Plant & Machinery	45,000
Rent	20,000
Opening stock	3,70,000
Bank overdraft	60,000
Cash in hand	9,000

Purchases	7,08,000
Cash at bank	25,000
Sales	11,80,000
Investment	46,000
Closing Stock	80,000

6. Prepare trail balance of Lokesh as on 31-3-2020

Balances	□
Purchase:	5,05,000
Return Outward:	5,000
Sales:	8,20,000
Return Inward:	20,000
Debtors:	2,80,000
Cash in Hand:	20,000
Capital:	4,00,000
Plant and Machinery:	3,20,000
Wages:	30,000
Drawing:	50,000
Furniture:	35,000
Bank Overdraft:	32,000
Commission Received:	10,000
Rent Paid:	7000
General Reserve:	30,000
Manufacturing Expenses:	25,000
Prepaid Expenses:	5000
Bad Debt:	10,000
Creditors:	80,000
Administrative Expenses:	50,000
Bills Receivable:	20,000
Opening Stock:	25,000
Carriage Inward:	5000
Carriage Outward:	10,000
Bills Payable:	30,000
Bank Loan:	10,000

6. Prepare the Trial Balance for the following balances as of 31st March 2021.

Balances	□
Capital:	5,00,000
Opening Stock:	75,000
Purchase:	4,25,000
Salary & Wages:	10,000

Depreciation:	50,000
Purchase Return:	15,000
Sales:	6,20,000
Sales Return:	20,000
Plant & Machinery:	4,00,000
Debtors:	1,50,000
Drawing:	40,000
Travel Expenses:	10,000
Creditors:	2,20,000
Bills Receivable:	80,000
Motor Vehicle:	2,00,000
Cash in Hand:	25,000
Investment:	40,000
Bad Debts:	6000
Carriage:	4000
Closing Stock:	65,000

7. From the following balances extracted from the books of a trader, prepare Trial Balance as on 31st March, 2021.

Capital □2,00,000

Sales □3,70,000

Purchases □1,70,000

Creditors □50,000

Debtors □1,00,000

Building □2,50,000

Opening Stock □50,000

Cash at Bank □50,000

Commission Paid □11,000

Rent received □15,000

Drawings □4,000

8. From the following balances extracted from the books of Mr. K.K, prepare Trial Balance as on 31st March 2021.

Cash in hand □14,200

Cash at Bank □6,800

Bills Receivable□ 28,000

Bills payable □26,000

Sundry debtors □54,600

Sundry creditors□ 62,400

Capital □60,000

Drawings □ 28,000
Sales□2,05,000
Purchases □1,75,000
Carriage □Inward 2,700
Salaries □12,000
Advertisement □2,400
Insurance □1,600
Furniture □7,500
Opening Stock □18,600
Office Rent □2,000

9. From the following balances extracted from the books of Mr. P.K, prepare Trial Balance as on 31st March, 2021.

Closing Stock □10,000
Cash in hand □14,200
Outstanding Expenses □4,400
Prepaid Expenses □1,400
Accrued Income □3,000
Cash at Bank □16,800
Bills Receivable□ 28,000
Bills payable □36,000
Sundry debtors □54,600
Sundry creditors□ 62,400
Capital □1,60,000
Drawings Computers□ 28,000
Sales□2,05,000
Purchases □1,75,000
Carriage □Inward 2,700
Salaries □12,000
Advertisement □2,400
Insurance □1,600
Furniture □7,500
Opening Stock □18,600
Office Rent □2,000
Investment □1,00,000

10. From the following balances extracted from the books of Mr. S.K, prepare Trial Balance as on 31st March, 2021.

Debtors □17,200; Cash at Bank □17,000

Creditors □16,000; Capital □70,000
Opening stock □8,000; Drawing □9,000
Wages □6,700; Purchases □60,000
Rent □5,000; Sales □82,000
Salary □8,400
Machine □35,700
Bills Payable □12,000
Furniture □13,000
General Reserve □23,000
Investment □20,000
Bank Loan □12,000
Factory Expenses □15,000

Lesson-6
SUBSIDIARY BOOKS OF ACCOUNTS

STRUCTURE
6.0 Objectives
6.1 Introduction
6.2 Cash Book
6.3 Kinds of cash book
6.4 single column Book
6.5 Double column Book
6.6 Triple column Book
6.9 Journal Proper
6.10 Summary
6.11 Keywords
6.12 Self-assessment questions
6.13 References/suggested readings

6.0 OBJECTIVES

After going through this lesson, you should be able to-

- Know the meaning and importance of subsidiary books.
- Understand cash book.
- Familiar with other subsidiary books.

6.1 INTRODUCTION

All business transactions, at the first stage, are recorded in the book of original entry i.e. Journal and then posted into the ledger under the double entry system of book-keeping. This procedure is easy and practicable in small business houses where the number of business transactions are less and when a single person can handle the business transactions. But it is practically very difficult, rather impossible, to record all the business transactions of a day in the Journal of a large business house where the number of business transactions are varied and enormous because of the following reasons:

(a) The system of recording all transactions in a journal requires (i) writing down of the name of the account involved as many times as the transactions occur; and (ii) an individual posting of each account debited and credited and hence, involves the repetitive journalising and posting labour.

(b) Such a system does not provide the information on a prompt basis.

(c) The journal becomes bulky and voluminous.

(d) Such a system does not facilitate the installation of an internal check system since the journal can be handled by only one person.

Therefore, to overcome the shortcomings of the use of the journal as the only book of original entry, the journal is subdivided into special journals. It is divided in such a way that a separate book is used for each category of business transactions which are repetitive in nature, similar and are sufficiently large in number. Special journals refer to the journals meant for recording specific business transactions of similar nature. These special journals are also known as "Subsidiary Books" or "Day Books". The main types of special journals are as follows:

(i) Cash Book: It records all those transactions which are in cash or by cheques.

(ii) Purchases Book: It records all transactions relating to goods purchased on credit.

(iii) Sales Book: It records all transactions relating to goods sold on credit.

(iv) Purchases Return Book: It records return of goods to suppliers.

(v) Sales Return Book: It records return of goods by the customers.

(vi) Bills Receivable Book: It records entries regarding bills receivables. The details of bills are given in this book.

(vi) Bills Payable Book: All bills which are accepted and payable by a business house are recorded in this book.

(viii) Journal Proper: Those transactions which are not recorded in any of the above mentioned books are recorded in the

6.2 CASH BOOK

A Cash Book is a special journal which is used for recording all cash receipts and cash payments. If a cash book is maintained, there is no need for preparing a cash account in the ledger. However, the other aspects of the transactions will be recorded in the ledger. Cash Book serves dual role of journal as well ledger. Cash Book is the book of original entry (Journal) since transactions are recorded for the first time from the source documents. It is a ledger in the sense that it is designed in the form of Cash Account and records cash receipts on the debit side and cash payments on the credit side.

Features

· Only cash transactions are recorded in the Cash Book.

· It performs the functions of both journal and the ledger at the same time.

· All cash receipts are recorded on the debit side and all cash payments are recorded on the credit side.

· The Cash Book, recording only cash transactions can never show a credit balance.

6.3 Kinds of Cash Book

Cash Book can be of several kinds:

(a) Single Column Cash Book- For recording cash transactions only.

(b) Double (Two) Column Cash Book- For recording cash transactions involving gain or loss on account of discount.

(c) Triple (Three) Column Cash Book- For recording cash and bank transactions involving gain or loss on account of discount.

(d) Petty Cash Book- For recording petty expenses.

6.4 Single Column Cash Book

The Single Column Cash Book has one column of amount on each side. All cash receipts are recorded on the debit (left-hand) side and all cash payments are recorded on credit (right-hand) side. In fact, it is nothing but a Cash Account. Hence, there is no need to open Cash Account in the ledger. Posting from the debit (receipt) side of the Cash Book is done to the credit side of concerned accounts and from the credit (payment) side of the Cash Book to the debit side of concerned accounts.

Balancing the Cash Book: The Cash Book is balanced in the same manner as a ledger account. To verify the accuracy of the entries made and to confirm the authenticity of cash balance, it should be balanced daily. The balance as per Cash Book must tally with the actual cash in hand. In the Cash Book, the total of amount column of the debit side always exceeds the total of credit side. As such, the Cash Book always shows a debit balance, since we cannot pay more than we have with us. At the end of the period, the balance of the Cash Book is placed on the credit side by writing “By Balance c/d” and then the totals are shown on both side in one straight line. The total of each side should be the same.

6.5 Double Column Cash Book

This Cash Book has two amount columns one for cash and another for discount on each side. It is customary in business to allow discount when payment is received from a customer promptly and before due date. It is equally so when payment is made to a creditor before due date. All cash receipts and discount allowed are recorded on the debit side and all cash payments and discount received are recorded on the credit side of Cash Book.

The posting from the cash columns is done in the same manner as it is done in Single Column Cash Book. Entries from discount column of the debit side of the Cash Book are posted on the credit side of every individual debtor's account to whom the business has allowed the discount. The total of the debit side of the discount column is shown on the debit side of the "Discount Allowed Account" by writing "To Sundries"in the particulars column. Entries from the discount column of the credit side of the Cash Book are posted on the debit side of every individual creditor's account by whom the discount is allowed to the business. The total of the credit side of the discount column is shown on the credit side of the "Discount Received Account" by writing "By Sundries" in the particulars column.

The cash column of the Double Column Cash Book is balanced exactly in the same manner as in case of the Single Column Cash Book. But, the discount columns are not balanced but merely totalled. These totals are posted to the respective Discount Allowed Account and Discount Received Account.

6.6 Triple Column Cash Book: This type of Cash Book is an improvement over the Double Column Cash Book. In modern times, it is virtually impossible to imagine any business without having dealings with a bank. Most of the transactions relating to receipts and payments of money are made through cheques.

So transactions through bank are also recorded in the cash book by adding one more column i.e. bank column on both sides of the cash book. Therefore there are three columns on both sides of the cash book i.e. cash, bank and discount columns. That is why this type of cash book is known as Triple Column Cash Book.

Receipt side (Dr side) of the Triple Column Cash Book is used to record all receipts both in cash and by cheques as also to record the discount allowed to our debtors while receiving the payment. Cash receipts are entered in the cash column whereas amounts received by cheques are entered in the bank column and discount allowed in the discount column. Posting from the debit side of the cash book is made to the credit side of each account in the ledger– in case of personal accounts

credit is to be given for cash or cheques received plus discount allowed.

Payment side (Cr. side) of the Cash Book is used to record all payments both in cash and through cheques as also to record the discount received or availed by us from over creditors while making payment to them. Cash payments are recorded in the cash column, payments through cheques are entered in the bank column and discount received in the discount column.

Posting from the credit side of the cash book is made on the debit side of respective accounts– in case of personal accounts debit is to be given for the total of the payments made and discount received.

After recording all the relevant transactions in the Cash Book, all the columns of the Cash Book are totalled. The difference in the cash columns is put on the credit side of Cash Book in the column by writing "By Balance c/d". The bank balance may have a debit balance or a credit balance. If the total of the debit side of the bank column is more than the total of the credit side of the bank column, it has a debit balance and if the total of the credit side is more than that of the debit side, then it has a credit balance (overdraft). However, the difference is put on the lesser side. There is no need to balance the discount columns. The discount columns of both the sides are totalled.

In the Triple Column Cash Book there will be some cross or contra entries i.e., transfer of money from cash to bank (amount deposited) and vice-versa (amount withdrawn from bank for office use). In all such cases both entries occur in the cash book and no ledger entry is required. This is indicated by a contra sign (C) in the folio column indicating thereby that the double entry aspect of this transaction is complete and it requires no posting to the ledger.

To overcome the shortcoming of the use of the Journal as the only book of original record, the Journal is sub-divided into special journals. A special journal refers to the journals meant for recording specific business transactions of similar nature which are known as 'subsidiary books' or 'day books'. The main types of special journals are– (i) cash book; (ii) purchases book; (iii) sales book; (iv) purchase return book; (v) sales return book; (vi) bills receivable book; (vii) bills payable book; and (viii) journal propers. Cash book is a special journal which is used for recording all cash receipts and payments. Purchase book is used for recording only the credit purchases of goods and merchandise in which the business in dealing in. Sales book is used to record all the credit sales, purchase return book is used to record the goods returned by the enterprise and sales return book is used to record the goods returned by the customers. Bills receivable book and bills payable book are used to record the details of B/R and B/P respectively. Any entry which is to taking place in the above mentioned book is being recorded in the book 'Journal Proper'.

6.7 Journal Proper.

Before recording transactions in these day books, it is necessary to explain the special meaning given in business to the words 'Goods', 'Purchases' and 'Sales'.

Goods: It refers to items forming part of the stock-in-trade of a business house which are purchased and are to be resold at a profit. A business house may purchase fixed assets or stationery for use in business, but they are not purchases of goods.

Purchases: It refers to the purchase of goods for resale, and not the purchase of assets or stationery. The Purchases Account, therefore, only contains purchases of goods for resale.
Sales: It refers to the sale of goods which form part of the stock-in trade of the business.

Advantages

The advantages of using Special Journals are as under:

(a) Facilitates division of work: The accounting work can be divided among many persons.

(b) Time and labour saving in journalising and posting: For instance, when a Sales Book is kept, the name of the Sales Account will not be required to be written down in the Journal as many times as the sales transactions occur and at the same time, Sales Account will not be required to be posted again and again since, only a periodic total of Sales Book is posted to the Sales Account.

(c) Permits the use of specialised skill: The accounting work requiring specialised skill may be assigned to a person possessing the required skill. With the use of a specialised skill, prompt, economical and more accurate supply of accounting information may be obtained.

(d) Permits the installation of internal check system: The accounting work can be divided in such a manner that the work of one person is automatically checked by another person. With the use of internal check, the possibility of occurrence of error/fraud may be avoided.

6.8 Application Of Computers And Information Technology To Accounting And Financial management

Business Accounting and Financial Management are crucial management functions in every enterprise. Whether you manage a small department, a major division, big company, small company or your micro enterprise, you work with numbers every day. Numbers are the language of business and industrial enterprises. Use of computers in general and electronic spread sheet in particular can economically and effectively replace traditional tools of accounting like ledger pager, stubby pencils, worn-out erasers, desktop calculators etc. Use of computer and spread sheet in today's complex business can take you ahead in speed, accuracy and capability.

Computer application in accounting and financial management can help you in transaction recording, financial planning, analysis, and forecasting. Best of all, it gives you a method of examining the implications of endless "What if ?" situations - the tough alternatives you face in running your business profitably. Computer software developing companies have developed a large number of accounting and financial management software. A brief account of some of the important soft wares available in India is given below. The basic function of these softwares is to enter the transactions and the rest of things i.e posting , balance calculation is done by these software. These software can prepare the trail balance, cash book, balance sheet and profit and loss account.

6.9 KEYWORDS

Bill of Exchange: An instrument is 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. For the party who will receive the money against bill is bills receivable and for counter party it is known as bills payable.

Journal: Journal is a primary book for recording the day to day transactions in a chronological order.

Goods: The items in which enterprise deals in.

Contra Entry: Entries related to cash and banks are known as contra entries.

Debit Balance: Total of debit side is greater than credit side.

6.10 SELF ASSESSMENT QUESTIONS

Test Your Understanding - I

Complete the following sentences with appropriate words:

(a) Information in financial reports is based on ....

(b) Internal users are the .... of the business entity.

(c) A .... would most likely use an entities financial report to determine whether or not the business entity is eligible for a loan.

(d) The Internet has assisted in decreasing the .... in issuing financial reports to users.

(e) .... users are groups outside the business entity, who uses the information to make decisions about the business entity.

(f) Information is said to be relevent if it is ....

(g) The process of accounting starts with .... and ends with ....

(h) Accounting measures the business transactions in terms of .... units.

(i) Identified and measured economic events should be recording in .... order.

Test Your Understanding - IV

Tick the Correct Answer

1. Which of the following is not a business transaction?
   a. Bought furniture of ₹10,000 for business
   b. Paid for salaries of employees ₹ 5,000
   c. Paid sons fees from her personal bank account ₹ 20,000
   d. Paid sons fees from the business ₹ 2,000
2. Deepti wants to buy a building for her business today. Which of the following is the relevant data for his decision?
   a. Similar business acquired the required building in 2000 for ₹ 10,00,000
   b. Building cost details of 2003
   c. Building cost details of 1998
   d. Similar building cost in August, 2005 ₹ 25,00,000
3. Which is the last step of accounting as a process of information?
   a. Recording of data in the books of accounts
   b. Preparation of summaries in the form of financial statements
   c. Communication of information
   d. Analysis and interpretation of information
4. Which qualitative characteristics of accounting information is reflected when accounting information is clearly presented?
   a. Understandability
   b. Relevance
   c. Comparability
   d. Reliability
5. Use of common unit of measurement and common format of reporting promotes;
   a. Comparability
   b. Understandability
   c. Relevance
   d. Reliability

Test Your Understanding - V

Mr. Sunrise started a business for buying and selling of stationery with ₹ 5,00,000 as an initial investment. Of which he paid ₹1,00,000 for furniture, ₹ 2,00,000 for buying stationery items. He employed a sales person and clerk. At the end of the month he paid ₹ 5,000 as their salaries. Out of the stationery bought he sold some stationery for ₹1,50,000 for cash and some other stationery for ₹1,00,000 on credit basis to Mr.Ravi. Subsequently, he bought stationery items of ₹1,50,000 from Mr. Peace. In the first week of next month there was a fire accident and he lost ₹ 30,000 worth of stationery. A part of the machinery, which cost ₹ 40,000, was sold for ₹ 45,000.

From the above, answer the following :

1. What is the amount of capital with which Mr. Sunrise started business.
2. What are the fixed assets he bought?
3. What is the value of the goods purchased?
4. Who is the creditor and state the amount payable to him?
5. What are the expenses?
6. What is the gain he earned?
7. What is the loss he incurred?
8. Who is the debtor? What is the amount receivable from him?
9. What is the total amount of expenses and losses incurred?
10. Determine if the following are assets, liabilities, revenues, expenses or none of the these: sales, debtors, creditors, salary to manager, discount to debtors, drawings by the owner.

6.11 QUESTIONS FOR PRACTICE

Short Answers

1. Define accounting.
2. State the end product of financial accounting.
3. Enumerate main objectives of accounting.
4. Who are the users of accounting information.
5. State the nature of accounting information required by long-term lenders.
6. Who are the external users of information?
7. Enumerate information needs of management.
8. Give any three examples of revenues.
9. Distinguish between debtors and creditors; profit and gain
10. 'Accounting information should be comparable'. Do you agree with this statement. Give two reasons.
11. If the accounting information is not clearly presented, which of the qualitativecharacteristic of the accounting information is violated?
12. "The role of accounting has changed over the period of time"- Do you agree?Explain.
13. Giving examples, explain each of the following accounting terms :
    - Fixed assets • Revenue • Expenses
    - Short-term liability • Capital
14. Define revenues and expenses?
15. What is the primiary reason for the business students and others to familiarise themselves with the accounting discipline?

Long Answers

1. What is accounting? Define its objectives.
2. Explain the factors which necessitated systematic accounting.
3. Describe the informational needs of external users.
4. What do you mean by an asset and what are different types of assets?
5. Explain the meaning of gain and profit. Distinguish between these two terms.
6. Explain the qualitative characteristics of accounting information.
7. Describe the role of accounting in the modern world.

6.12 CHECKLIST TO TEST YOUR UNDERSTANDING

Test Your Understanding – I

(a) Economic Transactions (b) Management/Employees (c) Creditor

(d) Time-gap (e) External (f) Free from bias

(g) Identifying the transactions and communicating information

(h) Monetary (i) Chronological

Test Your Understanding - IV

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

Test Your Understanding - V

1. ` 5,00,000 2. ` 1,00,000, 3. ` 2,00,000

4. Mr. Reace, ` 1,50,000 5. ` 5,000 6. ` 5,000

7. ` 30,000 8. Mr. Ravi, ` 1,00,000 9. ` 35,000

10. Assets : debtors; Liabilities : creditors; drawings; Revenues : sales expenses,discount, salary.

Test these questions:

1. What do you mean by subsidiary books? Name the principal subsidiary books used for recording credit transactions and also give a brief account of each.

2. What is Cash Book? What are the different types of cash book? How it is balanced?

3. Write short notes on:

(a) Petty Cash Book

(b) Debit Note

(c) Journal Proper

(d) Credit Note

(e) Contra entries

4. In which Book of Original Entry, will you record each of the following transactions?

(i) A allowance of Rs. 50 was offered for an early payment of Cash of Rs. 1,050.

(ii) A second hand motor car was purchased on credit from Ross for Rs. 10,000 for free delivery van.

(iii) Goods, the payment of which is due after 2 months, were sold to M/s Bell & Co. for Rs. 1,000.

(iv) Accounting for the partial recovery from Hari, of an amount of Rs. 2,000 earlier written-off as bad debt.

(v) Credit purchase of stationery worth Rs. 5,000, by a stationery dealer from Mr. Dubey.

Activity 1 : Tick (✓) the appropriate one:

Items	Current Assets	Non-Current Assets	Current Liabilities	Non-Current Liabilities
Machinery				
Sundry Creditors				
Cash at Bank				
Goodwill				
Bills Payable				
Land & Building				
Furniture				
Computer Software				
Motor Vehicles				
Inventory				
Investments				
Loan from Bank				
Sundry Debtors				
Patents				
Air-Conditioners				
Loose tools				

PROBLEMS TO SOLVE AND UNDERSTAND

1. Enter the following transactions of the Premier Trading Company in Cash Book with three columns- Discount, Cash and Bank and balance the accounts as on 31st December 2004:

2004 Dec. 1 Cash in hand Rs 4,000

2004 Dec. 1 Bank Rs 1,000 (Cr.)

2004 Dec. 3 Received a cheque from A Rs 290 and allowed him discount of Rs 40

2004 Dec. 7 A's cheque deposited into the bank

2004 Dec. 10 Withdrew from bank for office use Rs 800

2004 Dec. 12 Paid B/P by cheque Rs 600

2004 Dec. 15 B/R from Ram. Rs 2,500: Discounted it, crediting with bank Rs 2,400

2004 Dec. 20 Issued a cheque for Petty Cashier Rs 100

2004 Dec. 25 Paid to Gupta by cheque Rs 920; discount received Rs 30

2004 Dec. 28 Made cash-sales Rs 900.

2. Enter the following transactions in the cash book of M/s. Rohan Traders:

Date Details Amount (Rs.)

2005

December 01 Cash in Hand 27,500

December 05 Cash received from Nitu 12,000

December 08 Insurance Premium paid 2,000

December 10 Furniture purchased 6,000

December 14 Sold Goods for cash 16,500
December 18 Purchased Goods from Naman for cash 26,000
December 22 Cash paid to Rohini 3,200
December 25 Sold Goods to Kanika for cash 18,700
December 28 Cash Deposited into Bank 5,000
December 30 Rent paid 4,000
December 31 Salary paid 7,000

3. Prepare Cash Book for the month of April 2006 from the following particulars :

Date Details Amount (Rs.) 2006
April 01 Cash in hand 17,600
April 03 Purchased Goods for cash from Rena 7,500
April 06 Sold Goods to Rohan 6,000
April 10 Wages paid in cash 500
April 15 Cash paid to Neena 3,500
April 17 Cash Sales 10,000
April 19 Commission paid 700
April 21 Cash received from Teena 1,500
April 25 Furniture Purchased for cash 1,700
April 28 Rent paid 3,000
April 30 Paid Electricity bill in cash 1,300

4. Write up a Sharjeel Siraj Khan's single column cash book for the month of April 2015, from the following?

1 Cash in hand ……………….…. 1,650
2 Cash sales …………….……….. 16,000
3 Paid check to creditors………….. 4,000
4 Wages paid in cash ……………… 2,250
4 Cash sales ……………………….… 18,000
9 Paid cash to TCP ……………………….… 420
11 Paid salaries by cash ………….…… 2,850
12 Credit Sales …….……………..……… 1,000
14 Note Receivable Realized ………….. 3,000

17 Paid cash for repairing ……………… 360
19 Sales by cash …………………..……… 11,400
21 Paid office expense ………………….. 180
25 Paid rent and rates …………………… 3,600
26 Cash sales …………….……….……… 19,200
27 Paid electricity bill ………………..…. 900
28 Cash collected from debtor……..…….. 4,500

29 Goods Purchase ……….………….……. 2,000
30 Retire bank loan ………………..……. 3,000

5. Enter the following transactions in a single column cash book of Mr. Adeel Nawaz:

2016 November

1. Started business with cash Rs. 70,000 and Land Rs. 30,000.
3. Purchased merchandising for cash Rs. 5,000.
4. Sold goods Rs. 1,700 on cash and Rs. 1,300 on account.
5. Cash received from Manzoor Alam Rs. 200.
12. Paid to Naima Kayani Rs. 150.
14. Bought furniture worth of Rs. 200.
15. Purchased goods from Muhammad Abid Tariq on credit Rs. 2,000.
16. Purchase machinery of worth Rs. 20,000 cash down payment was 5,000 and remaining note payable.
19. Received advance payment from customers Rs. 5,200, services will be provided in December.
20. Paid electric charges Rs. 225.
24. Paid salaries Rs. 250.
25. Bought goods from Maria Muhammad Rs. 4,000 and by cash from Seemab Akhter Co. Rs 2,000.
28. Received commission Rs. 750.
28. Owner draws out Rs. 700 from the business for his own use.
29. Accrued expenses Rs. 1,500.
30. Sale of marketable securities that cost Rs. 6,000 for Rs. 7,500.

6. From the following particulars write up the two column cash book (Cash and Bank) for Habib Ullah Sadiq Trading Co. for the month of Oct 2016:

2016 Oct

1. Cash in hand Rs. 16,000; Bank balance Overdraft Rs. 4,000
3. Paid Salaries and Wages Rs. 1,200 by cash and Rent by check Rs. 400
5. Cash Sales Rs. 5,000 and Credit Sales Rs. 1,000
7. Rs. 3,000 bring by owner of the business, of which Rs. 2,000 was banked and the balance was retained
8. Received a check from Mr. Kamal and deposited into the bank of worth Rs. 8,000
9. Withdrew from bank for business purpose Rs. 3,000 and for office use Rs. 7,000
13. Received check from Ahmed of Rs. 12,000 which was not deposited in same date
15. Purchased goods for cash Rs. 2,400
17. Ahmed check received on 13th October were deposited into bank

23. Paid Insurance Premium by check of Rs. 800
25. Sales by cash Rs. 8,000
30. Check received form Ahmed was dishonored and return by bank

7. Record the following transaction in a suitable cash book of Ms. Anjum Iqbal for the month of March 2017, and show the closing balances of cash and bank (all figures in rupees)?

1 He had cash in hand ……………… 50,000
2 Opened a Bank Account ………….. 30,000
4 Received cash from customer Ahmed . 4,000
6 Paid to creditor Ali by bank ………… 500
7 Purchase by cash ……………………… 1,000
10 Rent paid ……………………………… 250
11 Owner withdrawn by bank …………… 3,000
12 Cash Sales ……………………………… 5,000
14 Received check from Debtor Jamal … 10,000
15 Paid wages …………………………… 200
17 Buy furniture paid check ……………… 4,000
19 Cash Purchases of Inventory………… 3,000
20 Deposited Jamal's check ……………… 10,000
21 Drawing by cash ……………………… 1,500
22 Paid Electricity bill by check …………… 350
23 Taxes payment made ………………… 100
24 Merchandising purchases by bank ……. 7,000
25 Sales by check (not deposited) …………12,000
26 Sales to Bilal on credit ………………… 5,000
27 Purchase Machinery …………………… 2,000
28 Received debtor's check and deposited .. 3,000
29 Paid railway freight by bank ……………… 250
29 Purchase stamps & stationery…………… 20
30 Withdrawal cash for business use ………. 2,500

8. Enter the following transactions in a simple cash book for December 2016

	₹
01- Cash in hand	12,000
05- Cash received from Bhanu	4,000
07-Rent Paid	2,000
10-Purchased goods Murari for cash	6,000
15-Sold goods for cash	9,000

18- Purchase Stationery	300
22-Cash paid to Rahul on account	2,000
28-Paid salary	1,000
30-Paid Rent	500

9. Prepare a double column cash book with the help of following information for December 2016:

01-Started business with cash-1,20,000

03-Cash paid into bank-50,000

05-Purchased goods from Sushmita-20,000

06-Sold goods to Dinker and received a cheque-20,000

10-Paid to Sushmita cash-20,000

14-Cheque received on December 06, 2016 deposited into bank

18-Sold goods to Rani-12,000

20-Cartage paid in cash-500

22-Received cash from Rani-12,000

27-Commission received-5,000

30-Drew cash for personal use-2,000

10. Prepare double column cash book from the following information for July 2017:

01-Cash in hand- 7,500
Bank overdraft-3,500
03-Paid wages-200
05-Cash sales-7,000
10-Cash deposited into bank-4,000
15-Goods purchased and paid by cheque-2,000
20-Paid rent-500
25-Drew from bank for personal use-400
30-Salary paid-1,000

6.13 3 REFERENCES/SUGGESTED READINGS

1. R.L. Gupta (2001), “Advanced Accountancy”, Sultan Chand & Sons, New Delhi.
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3. R. Narayanaswamy (2003), “Financial Accounting”, Prentice Hall of India, New Delhi.
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Unit-II
FINAL ACCOUNTS

Lesson-7
PREPARATION OF PROFIT AND LOSS ACCOUNT AND BALANCE SHEET

STRUCTURE

7.0 OBJECTIVES

After going through this chapter, you should be able-

- To know the meaning of financial statements.
- To understand the meaning and preparation of Trading Account, Manufacturing Account, Profit and Loss Account, and Balance Sheet
- To know the meaning of Adjustments and Accounting treatment of the same.

7.1 INTRODUCTION

The transactions of a business enterprise for the accounting period are first recorded in the books of original entry, then posted therefrom into the ledger and lastly tested as to their arithmetical accuracy with the help of trial balance. After the preparation of the trial balance, 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, and (ii) Where does he stand now? In other words, what is his financial position?

For the above said purposes, the businessman prepares financial statements for his business i.e. he prepares the Trading and Profit and Loss Account and Balance Sheet at the end of the accounting period. These financial statements are popularly known as final accounts. The preparation of financial statements depends upon whether the business concern is a trading concern or manufacturing concern. If the business concern is a trading concern, it has to prepare the following accounts along with the Balance Sheet: (i) Trading Account; and (ii) Profit and Loss Account.

But, if the business concern is a manufacturing concern, it has to prepare the following accounts along with the Balance Sheet: (i) Manufacturing Account; (ii) Trading Account; and (iii) Profit and Loss
Account. Trading Account is prepared to know the Gross Profit or Gross Loss. Profit and Loss Account discloses net profit or net loss of the business. Balance sheet shows the financial position of the business on a given date. For preparing final accounts, certain accounts representing incomes or expenses are closed either by transferring to Trading Account or Profit and Loss Account. Any Account which cannot find a place in any of these two accounts goes to the Balance Sheet.

7.2 MANUFACTURING ACCOUNT

The concern which are engaged in the conversion of raw materials into finished goods, are interested to knowing the cost of production of the goods produced. The cost of the goods produced cannot be obtained from the Trading Account. So, it is desirable to prepare a Manufacturing Account prior to be preparation of the Trading account with the object of ascertaining the cost of goods produced during the accounting period. The format of Manufacturing Account is given as under:

Manufacturing Account

Dr. (For the period ended . . . .) Cr.

Particulars	Amount	Particulars	Amount
To Work-in progress (Opening)		By Work-in progress (Closing)	
To Raw materials consumed:		By Sale of scrap	
Opening stock		By Cost of production of finished goods	
Add: Purchase of raw materials			
Less: Closing stock of raw materials			
To direct wages			
To factory overheads			

Important Points Regarding Manufacturing Account

1. Raw Materials Consumed: The cost of raw materials consumed to be included in the debit side of the Manufacturing Account shall be calculated as follows:

		Rs.
Opening Stock of raw materials	....	
Add Purchases of raw materials	....	....
Less Purchase return of raw materials	....	
Less Closing stock of raw materials	....	
Cost of raw material consumed		

2. Direct Expenses: The expenses and wages that are directly incurred in the process of manufacturing of goods are included under this head..

3. Factory Overheads: The term "overheads" includes indirect material, indirect labour and indirect expenses. Therefore, the term "factory overheads" stands for all factory indirect material, indirect labour and indirect expenses.

Examples of factory overheads are: rent for the factory, depreciation of the factory machines and insurance of the factory, etc.

4. Cost of Production: Cost of production is computed by deducting from the total of the debit side of the Manufacturing Account, the total of the various items appearing on the credit side of the Manufacturing Account.

7.3 TRADING ACCOUNT

After the preparation of trial balance, the next step is to prepare Trading Account. Trading Account is one of the financial statements which shows the result of buying and selling of goods and/or services during an accounting period. The main objective of preparing the Trading Account is to ascertain gross profit or gross loss during the accounting period. Gross Profit is said to have made when the sale proceeds exceed the cost of goods sold. Conversely, when sale proceeds are less than the cost of goods sold, gross loss is incurred. For the purpose of calculating cost of goods sold, we have take into consideration opening stock, purchases, direct expenses on purchasing or manufacturing the goods

and closing stock. The balance of this account i.e. gross profit or gross loss is transferred to the Profit and Loss Account.

FORMAT OF A TRADING ACCOUNT

Now let us consider the preparation of Trading Account from out of the Trial Balance and the value of the closing stock. A model Trading Account is given below:

TRADING ACCOUNT
for the year ended --------------

Dr. Cr.

	Rs.	Rs.		Rs.	Rs.
To Opening stock			By Sales Less Sales Returns		
To Purchases			By Closing Stock		
Less Purchases Returns					
To Carriage on Purchases					
To Freight and Insurance					
To Duty and Clearing charges					
To Wages					
To Fuel, Coal, Gas, etc.					
To Factory Lighting					
To Factory Rent					
To Manufacturing Expenses					
To Gross Profit Transferred to P & L A/c					

7.4 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:

(a) Opening stock
(b) Closing stock

Opening stock refers to the closing stock of unsold goods at the end of previous accounting period which has been brought forward in the current accounting period. This is shown on the debit side of the
Trading Account.

Closing stock refers to the stock of unsold goods at the end of the current accounting period. Closing stock is valued either at cost price or at market price whichever is less. Such valuation of stock is based on the principle of conservatism which lays down that the expected profit should not be taken into account but all possible losses should be duly provided for.

Closing stock is an item which is not generally available in the trial balance. If it is given in Trial Balance, it is not to be shown on the credit side of Trading Account but appears only in the Balance Sheet as an asset. But if it is given outside the trial balance, it is to be shown on the credit side of the Trading Account as well as on the asset side of the Balance Sheet.

2. Purchases

Purchases refer to those goods which have been bought for resale. It includes both cash and credit purchases of goods. The following items are shown by way of deduction from the amount of purchases:

(a) Purchases Returns or Return Outwards.

(b) Goods withdrawn by proprietor for his personal use.

(c) Goods received on consignment basis or on approval basis or on hire purchase.

(d) Goods distributed by way of free samples.

(e) Goods given as charity.

3. Direct Expenses

Direct expenses are those expenses which are directly attributable to the purchase of goods or to bring the goods in saleable condition. Some examples of direct expenses are as under:

(a) Carriage Inward: Carriage paid for bringing the goods to the godown is treated as carriage inward and it is debited to Trading Account.

(b) Freight and insurance: Freight and insurance paid for acquiring goods or making them saleable is debited to Trading Account. If it is paid for the sale of goods, then it is to be charged (debited) to Profit
and Loss Account.

(c) Wages: Wages incurred in a business is direct, when it is incurred on manufacturing or merchandise or on making it saleable. Other wages are indirect wages. Only direct wages are debited to the Trading Account. Other wages are debited to the Profit and Loss Account. If it is not mentioned whether wages are direct or indirect, it should be assumed as direct and should appear in the Trading Account.

(d) Fuel, Power and Lighting Expenses: Fuel and power expenses are incurred for running the machines. Being directly related to production, these are considered as direct expenses and debited to Trading Account. Lighting expenses of factory is also charged to Trading
Account, but lighting expenses of administrative office or sales office are charged to Profit and Loss Account.

(e) Octroi: When goods are purchased within municipality limits, generally octroi duty has to be paid on it. It is debited to Trading Account.

(f) Packing Charges: There are certain types of goods which cannot be sold without a container or proper packing. These form a part of the finished product. One example is ink, which cannot be sold without a bottle. These type of packing charges are debited to Trading Account. But if the goods are packed for their safe despatch to customers, i.e. packing meant for transportation or fancy packing meant for advertisement will appear in the Profit and Loss Account.

(g) Manufacturing Expenses: All expenses incurred in manufacturing the goods in the factory such in factory rent, factory insurance etc. are debited to Trading Account.

(h) Royalties: These are the payments made to a patentee, author or landlord for the right to use his patent, copyright or land. If royalty is paid on the basis of production, it is debited to Trading Account and if it is paid on the basis of sales, it is debited to Profit and Loss Account.

4. Sales

Sales include both cash and credit sales of those goods which were purchased for resale purposes. Some customers might return the goods sold to them (called sales return) which are deducted from the sales in the inner column and net amount is shown in the outer column. While ascertaining the amount of sales, the following points need attention:

(a) If a fixed asset such as furniture, machinery etc. is sold, it should not be included in sales.

(b) Goods sold on consignment or on hire purchase or on sale or return basis should be recorded separately.

(c) If goods have been sold but not yet despatched, these should not be shown under sales but are to be included in closing stock.

(d) Sales of goods on behalf of others and forward sales should also be excluded from sales.

7.5 PROFIT AND LOSS ACCOUNT

Trading Account results in the gross profit/loss made by a businessman on purchasing and selling of goods. It does not take into consideration the other operating expenses incurred by him during the course of running the business. Besides this, a businessman may have other sources of income. 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 net loss suffered by a business during a particular period. All the indirect revenue expenses and losses are shown on the debit side of the Profit and Loss Account, whereas all indirect revenue incomes are shown on the credit side of the Profit and Loss Account. Profit and Loss Account measures net income by matching revenues and expenses according to the accounting principles. Net income is the difference between total revenues and total expenses. In this connection, we must remember that all the expenses, for the period are to be debited to this account - whether paid or not. If it is paid in advance or outstanding, proper adjustments are to be made (Discussed later). Likewise all revenues, whether received or not are to be credited. Revenue if received in advance or accrued but not received, proper adjustment is required.

A proforma of the Profit and Loss Account showing probable items therein is as follows:

FORMAT OF A PROFIT AND LOSS ACCOUNT

Profit and Loss Account for the year ended 31st December, . .

Dr. Cr.

	Rs.		Rs.
To Salaries		By G.P. transferred from Trading A/c	
To Rent, Rates &Taxes			
To Printing and Stationery		By Discount (Cr.)	
To Postage and Telegram		By Interest (Cr.)	
To Insurance		By Commission (Cr.)	
To Repairs and Renewals			
To Interest			
To Trade Expenses			
To Stable Expenses			
To Travelling Expenses			
To Commission			
To Discount			
To Advertisement			
To Packing Expenses			
To Bad debts			
To Carriage Outwards			
To Net Profit transferred to Capital A/c			

Important points in Profit and Loss account

1. Selling and Distribution Expenses :These expenses are incurred for promoting sales and distribution
of sold goods. Example of such expenses are godown rent, carriage outwards, advertisement, cost of after sales service, selling agents commission, etc.

2. Management Expenses : These are the expenses incurred for carrying out the day-to-day administration of a business. Expenses, under this head, include office salaries, office rent and lighting, printing and stationery and telegrams, telephone charges, etc.

3. Maintenance Expenses : These expenses are incurred for maintaining the fixed assets of the administrative office in a good condition. They include repairs and renewals, etc.

4. Financial Expenses : These expenses are incurred for arranging finance necessary for running the business. These include interest on loans, discount on bills, etc.
5. Abnormal Losses : There are some abnormal losses that may occur during the accounting period. All types of abnormal losses are treated as extra ordinary expenses and debited to Profit and Loss Account. Examples are stock lost by fire and not covered by insurance, loss on sale of fixed assets, etc.
Following are the expenses not to appear in the Profit and Loss Account:
(i) Domestic and household expenses of proprietor or partners.
(ii) Drawings in the form of cash, goods by the proprietor or partners.
(iii) Personal income tax and life insurance premium paid by the firm on behalf of proprietor or partners.

6. Gross Profit: This is the balance of the Trading Account transferred to the Profit and Loss Account. If the Trading Account shows a gross loss, it will appear on the debit side.
7. Other Income : During the course of the business, other than income from the sale of goods, the business may have some other income of financial nature. The examples are discount or commission received.

8. Non-trading Income : Such incomes include interest on bank deposits, loans to employees and investment in debentures of companies. Similarly, dividend on investment in shares of companies and units of mutual funds are also known as non-trading incomes and shown in Profit and Loss Account.

9. Abnormal Gains : There may be capital gains arising during the course of the year, e.g., profit arising out of sale of a fixed asset. Such profit is shown as a separate income on the credit side of the Profit and Loss Account.

7.6 BALANCE SHEET

A Balance Sheet is a statement of financial position of a business concern at a given date. It is called a Balance Sheet because it is a sheet of balances of those ledger accounts which have not been closed till the preparation of Trading and Profit and Loss Account. After the preparation of Trading and Profit and Loss Account the balances left in the trial balance represent either personal or real accounts. In other words, they either represent assets or liabilities existing on a particular date. Excess of assets over liabilities represent the capital and is indicative of the financial soundness of a company.

A Balance Sheet is also described as a “Statement showing the Sources and Application of Capital”. It is a statement and not an account and prepared from real and personal accounts.

The left hand side of the Balance Sheet may be viewed as description of the sources from which the business has obtained the capital with which it currently operates and the right hand side as a description of the form in which that capital is invested on a specified date.

Proforma of balance sheet

BALANCE SHEET OF Mr…………………… as on 31st December…………………..

Capital and Liabilities		Rs.	Assets	Rs.
Capital Account	----	----	Good will	----
ADD Net profit	-----	----	Land and Building	----
Loan Account		----	Plant and Machinery	----
Sundry Creditors		----	Fixtures	----
Bank Over draft		----	Patent Rights	----
Bills Payable		----	Closing Stock	----
			Sundry Debtors	----
			Bills Receivable	----
			Cash at Bank	----
			Cash in Hand	----

Characteristics

The characteristics of a Balance Sheet are summarised as under:

(a) A Balance Sheet is only a statement and not an account. It has no debit side or credit side. The headings of the two sides are 'Assets' and 'Liabilities'.

(b) A Balance Sheet is prepared at a particular point of time and not for a particular period. The information contained in the Balance Sheet is true only at that particular point of time at which it is prepared.

(c) A Balance Sheet is a summary of balances of those ledger accounts which have not been closed by transfer to Trading and Profit and Loss Account.

(d) A Balance Sheet shows the nature and value of assets and the nature and the amount of liabilities at a given date.

7.7 Classification of assets and liabilities

Assets : Assets are the properties possessed by a business and the amount due to it from others. The various types of assets are:

(a) Fixed Assets : All assets that are acquired for the purpose of using them in the conduct of business operations and not for reselling to earn profit are called fixed assets. These assets are not readily convertible into cash in the normal course of business operations. Examples are land and building, furniture, machinery, etc.

(b) Current Assets: All assets which are acquired for reselling during the course of business are to be treated as current assets. Examples are cash and bank balances, inventory, accounts receivables, etc.

(c) Tangible Assets: There are definite assets which can be seen, touched and have volume such as machinery, cash, stock, etc.
(d) Intangible Assets: Those assets which cannot be seen, touched and have no volume but have value are called intangible assets. Goodwill, patents and trade marks are examples of such assets.
(e) Fictitious Assets : Fictitious assets are not assets at all since they are not represented by any tangible possession. They appear on the asset side simply because of a debit balance in a particular account not yet written off e.g. provision for discount on creditors, discount on issue of shares etc.
(f) Wasting Assets: Such assets as mines, quarries etc. that become exhausted or reduce in value by their working are called wasting assets.
(g) Contingent Assets: Contingent assets come into existence upon the happening of a certain event or the expiry of a certain time. If that event happens, the asset becomes available otherwise not, for example, sale agreement to acquire some property, hire purchase contracts etc.

In practical no reference is made to contingent assets in the Balance Sheet. At the most, they may form part of notes to the Balance Sheet.

Liabilities: A liability is an amount which a business is legally bound to pay. It is a claim by an outsider on the assets of a business. The liabilities of a business concern may be classified as:
(a) Long Term Liabilities: The liabilities or obligations of a business which are not payable within the next accounting period but will be payable within next five to ten years are known as long term liabilities. Public deposits, debentures, bank loan are the examples of long term liabilities.
(b) Current Liabilities: All short term obligations generally due and payable within one year are current liabilities. This includes trade creditors, bills payable etc.
(c) Contingent Liabilities : A contingent liability is one which is not an actual liability. They become actual on the happenings of some event which is uncertain. In other words, they would become liabilities in the future provided the contemplated event occurs. Since such a liability is not actual liability it is not shown in the Balance Sheet. Usually it is mentioned in the form of a footnote below the Balance Sheet.

7.8 Marshalling of assets and liabilities

The arrangement of assets and liabilities in a particular order is called marshalling of the Balance Sheet. Assets and liabilities can be arranged in the Balance Sheet into two ways:
(a) In order of liquidity.
(b) In order of permanence.

Illustration-1:

Prepare final accounts from the following trail balance of Mr.Saitejas for the year 2021

Particulars	Amount.Rs	Particulars	Amount.Rs
Machinery	4000	Capital	9000
Cash	1000	Sales	12000
Bank	500	Bank loan	4000
Wages	1000	Creditors	4500
Purchases	8000	Dividend	300
Opening stock	6000		
Debtors	4400		
Bills receivable	2900		
Rent	400		
Interest on bank loan	50		
Commission	250		
General expenses	800		
salaries	500		
Total	29800	Total	29800

Adjustments: Closing stock-Rs.8000; Wages outstanding-Rs.100; Salaries unpaid-Rs.100; Rent prepaid-Rs.150; Commission due-Rs.50 and Interest on bank loan yet to paid-Rs.400

Sol:

Trading and Profit & Loss Account of M/s.Saitejas
for the year ending 31-12-2021

Dr **Cr**

Particulars	Amount.Rs	Particulars	Amount.Rs
To opening stock	6000	By sales	12000
To purchases	8000	By closing stock	8000
To wages + outstanding =(1000+100)	1100		
To Gross profit (B/F) C/d	**4900**		
	20000		**20000**
To Rent-prepaid(400-150)	250	By Gross Profit B/d	4900
To commission +Outstanding (250+50)	300	By dividend	300
To general expenses	8000		
To Salaries + Due ((500+100)	600		
To interest on loan paid+ Due(50+400)	450		
To Net Profit (B/F)	**2800**		
Total	**5200**		**5200**

Balance sheet of M/s Saitejas as on 31-12-2021

Liabilities	Amt.Rs	Assets	Amt.Rs
Capital-9000 + Net Profit-2800	11800	Cash	500
Creditors	4500	Bank	1000
Bank loan-4000 +interest due-400	4400	Debtors	4400
Outstanding expenses	250	Bills receivable	2900
Wages-100		Machinery	4000
Salaries-100		Prepaid rent	150
Commission-50		Closing stock	8000
Total	**20950**	**Total**	**20950**

Illustration-2: prepare final accounts of M/s.Manaswini traders for the year ending 30-6-2021

Particulars	Amount.Rs	Particulars	Amount.Rs
Cash	160	Capital	49000
Shares	5000	Sales	130720
Wages	14400	Bank loan@6%	15000
Purchases	93550	Creditors	5760
Opening stock	32400	Apprentice premium	1800
Debtors	12560	Commission	2640
Electricity	2810	Bills payable	7700
Rent	500	Bank od	6600
Interest on bank loan	450		
General expenses	5680		
Drawings	4000		
Buildings	32000		
Coal	4480		
Tax and insurance	2630		
Discount	1100		
Moped	7500		
Total	**219220**	**Total**	**219220**

Adjustments:

1. Closing stock-Rs.47000
2. Six months interest on loan is due.
3. Insurance eprepaid-Rs.230
4. Premium receivable-Rs.200
5. Commission received in advance-Rs.340.

Sol:

Trading and Profit & Loss Account of M/s.Manaswini Traders for the year ending 30-06-2021

Dr **Cr**

Particulars	Amount.Rs	Particulars	Amount.Rs
To opening stock	32400	By sales	136720
To purchases	93550	By closing stock	47000
To wages	14400		
To coal	4480		
To Gross profit (B/F) C/d	**32890**		
	177720		**177720**
To Rent	500	By Gross Profit B/d	32890
To electricity	2810	By Apprentice premium+ receivable (1800+200	2000
To general expenses	5680	By commission-advance(2640-340)	2300
To Discount	1100		
To interest on loan paid+ Due(450+450)	900		
To insurance premium- prepaid(2630-230	2400		
To Net Profit (B/F)	**23800**		
Total	**37190**		**37190**

Balance sheet of M/s Saitejas as on 31-12-2021

Liabilities	**Amt.Rs**	**Assets**	**Amt.Rs**
Capital-9000 + Net Profit-2800 - Drawingfs-4000	68800	Cash	160
Creditors	5760	Shares	5000
Bills payable	7700	Buidings	32000
Bank loan-15000 +interest due-450	15450	Debtors	12560
Bank OD	6600	Moped	7500
Commission advance	340	Apprentice premium	200
		Prepaid insurance	230
		Closing stock	47000
Total	**104650**	**Total**	**104650**

Illustration-3: prepare final accounts of M/s.Swarna Homes for the year ending 31-3-2020

Particulars	Amount.Rs	Particulars	Amount.Rs
Cash	6500	Capital	20000
Bank	1700	Sales	16000
Wages	1000	Creditors	4500
Purchases	2000		
Opening stock	6000		
Debtors	4400		
Buildings	10000		
Bills receivable	2900		
Rent	450		
Commission	250		
Drawings	4000		
General expenses	800		
Furniture	500		
	40500		40500

Adjustments:

Closing stock-Rs.4000; interest on capital @6% pa; interest on drawings@5%pa; wages outstanding-Rs.100; Rent prepaid-Rs.50

Sol:

Trading and Profit & Loss Account of M/s. Swarna Homes for the year ending 30-06-2021

Dr **Cr**

Particulars	Amount.Rs	Particulars	Amount.Rs
To opening stock	6000	By sales	16000
To purchases	2000	By closing stock	4000
To wages	1100		
To Gross profit (B/F) C/d	**10900**		
	20000		**20000**
To Rent-prepaid	400	By Gross Profit B/d	10900
To commission	250	By interest on drawings	200
To general expenses	800		
To interest on capital	1200		
To Net Profit (B/F)	**8450**		
Total	**11100**		**11100**

Balance sheet of M/s Saitejas as on 31-12-2021

Liabilities	Amt.Rs	Assets	Amt.Rs
Capital-20000 + Net Profit-8450 +interest on capital 1200 - Drawings -4000 -Interest on drawings 200	25450	Cash	6500
Creditors	4500	Bank	1700
Wages outstanding	100	Bills receivable	2900
		Debtors	4400
		Buildings	10000
		Furniture	500
		Rent prepaid	50
		Closing stock	4000
Total	**30050**	**Total**	**30050**

Illustration-4

Illustration III: The following balances are extracted from the books of Kautilya & Co. on 31st March, 2006. You are required prepare the Trading and Profit and Loss Account and a Balance Sheet as on that date.

	Rs.		Rs.
Stock on April, 1	500	Commission (Cr.)	200
B/R	2,250	Returns Outwards	250
Purchases	19,500	Trade Expenses	100
Wages	1,400	Office Fixtures	500
Insurance	550	Cash in Hand	250
Sundry Debtors	15,000	Cash at Bank	2,375
Carriage Inwards	400	Rent & Taxes	550
Commission (Dr.)	400	Carriage Outwards	725
Interest on Capital	350	Sales	25,000
Stationary	225	Bills Payable	1,500
Returns Inwards	650	Creditors	9,825
		Capital	8,950

The closing stock was valued at Rs.12,500.

Solution

TRADING & PROFIT AND LOSS A/C OF MESSRS KAUTILYA & CO.

FOR THE YEAR ENDED 31ST MARCH, 2006

	Rs.	Rs.		Rs.	Rs.
To Opening stock		500	By Sales	25,000	
To Purchases	19,500		Less returns	650	24,350
Less returns	250	19,250	By Closing Stock		12,500
To Wages		1,400			
To Carriage Inwards		400			
To Gross Profit c/d		15,300			
		36,850			36,850
To Insurance		550	By Gross Profit b/d		15,300
To Commission		400	By Commission		200
To Interest on Capital		350			
To Stationary		225			
To Trade Expenses		100			
To Rent and Taxes		550			
To Carriage Outwards		725			
To Net Profit transferred to Capital A/c		12,600			
		15,500			15,500

BALANCE SHEET OF MESSERS KAUTILYA & CO

AS ON 31ST MARCH, 2006

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Creditors		9,825	Cash in Hand	250
Bills Payable		1,500	Cash at Bank	2,375
Capital	8,950		Bill Receivable	2,250
Add Net Profit	12,600	21,550	Stock	12,500
			Sundry Debtors	15,000
			Office Fixtures	500
		32,875		32,875

Illustration-5 From the following trial balance of Mr X for the year ending on 31.12.2003. Prepare final accounts with the closing stock of Rs.15, 000.

Particulars	**Debit (Rs)**	**Credit (Rs)**
Stock	46800	-
Returns inwards or sales return	10,000	-
Purchase	2,40,000	-
Rent& rates	4,000	-
Sales	-	3,21,900

Debenture	-	25000
Reserve fund	-	45,000
Debtors	60,000	-
Salaries	3,000	-
Commission Received	-	4,900
Bad debts	2,000	-
Bad debts Provision	-	6,000
Wages	6000	-
Return outwards	-	2000
Bills receivable	25,000	-
Investment	60000	-
Creditors	-	20000
Bank overdraft	-	5000
Cash in hand	11000	-
Good will	26000	-
Capital	-	63,000
Furniture	15000	-
General expenses	2000	-
Discount		18000
Total	**5,10,800**	**5,10,800**

Trading Account

Debit			**Credit (Direct Income)**		
Particulars (Direct Exp)	**Rs**	**Rs**	**Particulars**	**Rs**	**Rs**
To opening Stock		46,800			
To Purchase (-) Purchase Return	2,40,000 2,000	2,38,000	By Sales (-) Sales Return	3,21,900 10,000	3,11,900

To Wages		6,000	By Closing Stock		15,000
To Gross Profit (Balance Amount Transfer to P& L Credit Side)		**36100**			
Total		**3,26,900**			**3,26,900**

Profit and Loss Account

Debit			**Credit (Indirect Income)**		
Particulars (Indirect exp)	**Rs**	**Rs**	**Particulars**	**Rs**	**Rs**
To Rent & Rates		4,000	**By Gross Profit (Transfer from Trading Account)**		**36100**
To Salaries		3000	By Commission received		4,900
To Bad Debts		2000	By Bad debts recovery		6,000
To General expenses		2000	By Discount received		18,000
To **Net Profit (Balance amount transfer to capital A/c in Balance sheet)**		**54,000**			
Total		**65,000**			**65,000**

Balance Sheet

Liabilities	**Rs**	**Rs**	**Assets**	**Rs**	**Rs**
Capital Add: **Net profit** (transfer from P&L A/C)	63,000 **54,000**	1,17,000	Debtors		60,000
Debentures		25,000	Bills receivable		25,000

Reserve fund		45,000	investments		60,000
Creditors		20,000	Cash in hand		11,000
Bank overdrafts		5,000	Good will		26,000
			Furniture		15,000
			Closing stock		15,000
Total		**2,12,000**			**2,12,000**

Illustration-6 From the following trial balance of Mr X for the year ending on 31.12.2003. Prepare final accounts with the closing stock of Rs.20400.

Particulars	Debit (Rs)	Credit (Rs)
Capital		186000
Drawings	15735	
Stock	17280	
Creditors		18900
Debtors	43500	
Machinery	60000	
Patents	22500	
Freeholds land	30000	
Buildings	96000	
Sales		296340
Purchase	122025	
Sales return	2040	
Purchase returns		1500
Cash at bank	7890	
Cash in hand	1620	

Insurance	1800	
General expenses	9000	
Salaries	45000	
Wages	25440	
Fuel	14190	
Carriage on purchase	6120	
Carriage on sales	9600	
Rent		27000
Total	**529740**	**529740**

The following adjustments are to be effected:

1) 5% on debtors is to be written off as bad
2) Salaries for the months June 2003 amounting to Rs.4500 were unpaid.
3) Rent Rs.3, 000 is accrued but received.
4) Depreciate machinery @ 10% and patents

   @10%.

Solution

Trading Account

Debit			**Credit**		
Particulars	**Rs**	**Rs**	**Particulars**	**Rs**	**Rs**
To Stock		17,280			
To Purchase (-) Purchase Return	122025 1500	120525	By Sales (-) Sales Return	2,96,340 2,040	294300
To Wages		25440	BY Closing Stock		20400
To Fuel		14190			
To carriage		6120			

inwards/purchase					
To Gross Profit (Balance Amount Transfer to P& L Credit Side)		**1,31,145**			
Total		**3,14,700**			**3,14,700**

Profit and Loss Account

Debit			**Credit**		
Particulars	**Rs**	**Rs**	**Particulars**	**Rs**	**Rs**
To insurance		1800	**By Gross Profit (Transfer from Trading Account)**		**1,31,145**
To Salaries (+) outstanding Salaries	45000 4500	49,500	By Rent (+) Accrued Rent	27000 3000	30,000
To Bad Debts (43500X5/100)		2175			
To General expenses		9000			
To carriage on sales/ outwards		9600			
To depreciation on machinery (60,000X10/100)		6000			
To depreciation on Patents (22500X10/100)		2250			
To **Net Profit (Balance amount transfer to capital A/c in Balance sheet)**		**80,820**			
Total		**1,61,145**			**1,61,145**

Balance Sheet

Liabilities	Rs	Rs	Assets	Rs	Rs
Capital Add: Net profit (transfer from P&L A/C) (-) Drawings	186000 80820 266820 15735	251085	Debtors (-) Bad Debts (43500X5/100)	43500 2175	41325
Creditors		18900	Machinery (-) depreciation (60,000X10/100)	60,000 6000	54,000
outstanding Salaries		4500	Patents (-) depreciation (22500X10/100)	22500 2250	20250
			Freeholds		30000
			Buildings		96000
			Cash at Bank		7890
			Cash in hand		1620
			Accrued Rent		3000
			Closing stock		20,400
Total		**2,74,485**			**2,74,485**

7.9 ADJUSTMENTS

While preparing trading and Profit and Loss account one point that must be kept in mind is that expenses and incomes for the full trading period are to be taken into consideration. For example if an expense has been incurred but not paid during that period, liability for the unpaid amount should be created before the accounts can be said to show the profit or loss. All expenses and incomes should properly be adjusted through entries. These entries which are passed at the end of the accounting period are called adjusting entries. Some important adjustments which are to be made at the end of the accounting year are discussed in the following pages.

1. Closing Stock

This is the stock which remained unsold at the end of the accounting period. Unless it is considered while preparing the trading account, the gross profit shall not be correct. Adjusting entry for closing stock is as under:

Closing stock Account Dr.

To Trading account

(Being closing stock brought in to books)

Treatment in final accounts

(i) Closing stock is shown on the credit side of Trading account.

(ii) At same value it will be shown as an asset in the balance sheet.

2. Outstanding Expenses

Those expenses which have become due and have not been paid at the end of the accounting year, are called outstanding expenses. For example, the businessman has paid rent only for 4 months instead of one year. This means 8 months' rent is outstanding. In order to bring this fact into books of accounts, the following adjustment entry will be passed at the end of the year:

Rent A/c Dr.

To outstanding Rent A/c

(Being rent outstanding for 8 months)

The two fold effect of the above adjustment will be (i) the amount of outstanding rent will be added to the rent on the debit side of Profit and Loss Account, and (ii) outstanding rent will be shown on the liability side of the Balance Sheet.

3. Prepaid Expenses

There are certain expenses which have been paid in advance or paid for the future period which is not yet over or not yet expired. The benefit of such expenses is to be enjoyed during the next accounting period. Since, such expenses have already been paid, they have also recorded in the books of account of that period for which they do not relate. For example, insurance premium paid for one year Rs.3,600 on 1stJuly, 1996. The final accounts are prepared on 31st March, 1997. The benefit of the insurance premium for the period from 1st April to 30thJune, 1997 is yet to expire. Therefore, the insurance premium paid for the period from 1st April 1997 to 30th June, 1997, i.e. for 3 months, shall be treated as "Prepaid Insurance Premium".

The adjustment entry for prepaid expenses is as under:

Prepaid Expenses Account Dr.

To Expenses Account

(Being the adjustment entry for prepaid expenses)

The amount of prepared expenses will appear as an asset in the Balance Sheet while amount of appropriate expense account will be shown in the Profit and Loss Account by way of deduction from the said expense.

4. Accrued Income

Accrued income means income which has been earned during the current accounting year and has become due but not received by the end of the current accounting period. Examples of such income are income from investments, dividend on shares etc. The adjustment entry for accrued income is as under:

Accrued Income A/c Dr.

To Income A/c

(Being the adjustment entry for accrued income)

Treatment in final accounts

i) The amount of accrued income is added to the relevant item of income on the credit side of the Profit and Loss Account to increase the amount of income for the current year.

ii) The amount of accrued income is a debt due from a third party to the business, so it is shown on the assets side of the Balance Sheet.

5. Income Received in Advance

Income received but not earned during the current accounting year is called as income received in advance. For example, if building has been given to a tenant on Rs.2,400 p.a. but during the year Rs.3,000 has been received, then Rs.600 will be income received in advance. In order to bring this into books of account, the following adjusting entry will be made at the end of the accounting year:

Rent A/c Dr. Rs.600

To Rent Received in Advance A/c Rs.600

The two-fold effect of this adjustment will be:

(i) It is shown on the credit side of Profit and Loss account by way of deduction from the income, and

(ii) It is shown on the liabilities side of the Balance Sheet as income received in advance.

6. Depreciation

Depreciation is the reduction in the value of fixed asset due to its use, wear and tear or obsolescence. When an asset is used for earning purposes, it is necessary that reduction due to its use, must be charged to the Profit and Loss account of that year in order to show correct profit or loss and to show the asset at its correct value in the Balance Sheet. There are various methods of charging depreciation on fixed assets.

Suppose machinery for Rs.10,000 is purchased on 1.1.98, 20% p.a. is the rate of depreciation. Then Rs.2,000 will be depreciation for the year 1998 and will be brought into account by passing the following adjusting entry:

Depreciation A/c Dr. Rs. 2,000

To Machinery A/c Rs.2,000

The two-fold effect of depreciation will be:

(i) Depreciation is shown on the debit side of Profit and Loss Account, and

(ii) It is shown on the asset side of the balance sheet by way of deduction from the value of concerned asset.

7. Interest on Capital

The amount of capital invested by the trader in his business is just like a loan by the firm. Charging interest on capital is based on the argument that if the same amount of capital were invested in some securities elsewhere, the businessman would have received interest thereon. Such interest on capital is not actually paid to the businessman. Interest on capital is a gain to the businessman because it increases its capital, but it is a loss to the business concern.

Calculation of Interest on Capital

Interest is calculated on the opening balance of the capital at the given rate for the full accounting period. If some additional amount of capital has been brought in the business during the course of accounting period, interest on such additional amount of capital is calculated from the date of introduction to the end of the accounting period. The following adjustment entry is passed for allowing interest on capital:

Interest on Capital Account Dr.

To Capital Account

(Being the adjustment entry for interest on capital)

Treatment in final accounts

(i) Interest allowed on capital is an expense for the business and is debited to Profit and Loss Account, i.e. it is shown on the debit side of the Profit and Loss Account.

(ii) Such interest is not actually paid in cash to the businessman but added to his capital account. Hence, it is shown as an addition to capital on the liabilities side of the Balance Sheet.

8. Interest of Drawings

It interest on capital is allowed, it is but natural that interest on drawings should be charged from the proprietor, as drawings reduce capital. Suppose during an accounting year, drawings are Rs.10,000 and interest on drawings is Rs.500. In order to bring this into account, the following entry will be passed:

Drawings A/c Dr. Rs.500

To Interest on Drawings A/c Rs.500

The two-fold effect of interest on drawings will be:
(i) Interest on drawings will be shown on the credit side of Profit and Loss Account, and
(ii) Shown on the liabilities side of the Balance Sheet by way of addition to the drawings which are ultimately deducted from the capital.

9. Bad Debts

Debts which cannot be recovered or become irrecoverable are called bad debts. It is a loss for the business. Such a loss is recorded in the books by making following adjustment entry:

Bad Debts A/c Dr.
To Sundry Debtors A/c
(Being the adjustment entry for bad debts)

Treatment in final accounts

The profit and Loss Account is debited with the amount of bad debts and in the Balance Sheet, the Sundry Debtors balance will be reduced by the same amount in the assets side.

10. Provisions for Doubtful Debts

In addition to the actual bad debts, a business unit may find on the last day of the accounting period that certain debts are doubtful, i.e., the amount to be received from debtors may or may not be received. The amount of doubtful debts is calculated either by carefully examining the position of each debtor individually and summing up the amount of doubtful debts from various debtors or it may be computed (as is usually done) on the basis of some percentage (say 5%) of debtors at the end of the accounting period. The percentage to be adopted is usually based upon the past experience of the business. The reasons for making provision for doubtful debts are two as discussed below:
(i) Loss caused by likely bad debts must be charged to the Profit and Loss of the period for which credit sales have been made to ascertain correct profit of the period.
(ii) For showing the true position of realisable amount of debtors in the Balance Sheet, i.e., provision for doubtful debts will be deducted from the amount of debtors to be shown in the balance sheet.

For example, sundry debtors on 31.12.1998 are Rs.55,200. Further bad debts are Rs.200. Provision for doubtful debts @ 5% is to be made on debtors. In order to bring the provision for doubtful debts of Rs.2,750, i.e., 5% on Rs.55,000 (55,200-200), the following entry will be made:

Profit and Loss A/c Dr. Rs.2,750
To Provision for Doubtful Debts A/c Rs.2,750
(Being Provision for Doubtful Debts provided)

It may be carefully noted that further bad debts (if any) will be first deducted from debtors and then a fixed percentage will be applied on the remaining debtors left after deducting further debts. It is so because percentage is for likely bad debts and not for bad debts which have been decided to be written off.

Treatment in final accounts

(i) The amount of provision for doubtful debts is a provision against a possible loss so it should be debited to Profit and Loss account.

(ii) The amount of provision for doubtful debts is deducted from sundry debtors on the assets side of the balance sheet.

11. Provision for Discount on Debtors

It is a normal practice in business to allow discount to customers for prompt payment and it constitutes a substantial sum. Some times the goods are sold on credit to customers in one accounting period whereas the payment of the same is received in the next accounting period and discount is to be allowed. It is a prudent policy to charge this expenditure (discount allowed) to the period in which sales have been made, so a provision is created in the same manner, as in case of provision for doubtful debts i.e.

Profit and loss account Dr.

To provision for discount on debtors account

(Being provision for discount on debtors provided)

Treatment in final accounts

(i) Provision for discount on debtors is a probable loss, so it should be shown on the debit side of Profit and Loss account.

(ii) Amount of provision for discount on debtors is deducted from sundry debtors on the assets side of the Balance Sheet. Note: Such provision is made on debtors after deduction of further bad debts and provision for doubtful debts because discount is allowable to debtors who intend to make the payment.

12. Reserve for Discount on Creditors

Prompt payments to creditors enable a businessman to earn discount from them. When a businessman receives cash discount regularly, he can make a provision for such discount since he is likely to receive the discount from his creditors in the following years also. The discount received being a profit, the provision for discount on creditors amounts to an addition to the profit.

Accounting treatment of Reserve for Discount on Creditors is just reverse of that in the case of Provision for Discount on Debtors. The adjustment entries for Reserve for Discount on Creditors is as follows:

Reserve for Discount on Creditors Account Dr.

To Profit and Loss Account

(Being the adjustment entry for discount on creditors)

Treatment in final accounts

i) Reserve for discount on creditors is shown on the credit side of Profit and Loss account.

ii) In the liabilities side of the Balance Sheet, the reserve for discount on creditors is shown by way of deductions from Sundry Creditors.

13. Loss of Stock by Fire

In business, the loss of stock may occur due to fire. The position of the stock may be:

(a) all the stock is fully insured.

(b) the stock is partly insured.

(c) the stock is not insured at all.

It the stock is fully insured, the whole loss will be claimed from the insurance company. The following entry will be passed:

Insurance Co. A/c Dr.

To Trading A/c

(Being the adjustment entry for Loss of goods charged from insurance Co.)

The value of goods lost by fire shall be shown on the credit side of the trading Account and this is shown as an asset in the Balance Sheet.If the stock is not fully insured, the loss of stock covered by insurance policy will be claimed from the insurance company and the rest of the amount will be loss for the business which is chargeable to Profit and Loss Account. In this case, the following entry will be passed:

Insurance Co. A/c Dr.

Profit and Loss A/c Dr.

To Trading A/c

(Being the adjustment entry for Loss of goods)

The amount of goods lost by fire is credited to Trading Account, the amount of claim accepted by insurance company shall be treated as an asset in the Balance Sheet, while the amount of claim not accepted is a loss so it will be debited to Profit and Loss Account. If the stock is not insured at all, the whole of the loss will be borne by the business and the adjusting entry shall be:

Profit and Loss A/c Dr.

To Trading A/c

(Being the adjustment entry for Loss of goods)

The double effect of this entry will be (a) it is shown on the credit side of the Trading Account (b) it is shown on the debit side of the Profit and Loss Account.

14. Manager's Commission

Sometimes, in order to increase the profits of the business, manager is given some commission on profits of the business. It can be given at a certain percentage on the net profits but before charging such commission or on the net profits after charging such commission. In both the cases, the adjustment entry will be:

Profit and Loss A/c Dr.

To Commission Payable A/c

(Being the adjustment entry for manager's commission)

Treatment in final accounts

(i) The amount of managers commission being a business expenditure is shown on the debit side of the Profit and Loss account.

(ii) As the commission to manager has not been paid so far, commission payable would be shown as liability on the liability side of balance sheet.

Transactions Requiring Adjustments:

Generally the following transactions require adjustment treatment while preparing final accounts:

1. Closing Stock
2. Expenses and Incomes
3. Depreciation
4. Bad Debts &Provision for Bad Debts
5. Provision for Discount on Debtors
6. Reserve for Discount on Creditors
7. Interest on Capital
8. Interest on Drawings
9. Transfer to Reserves
10. Stock destroyed by Fire
11. Writing off Goodwill/Preliminary Expenses, etc.
12. Goods Drawn for Personal use by the Proprietor
13. Goods included in stock but not recorded in Books
14. Goods under Sale or Return
15. Commission Payable on Net Profits

S. No	Transaction	Accounting Treatment
1	Closing Stock	1. Trading Account - Credit side 2. Balance Sheet - Asset side
2	Outstanding Expenses	1. Add with the concerned expenses 2. Show it as a liability
3	Prepaid Expenses	1. Deduct from concerned expenses 2. Show it as an Asset
4	Outstanding Income	1. Add with the concerned income 2. Show it as an Asset
5	Income Received in Advance	1. Deduct from the concerned income 2. Show it as a liability
6	Depreciation	1. Debit P & L A/c 2. Deduct from the concerned Asset
7	Provision for Bad debts	1. Debit P & L A/c [after deducting old Reserve, if any] 2. Deduct from Sundry Debtors.
8	Reserve for Discount on Debtors	1. Debit P & L A/c 2. Deduct from Sundry Debtors
9	Reserve for Discount on Creditors	1. Credit P & L A/c 2. Deduct from Sundry Creditors
10	Interest on Capital	1. Debit P & L A/c 2. Add with the Capital
11	Interest on Drawings	1. Credit P & L A/c 2. Deduct from capital
12	Transfer to Reserves	1. Debit P & L A/c 2. Show it as a liability
13	Stock Destroyed by Fire	1. Debit Trading Account with the whole value of loss caused by fire 2. Debit P & L A/c with the value of stock not compensated by Insurance Company. 3. Show as asset the amount of compensation given by the Insurance Company.
14	Write off Goodwill/Preliminary Expenses	1. Debit P & L A/c 2. Deduct from Goodwill/ Preliminary Expenses
15	Goods Drawn for personal use by the proprietor	1. Deduct from Purchases 2. Add with the Drawings
16	Goods Included in stock but not recorded in Books	1. Add with purchases 2. Add with Creditors
17	Goods under Sale or Return	1. Deduct from Sales (at selling price) Deduct from Debtors (at selling price) 2. Add with closing stock (at cost price)
18	Commission Payable on Net Profits	1. Debit P & L A/c 2. Show it as a liability (Appropriate calculation should be made to find out the commission payable depending on whether it is before charging commission or after charging commission)

7.10 SUMMARY

Every businessman is interested in knowing about two facts i.e. whether he has earned a profit or suffered losses and what is his financial position. To fulfill above said purposes, the businessman prepares financial statements for his business i.e. trading A/c, Profit & Loss Account and Balance Sheet. Trading Account shows the result of buying and selling of goods/services during an accounting period. Profit & Loss Account considers all the indirect revenue expenses and losses and all indirect revenue incomes. If indirect revenue income exceeds indirect expenses and cases, it is called net loss. Balance sheet is a statement of financial position of a business concern at a given date. The left hand side of the balance sheet shows the liabilities and right hand the assets of the business.

7.11 KEYWORDS

Outstanding Expenses: An expense which has been incurred in an accounting period but for which no enforceable claim has became in that period.

Prepaid Expenses: Expenses which has not incurred but paid in advance.

Amortisation: The gradual and systematic writing off of an asset or an account over an appropriate period.

Assets: Tangible objects or intangible rights owned by an enterprise.

Bad-debt: Debts owed to an enterprise which are considered to be irrecoverable.

Balance Sheet: A statement of the financial position of an enterprise as at a given date.

Contingent Liability: An obligation relating to an existing condition which may arise or not.

Cost of Goods Sold: The cost of goods sold includes opening stock + net purchases + direct expenses.

Provision: An amount retained by way of providing for any known liability which cannot be determined with substantial accuracy.

Reserve: The portion of earnings appropriated by the management for a general or specific purpose.

7.12 SELF ASSESSMENT QUESTIONS

1. Distinguish between Trading Account and Profit and Loss Account. Give a specimen of Trading and Profit and Loss Account with imaginary figures.
2. What is a Balance Sheet? What do you understand by Marshalling used in the balance Sheet? Illustrate the different forms of marshalling.
3. What are closing entries? Give the closing entries which are passed at the end of the accounting period.
4. What are adjustment entries? Why are these necessary for preparing final account.

PROBLEMS TO SOLVE AND UNDERSTAND

1. Prepare trading account from the following ledger balances presented by P. Sen as on 31st March, 2016.

Particulars	₹	Particulars	₹
Stock (1-4-2015)	10,000	Sales	3,00,000
Purchases	1,60,000	Returns inward	16,000
Wages	30,000	Returns outward	10,000
Carriage inwards	10,000	Gas and Fuel	8,000
Freight inwards	8,000		

Additional information:

i. Stock on 31st March, 2016 Rs. 20,000; ii. Outstanding wages amounted to Rs. 4,000 and iii. Gas and fuel was paid in advance for Rs. 1,000

2. From the following particulars presented by Thilak for the year ended 31st March, 2017, prepare profit and loss account.

Particulars	₹	Particulars	₹
Gross profit	1,00,000	Interest received	6,000
Rent paid	22,000	Bad debts	2,000
Salaries	10,000	Provision for bad debts (1-4-2016)	4,000
Commission (Cr.)	12,000	Sundry debtors	40,000
Discount received	2,000	Buildings	80,000
Insurance premium paid	8,000		

Adjustments:

1. Outstanding salaries amounted to Rs. 4,000
2. Rent paid for 11 months
3. Interest due but not received amounted to Rs. 2,000
4. Prepaid insurance amounted to Rs. 2,000
5. Depreciate buildings by 10%
6. Further bad debts amounted to Rs. 3,000 and make a provision for bad debts @ 5% on sundry debtors
7. Commission received in advance amounted to Rs. 2,000

3. From the following balances obtained from the books of Siva, prepare trading and profit and loss account.

Particulars	₹	Particulars	₹
Stock on 01.01.2016	9,000	Bad debts	1,200
Purchases	22,000	Sundry expenses	1,800
Sales	42,000	Discount allowed	1,700
Expenses on purchases	1,500	Expenses on sale	1,000
Bank charges paid	3,500	Repairs on office furniture	600

Adjustments:

i. Closing stock on, 31st December, 2016 was Rs. 4,500

ii. Manager is entitled to receive commission @ 5% of net profit after providing such commission.

4. From the following particulars, prepare the balance sheet of Madhu, for the year ended 31st March, 2018.

Particulars	₹	Particulars	₹
Capital	2,00,000	Sundry creditors	40,000
Drawings	40,000	Bills payable	20,000
Cash in hand	15,000	Goodwill	60,000
Loan from bank	40,000	Sundry debtors	80,000
Bank overdraft	20,000	Land and building	50,000
Investments	20,000	Vehicles	80,000
Bills receivable	10,000	Cash at bank	25,000

The following adjustments were made at the time of preparing final accounts:

i. Outstanding liabilities: Salaries Rs. 10,000; Wages Rs. 20,000; Interest on Bank overdraft Rs. 3,000 and Interest on bank loan Rs. 6,000

ii.Provide interest on capital @ 10% p.a.; iii. Bad debts amounted to Rs. 10,000 and make a provision for bad debts @ 10% on sundry debtors. ; iv. Closing stock amounted to Rs. 1,20,000

v. Depreciate vehicles @ 10% p.a.; Net profit for the year amounted to Rs. 96,000 after considering all the above adjustments.

5. The following balances were extracted from the books of Thomas as on 31st March, 2018

Particulars	₹	Particulars	₹
Purchases	75,000	Capital	60,000
Returns inward	2,000	Creditors	30,000
Opening stock	10,000	Sales	1,20,000
Freight inwards	4,000	Returns outward	1,000
Wages	2,000		
Investments	10,000		
Bank charges	1,000		
Land	30,000		
Machinery	30,000		
Building	25,000		
Cash at bank	18,000		
Cash in hand	4,000		
	2,11,000		2,11,000

Additional information:

i. Closing stock Rs. 9,000; ii. Provide depreciation @ 10% on machinery; iii.Interest accrued on investment Rs. 2,000; Prepare trading account, profit and loss account and balance sheet.

6. Given below are the balances extracted from the books of Nagarajan as on 31st March, 2016.

Particulars	₹	Particulars	₹
Purchases	10,000	Sales	15,100
Wages	600	Commission received	1,900
Freight inwards	750	Rent received	600
Advertisement	500	Creditors	2,400
Carriage outwards	400	Capital	5,000
Cash	1,200		
Machinery	8,000		
Debtors	2,250		
Bills receivable	300		
Stock on 1st January, 2016	1,000		
	25,000		25,000

Prepare the trading and profit and loss account for the year ended 31st March, 2016 and the balance sheet as on that date after adjusting the following:
i. Commission received in advance Rs. 400; ii. Advertisement paid in advance Rs. 150; iii. Wages outstanding Rs. 200; iv. Closing stock on 31st March 2016, Rs. 2,100.

7. Consider the following balances extracted from the books of Jain as on 31st December, 2016.

Prepare the final accounts.

Particulars	₹	Particulars	₹
Capital	20,000	Office Salaries	6,600
Debtors	8,000	Establishment expenses	4,500
Creditors	10,500	Selling expenses	2,300
Purchases	60,000	Furniture	10,000
Sales	80,000	Cash at bank	2,400
Income tax of Jain paid	500	Miscellaneous receipts	600
Opening stock	12,000	Drawings	4,800

Adjustments

a. Salaries outstanding for December, 2016 amounted to Rs. 600
b. Provide depreciation on furniture @ 10% p.a.
c. Provide interest on capital for the year @ 5% p.a.
d. Stock on 31st December, 2016 Rs. 14,000.

8. Edward's books show the following balances. Prepare his trading and profit and loss A/c for the year ended 31st December, 2016 and a balance sheet on at that date.

Debit balances	₹	Credit balances	₹
Drawings	5,000	Capital	1,31,500
Sundry debtors	60,000	Loan at 6% p.a.	20,000
Coal, gas and water	10,500	Sales	3,56,500
Returns inward	2,500	Interest on investments	2,550
Purchases	2,56,500	Sundry creditors	40,000
Stock on 1-1-2016	89,700		
Travelling expenses	51,250		
Interest on loan paid	300		
Petty cash	710		
Repairs	4,090		
Investments	70,000		
	5,50,550		5,50,550

Adjustments:

1. Closing stock was Rs. 1,30,000 on 31st December, 2016.
2. Create 5% provision for bad and doubtful debts on sundry debtors
3. Create provision at 2% for discount on debtors
4. Interest on loan due for 9 months.

9. Following is the trial balance of Brijesh. Prepare final accounts for the year ended on 31st March, 2016.

Particulars	Debit ₹	Credit ₹
Stock as on 01-04-2015	2,00,000	
Purchases and Sales	22,00,000	33,00,000
Returns	1,00,000	80,000
Carriage inwards	50,000	
Salaries	2,60,000	
Insurance	1,20,000	
Wages	80,000	
Bad debts	10,000	
Furniture	7,00,000	
Capital		7,50,000
Printing and stationery	80,000	
Cash at bank	3,15,000	
Petty cash	5,000	
Commission	10,000	
	41,30,000	41,30,000

Adjustments:

1. Stock on 31st March, 2016 was valued at Rs. 4,00,000.
2. Depreciate furniture @ 10% p.a.
3. Insurance of Rs. 60,000 was paid in advance
4. Commission receivable Rs. 50,000.

10. Given below are the balances of Pandian as on 31st March, 2016.

Particulars	Debit ₹	Credit ₹
Capital		1,20,000
Sundry debtors and creditors	22,000	22,500
Sales		59,700
Drawings	2,000	
Cash in hand	8,200	
Cash at bank	30,000	
Wages	2,500	
Purchases	10,000	
Opening stock	30,000	
Business premises	60,000	
Bills receivable	14,500	
Office telephone expenses	3,500	
General expenses	9,000	
Goodwill	10,500	
	2,02,200	2,02,200

Adjustments:

1. The stock value at the end of the accounting period was Rs. 5,000
2. Interest on capital at 6% is to be provided
3. Interest on drawing at 5% is to be provided
4. Write off bad debts amounting to Rs. 2,000
5. Create provision for bad and doubtful debts on sundry debtors @ 10%
6. Prepare final accounts for the year ended 31st March, 2016.

11. From the trial balance of Ajith and the adjustments given below, prepare trading and profit and loss A/c for the year ended 31st March, 2016 and the balance sheet as on that date.

Particulars	Debit ₹	Particulars	Credit ₹
Opening stock	15,000	Capital	25,000
Furniture and fixtures	30,000	Returns outward	1,000
Purchases	40,000	Bills payable	10,000
Sales returns	2,000	Sales	1,24,000
Carriage inwards	10,000	Provision for doubtful debts	500
Office rent	23,000	Provision for discount on debtors	100
Sundry debtors	20,100		
Bank balance	19,600		
Bad debts	900		
	1,60,600		1,60,600

Adjustments:

1. Stock at the end of the year was Rs. 8,000
2. Further bad debts amounted to Rs. 100
3. Create 2% provision for doubtful debts on sundry debtors
4. Create 1% provision for discount on sundry debtors

12. The following trial balance has been extracted from the books of Rajesh on 31st December, 2016.

Debit balance	₹	Credit balance	₹
Drawings	44,000	Capital	1,76,000
Plant and machinery	1,00,000	Cash sales	1,72,000
Opening stock	20,000	Provision for bad and doubtful debts	2,000
Purchases	2,70,000	Bank overdraft	20,000
Wages	62,000	Discount received	6,000
Salaries	70,000	Credit sales	3,00,000
Insurance	45,000	Sundry creditors	24,000
Rent and taxes	17,000		
Sundry debtors	50,000		
Suspense A/c	22,000		
	7,00,000		7,00,000

The following adjustments are to be made:

1. Stock on 31st December, 2016 was Rs. 28,000
2. Unexpired insurance was Rs. 15,000

3. Provision for doubtful debts is to be maintained at 5% on sundry debtors.
4. Depreciate plant and machinery at 20%.

You are required to prepare trading and profit and loss account for the year ended 31st December, 2016 and a balance sheet as on that date.

13. The following trial balance has been extracted from the books of Rajesh on 31st December, 2016.

Debit balance	₹	Credit balance	₹
Drawings	44,000	Capital	1,76,000
Plant and machinery	1,00,000	Cash sales	1,72,000
Opening stock	20,000	Provision for bad and doubtful debts	
Purchases	2,70,000		2,000
Wages	62,000	Bank overdraft	20,000
Salaries	70,000	Discount received	6,000
Insurance	45,000	Credit sales	3,00,000
Rent and taxes	17,000	Sundry creditors	24,000
Sundry debtors	50,000		
Suspense A/c	22,000		
	7,00,000		7,00,000

The following adjustments are to be made:

i. Stock on 31st December, 2016 was Rs. 28,000
ii. Unexpired insurance was Rs. 15,000
iii. Provision for doubtful debts is to be maintained at 5% on sundry debtors.
iv. Depreciate plant and machinery at 20%.

You are required to prepare trading and profit and loss account for the year ended 31st December, 2016 and a balance sheet as on that date.

7.13 REFERENCES/SUGGESTED READINGS

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2. Aggarwal, M.P. (1981), "Analysis of Financial Statements", Natioanl Publishing House, New Delhi.
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Lesson-8

ACCOUNTS FOR NON-PROFIT MAKING ORGANISATIONS

STRUCTURE

8.0 OBJECTIVES

After going through this chapter, you should be able to-

- Know the meaning and objectives of non-profit making organisations.
- Know the meaning and features of Receipts and Payments A/c, Income and Expenditure Account and Balance Sheet.
- Understand the preparation of Income and Expenditure Account and Balance Sheet.

8.1 INTRODUCTION

Non-profit making organisations, also known as non-trading institutions or organisations, include such voluntary associations of persons as are formed for the purpose of providing recreational facilities to its members or to promote art, culture, education, commerce, science, religion and other social and charitable purposes. There is no purchase or manufacture of goods for trading purposes in these non-profit making organisations. The primary object of these institutions is to render a service to their members (or society) or to satisfy members' common needs. The examples of such organisations include sport clubs, educational institutions, hospitals, libraries, temples, churches, urudwaras, masjids. Similarly, the associations of manufacturers or traders and professionals are also non-profit making organisations and include medical councils, banker's association, teachers association, The Institute of Chartered Accountants of India, The Institute of Cost and Works Accountants of India, The Institute of Company Secretaries of India. All these entities are formed for the purpose of promotion and protection of their professional interests. The non-trading organisations too like trading organisations have to prepare the financial statements at the end of the accounting year. The non-trading institutions are different from the trading institutions in several respects. They have not to purchase and sell goods, accept or receive bills of exchange nor do they have too many credit transactions. Most of their transactions are cash transactions and, therefore, they need not maintain as many books of accounts as trading institutions have to maintain. However, they do maintain a cash book and minimum number of such other books which may be required for their purposes. For example, a Register of Members, a Minute Book are maintained in case of a club or a society, a student fee register is maintained in case of a school or a college, 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-trading institution also prepares its final accounts, which include the following:

(i) Receipts and Payments Account,

(ii) Income and Expenditure Account, and

(iii) Balance Sheet.

8.2 RECEIPTS AND PAYMENTS ACCOUNT

Receipts and Payments Account is a summary of cash transactions for a given period. All the receipts, by cash or by cheque, are entered on the debit side, whereas all the payments, by cash or by cheque, are shown on the credit side. It begins with an opening balance (Cash or/and Bank) and is debited with all the items of receipts irrespective of whether they are of capital or revenue nature or whether they pertain to the accounting period or not. The payments are recorded on the credit side without making any distinction between items of capital and revenue nature and irrespective of the fact whether they belong to the accounting period or not. Moreover, this account is not used to record outstanding items of receipts and payments since these are non-cash items. At the end of the accounting period, this account is balanced to ascertain the balance of cash in hand or at the bank or the overspent amount or bank overdraft.

The basic objective of any trading institution dealing in sale of goods or services is to earn profits. Therefore, such trading institutions prepare their accounting records in such a way as to reveal not only true profit or losses but also the precise financial position for each accounting period. However, there are certain institutions which do not deal in purchasing or selling of goods but deal in services with or without profit motive. These are non-trading entities. Charitable institutions like hospitals, educational institutions, clubs, etc., are non-trading institutions which do not carry on any trading and do not have making of profit as one of their objectives. They do not prepare a trading and profit and loss Account.

However, they maintain a Cash Book and, on the basis of entries made in it, prepare a summary of the cash transactions. When presented in an account form, this summary is called Receipts and Payments Account.

Receipts and Payments Account 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 Receipts and payments Account is a summary of total cash receipts and total cash Payments received and made under different heads during a particular period.

Features of Receipts and Payments Account: The main features of the Receipts and Payments Account can be summarized as follows:

(i) It is a Real Account

(ii) It commences with the balance of cash and bank in the beginning of the accounting period.

(iii) 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 are entered in it.

(iv) Only actual receipts and payments are entered.

(v) The balance in the account will show the closing balance of cash in hand and at bank. However, if the credit side exceeds the debit side, it represents the net bank overdraft.

Features

The main features of the Receipts and Payments Account can be summarised as follows:

(a) It is a real account, i.e., it is a summarised copy of cash receipts and cash payments.

(b) It's form is similar to Cash Book (without discount and bank columns) with debit and credit sides. Receipts are recorded on the debit side while payments being entered on the credit side.

(c) It records all receipts and payments irrespective of the distinction between capital and revenue items. In other words, both capital and revenue receipts and payments are included.

(d) Only actual receipts and payments during the accounting period, whether relating to previous or current or succeeding years are recorded in it.

(e) The opening and closing balances in it mean cash in hand/bank in the beginning and at the end, respectively. The balance of Receipts and Payments Account must be debit being cash on hand and/or at bank, unless there is a bank overdraft.

Treatment of income and expenses pertaining to specific funds

Illustration-1: show how would you deal with the following items for the year 2020

Particulars	Dr.Amt.Rs	Cr.Amt.Rs
Tournament fund		5000
Tournament fund investments	5000	
Income from tournament fund investments		600
Tournament expenses	400	

Sol:

Balance sheet of a JCJRC club as on 31-3-2020

Liabilities		Amt.Rs	Assets	Amt.Rs
Tournament fund Add: Receipts Less: Expenses	-5000 600 (400)	5200	Tournament fund investments	5000

Illustration-2: Prepare Receipts and Payments account from the following information of YVC Club for the year ending 2019

Particulars	Amt.Rs	Particulars	Amt.Rs
Balance on 1-1-2019	3000	Billiard table purchased	39000
Entrance fee	5500	Wages paid	53300
Rent paid	52000	Repairs	8060
Stationary purchased	30680	Interest paid	15000
Donations	5000	Closing balance	23960
Special subscription for annual day party	34500		
Subscriptions			
2018	2000		
2019	169000		
2020	3000		

Sol:

YVC CLUB

RECEIPTS AND PAYMENTS ACCOUNT FOR THE YEAR ENDING 2019

Receipts	Amt.Rs	Payments	Amt.Rs
To opening balance	3000	By rent	52000
To entrance fee received	5500	By stationary	30680
To subscription		By billiard table	39000
2018	2000	By wages	53300
2019	169000	By repairs	8000
2020	3000	By interest	15000
To donations	5000	**By closing balance- B/F**	**23960**
To special subscription	34500		
Total	222000	Total	222000

Illustration: From the following particulars taken from the Cash Book of a Club, prepare a Receipts and Payments Account.

Opening Balance: Rs. Cash in hand 100 Cash at bank 500 Receipts: Subscriptions 3,300 Donations 260	Payments: Rent paid 1400 General expenses 210 Postage & stationary 70 Sundry expenses 30 Closing Cash Balance 200

Illustration 1

Prepare a Receipts and Payments Account of the Pondicherry Recreation Club from the following particulars taken out from the Cash Book of the Club:

Opening Balance:	Rs.
Cash in hand	500
Cash at bank	4500
Receipts: Subscriptions: 1994 - 700 1995 - 7000 1996 - 2000	9700
Admission fee	1200
Donations	5000
Sale of old sports materials	900
Investments realized	4000
Payments: Investments purchased Rent paid Sports materials purchased General expenses Postage and stationery Salaries Closing cash balance	 5000 1200 3000 800 100 2200 400

Solution:

Receipts and Payments Account for the year ended…………………

Dr. Cr.

Receipts	**Amount**	**Payments**	**Amount**
To opening balance: Cash in hand 500 Cash at bank 4500	5,000	By Investments " Rent " Sports Materials	5,000 1,200 3,000
" Subscriptions: 1994- 700 1995 - 7000 1996 - 2000	9,700	" General Expenses " Postage & Stationery " Salaries " Closing Balance:	800 100 2,200
" Admission fee	1,200	Cash in hand 400	
" Donations	5,000	Cash at bank 13,100	13,500
" Sale of old sports Materials	900	(Balancing figure)	
"Investments Realized	4,000		
	25,800		25,800

From the above illustration, students are advised to note the following points:

i) The items of Investment (Rs.5000) and Sports materials (Rs.3000) recorded in the credit side relate to Capital Expenditure which are assets;

ii) The depreciation of Sports materials and other assets, if any is unaccounted; and

iii) The accruals and prepayments of income and expense items like subscriptions, rent, etc., are not dealt with in the account.

This is because the Receipts and Payments Account deals, like the Cash Book, exclusively with the actual collections and disbursements (of cash and bank). Therefore, to know the exact result of the year's working, it is essential to prepare an Income and Expenditure Account on the double entry principle which also paves the way for a Balance sheet to appraise one's financial position as at the accounting date.

8.3 INCOME AND EXPENDITURE ACCOUNT

Receipts and Payments Account by itself does not indicate the financial position of any non-trading institution since a large cash balance can result from the sale of an asset; the balance will quickly disappear if current expenses exceed the current income. For the purpose of knowing the exact financial position of the institution, it is necessary to compare current expenses with current incomes and to compile assets and liabilities. For this, we have to prepare an Income and Expenditure Account and a Balance Sheet.

An Income and Expenditure Account is a revenue account of a non-trading institution and may be considered as equivalent to the Profit and Loss Account of a trading concern. It performs the same functions and is compiled and constructed on precisely the same principles.

Its salient features are summarized as follows:

i) It is a nominal account.

ii) Items of revenue nature alone are dealt with in the account, but they are not confined merely to the actual cash transacted during the period covered by it.

iii) All incomes and gains, whether received or accrued, are credited and expense and losses, whether paid or incurred, are debited to it.

iv) Any advance receipt of income or payment of expense is duly adjusted.

v) The final balance of the account, after due adjustments of accruals, pre-payments, provisions, depreciation, etc., represents an excess of income over expenditure or excess of expenditure over income for the relevant period.

The Balance sheet of a non-trading concern is prepared in the usual way and contains particulars of all assets and liabilities of the institution on the date on which it is prepared. The excess of assets over the liabilities is termed as Capital Fund or General Fund. The Capital Fund is made o up of excess of income over expenditure and other incomes or surpluses which might have been capitalized 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 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.

The following points should be remembered while preparing Income and Expenditure account. They are:

1. Entrance Fee.
2. Subscriptions.
3. Life Membership.
4. Donations.

1. Entrance Fee: Entrance Fee is generally considered as an item of income. As such, it is credited to the Income and Expenditure Account. However, some people argue that entrance fee is of a non-recurring nature and therefore they favour capitalizing the entrance fee, in which case it is added to the Capital Fund directly and not credited to the Income and Expenditure Account. But in the absence of any specific instructions in the question, students are advised to treat it as an item of income.

2. Subscriptions: Subscription is a source of income to a non-trading concern. While the Receipts and Payments Account records the actual subscriptions received, the Income and Expenditure Account records only the subscriptions which relate to the Accounting period, whether received or not. Therefore necessary adjustments should be made to find out the actual amount of income from subscription to be recorded to the accounting period.

3. Life Membership: In case of life membership, members have to pay fee only once in their life time. It is a receipt of non-recurring nature and should be added to the capital fund and not credited to the Income and Expenditure Account.

4. Donations: The amount of donation received by a non-trading institution may be treated either as an income or may be capitalized and taken to Balance Sheet depending upon whether it is a specific donation or a general donation. When any donation is received for any specific purpose, it is considered as a specific donation; (eg) donation for instituting a prize, donation for construction of a building. The amount of such donation cannot, therefore, be used for any other purpose. It should be taken to the Balance Sheet on the liabilities side and be used only for purpose for which it is meant, irrespective of the amount. A donation not received for a specific purpose is termed as a general donation. Its treatment depends upon the amount received. If the donation is of a substantial amount, it should be taken to the Balance Sheet on the liabilities side. However, if the amount of donation is small, it can be safely taken to the Income and Expenditure Account.

It is a nominal account of non-trading institutions equivalent to the Profit and Loss Account of the business concerns. It shows the classified summary of incomes, expenses and losses for current accounting period along with the excess of income over expenditure (i.e. surplus) or excess of expenditure over income (i.e. deficit) which is transferred to Capital Fund in the Balance Sheet. It is generally prepared from a given Receipts and Payments Account after making necessary adjustments. An Income and Expenditure Account being itself a nominal account includes only nominal accounts or revenue items. All items of revenue nature (nominal accounts) pertaining to relevant accounting period and, which appear, on the debit side of the Receipts and Payments Account are entered on the credit side (i.e. income side) of the Income and Expenditure Account with necessary adjustments for prepaid or outstanding figures.

Similarly, all the revenue items (nominal accounts) appearing on the credit side of the Receipts and Payments Account will be entered on the debit side (i.e. expenditure side) of the Income and Expenditure Account with necessary adjustments as to prepaid or outstanding items. Thus, items of capital nature, such as purchase of machinery, building, furniture, etc. shall appear in the Balance Sheet. The end balance of the Income and Expenditure Account, which may be either excess of income over expenditure or excess of expenditure over income would be added to or deducted from, as the case may be, the Capital Fund on the liabilities side of the Balance Sheet. Its essential features can be put as follows:

(a) It is debited with the expenses and losses.

(b) It is credited with the incomes.

(c) It records only those incomes, expenses and losses which are of revenue nature.

(d) It records only those incomes, expenses and losses which relates to current accounting year.

(e) It records non-cash items also (e. g. depreciation).

(f) Its balance at the end which represents either the net surplus (if credit side exceeds debit side) or net deficit (if debit side exceeds credit side) is transferred to the Capital Fund in the Balance Sheet.

Illustration: From the information given in Illustration I, prepare an Income and Expenditure Account

Solution

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDING ON..........

Dr. Cr.

Expenditure	Amount (Rs.)	Income	Amount (Rs.)
To Rent	1400	By Subscriptions	3,300
To General Expenses	210	By Donations	260
To Postage & Stationary	70		
To Sundry Expenses	30		
To Excess of Income over Expenditure	1,850		
	3,560		3,560

Distinction between Receipts and Payments Account and income and expenditure account

1. Receipts and Payments Account is a summarised statement of cash receipts and cash payments during a particular period, whereas Income and Expenditure Account is the substitute of Profit and Loss Account for non-trading concerns.

2. While Receipts and Payments Account, just like cash book, commences with opening cash balance/bank balance and closes with closing cash balance/bank balance, Income and Expenditure Account has nothing to do with opening or closing cash/bank balances.

3. Receipts and Payments Account concerns itself with actual cash received or paid during the period and ignores outstanding expenses as well as income accrued whereas Income and Expenditure Account includes all income even if not received and all expenses even if not paid.

4. Though Receipts and Payments Account includes both capital and revenue items, Income and Expenditure Account include revenue items only.

5. While Receipts and Payments Account shows receipts on the debit side and payments on the credit side, Income and Expenditure Account shows income on the credit side and expenses on the debit side.

6. Receipts and Payments Account includes items relating to preceding as well as succeeding years. Income and Expenditure Account, on the other hand, concerns itself, only with income and expenditure of the period to which it relates.

7. In Receipts and Payments Account difference between two sides will represent closing cash/bank balance. In Income and Expenditure Account, the difference will mean either excess of income over expenditure or vice-versa.

8. Receipts and Payments Account is generally accompanied by statement of affairs, whereas Income and Expenditure Account is always accompanied by Balance Sheet.

9. Receipts and Payments Account belongs to the category of “real accounts”, but Income and Expenditure Account belongs to the family of “nominal accounts”.

Difference between Receipts & Payments Account and Income & Expenditure Account:

Receipts and Payments Account		Income & Expenditure Account	
1	It is a summary of cash book and hence receipts are shown on the debit side and payments on the credit side.	1	It is similar to profit & loss account of trading concern and incomes appear on the credit side and expenses on the debit side.
2	It commences with opening cash balance.	2	Without any opening balance.
3	It includes both capital and revenue receipts and payments	3	Excludes all the capital receipts and payments.
4	It ignores accrued incomes and expenses as it deals only with the actual receipts and payments.	4	Deals with all income earned and the expenses incurred for the year actually received and paid or merely accrued.
5	It includes the items pertaining to preceding, current and succeeding years.	5	Confines to the items of current year only and hence the accrued items of the preceding year and prepayments for the succeeding year are excluded.
6	It is usually based on cash system which suggests the absence of double entry and balance sheet	6	Adopts mercantile system which suggests the presence of double entry and balance sheet.
7	Difference between the two sides represents cash at the close, unless a Bank overdraft, and is carried forward to the next year.	7	Difference denotes a surplus or deficit, depending upon the excess of income over expenditure or vice-versa and is merged with the capital fund.

8.4 BALANCE SHEET

Balance Sheet of a non-trading concern is prepared in the usual way and contains particulars of all assets on right-hand side and liabilities on left-hand side of the concern on the date on which it is prepared. The excess of total assets over total outside liabilities is known as Capital Fund. While preparing the Balance Sheet, the excess of income over expenditure is added to the opening Capital Fund and the excess of expenditure over the income is deducted from the opening Capital Fund. 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 concern as on that date.

Items Peculiar to Non-profit making organisations

The technique of preparing the final accounts of a non-trading concern is similar to that of preparing final accounts of a trading concern. However, there are certain peculiar items in case of non-trading institutions. The accounting treatment of these items and their presentation in the final accounts is as follows:

1. Legacy

Legacy refers to the amount which one gets on account of a will. The amount received on account of a legacy appears on the receipts side of Receipts and Payments Account. It should not be treated as an income because it is not of recurring in nature but should be treated as capital receipt, i.e., credited to Capital Fund Account.

2. Donations

This is very common receipt for non-trading institutions. It is a sort of gift in cash or property from some person, firm or a company. It appears on the receipts side of the Receipts and Payments Account, if received in cash. Donations can be for specific purposes or for general purposes. The accounting treatment for these is as follows:

(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 construction of building or for giving prizes to best artist. The amount of such donation cannot, therefore, be used for general purpose. It should be taken to the Balance Sheet on the liabilities side and be used only for the purpose which it is meant, irrespective of the amount.

(b) General donation: A donation not received for a specific purpose is termed as general donation. In case, the general donation is of a big or large amount, it can 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 taken to credit side of the Income and Expenditure Account. Whether the donation is of big amount or small amount would depend on the facts of each case. For example, in case of an educational institution, a sum of Rs. 11,000 can be taken as a small donation, but for a cricket club, a sum of Rs. 11,000 is quite substantial and, therefore, it will be proper to take the amount of such donation received to the Balance Sheet.

Illustration: Following are the extracts from the Receipts and Payments Account of a sports club. You are required to show the different items in the Income and Expenditure Account and Balance Sheet of the club after taking into account the additional information given.

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDING 31ST MARCH, 1999

	Rs.		Rs.
To Donations for Pavilion	5,000		
To Subscriptions for Governor's Party	2,000		
To Donations	1,000		

Additional Information

(i) Amount spent on Pavilion Rs. 1,000.

(ii) Outstanding subscriptions for Governor's Party Rs. 500.

Solution

INCOME AND EXPENDITURE ACCOUNT
FOR THE YEAR ENDING 31ST MARCH, 1999

Dr. Cr.

Expenditure	Rs.	Income	Rs.
		By Donations	1,000

BALANCE SHEET
AS ON 31ST MARCH, 1999

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Fund for Pavilion (donations received)	5,000	Outstanding Subscriptions for Governor's Party	500
Subscriptions for Governor's Party (including outstanding)	2,500	Pavilion (cost incurred)	1,000

3.Subscriptions

This is the major source of revenue income of a non-trading institution. Subscriptions are the amounts paid by the members of such entity to maintain their membership. Subscriptions may be paid periodically (usually on yearly basis) or as a lump sum for life membership. Periodical subscriptions are treated as revenue receipts, whereas life membership subscriptions are usually treated as capital receipts and, thus, are transferred to the Capital Fund. 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 be made to find out the actual amount of income from subscription. The following illustration is being given to clarify this point:

Illustration: From the following extracts of Receipts and Payments Account and the additional information, you are required to calculate the Income from Subscriptions for the year ending 31 December, 1997 and show them in the Income and Expenditure Account, and the Balance Sheet of a Club.

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDING 31ST DECEMBER 1997

Dr. Cr.

Receipts		Rs.	Payments	Rs.
To Subscriptions				
1996	5,000			
1997	30,000			
1998	6,000	41,000		

Additional Information

(i) Subscription outstanding on 31.12.96 Rs. 6,000

(ii) Subscription outstanding on 31.12.97 Rs. 5,000

(iii) Subscription received in advance on 31.12.96 Rs. 6,000

Solution

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDED 31ST DEC., 1997

Dr. Cr.

Expenditure	Rs.	Income	Rs.
		By Subscription	40,000

BALANCE SHEET

AS ON 31-12-97

Liabilities	Rs.	Assets		Rs.
Subscription in advance	6,000	Subscription Outstanding		
		for 1996 (6000-5000)	1,000	
		for 1997 (5000-1000)	4,000	5,000

Working Note: Calculation of Subscription Income for 1997-

a) Subscription received during 1997 for 1997 Rs. 30,000

b) Subscription received during 1996 for 1997 Rs.6,000

c) Subscription outstanding for 1997 as on 31.12.97 Rs.4,000

Rs. 40,000

4. Entrance fee or admission fee

This is the amount of fee usually charged by a club or a society or an educational institution from the new entrants. It is usually taken as an item of income. There are arguments that since it is paid only once for all and of non-recurring nature and, therefore, should be capitalised and taken to the liabilities side of the Balance Sheet. But another argument is that though it is paid by each member only once, the club or institution receives it regularly because of frequent changes in its membership for one reason or the other. Accordingly, it should be treated as revenue income and credited to Income and Expenditure Account. In the absence of any specific instructions about entrance fee in the question, any one of the above treatment may be followed but students should append a note justifying their treatment.

5. Sale of old newspapers and periodicals

The sale proceeds of old newspapers and periodicals is of a recurring nature and should, therefore, be taken as income in the Income and Expenditure Account.

6. Sale of old fixed assets

The sale proceeds of old fixed assets are treated as capital receipts and, thus, are credited to the respective fixed assets account. However, the profit or loss on sale of fixed assets is shown in the Income and Expenditure Account.

7. Sale of sports material

Sale of sports material is a regular feature of clubs and the amount received is treated as an ordinary or revenue income. It is, therefore, shown in the credit side of the Income and Expenditure Account.

8. Endowment Fund

It is a fund arising from a bequest or gift, the income of which is devoted for a specific purpose. Thus, endowment fund is a capital receipt and is shown in the liabilities side of the Balance Sheet.

9. Payment of Honorarium

This is the payment to a person for his specific services rendered by him not as a regular employee. For example, the payment made to a Professor to deliver lecture on a topic or to a Television artist for his/her specific performance, is termed as honorarium. This is an item of expense and is shown in the debit side of the Income and Expenditure Account.

10. Special Funds

An institution may keep special funds for some special purposes. For example, a sports club may keep a special fund for meeting sports expenses or for awarding of sports prizes. In case such special funds, all incomes relating to such funds should be added to these funds in the Balance Sheet on the liabilities side. Similarly, all expenses on account of these funds should be deduced from these funds. In case of a deficit, the amount should be met out from the

Income and Expenditure Account. In case of 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.

Illustration: Following is the information given in respect of certain items of a sports club. You are required to show them in the Income and Expenditure Account and prepare the Balance Sheet of the club.

	Rs.
Sports Fund as on 1.1.1998	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	30,000
General Fund Investments	30,000
Interest on General Fund Investments	4,000

Solution

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDING 31ST DECEMBER, 1998

Dr. Cr.

Expenditure	Rs.	Income	Rs.
		By interest on General Fund Investments	4,000

BALANCE SHEET

AS ON 31ST DECEMBER, 1998

Liabilities		Amount Rs.	Assets	Amount Rs.
Sports Fund	10,000		Sports Fund Investments	10,000
Add Interests on			General Fund Investments	30,000
Sports Fund Investments	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		30,000		

8.5 PREPARATION OF INCOME AND EXPENDITURE ACCOUNT

The practical steps involved in the preparation of an Income and Expenditure Account from the Receipts and Payments Account are as under:

Step I: Ignore opening and closing cash/bank balances appearing in the Receipts and Payments Account.

Step II : Eliminate all items of capital receipts and payments.

Step III : Ascertain the revenue income of the relevant period by excluding from the total receipts, the income received on account of previous and future years. Then add income accrued in the year but not received.

Step IV: Make adjustments as per additional information such as depreciation, bad debts, etc., if any,

Step V: Calculate the difference between the total of debit side and the total of credit side. If the total of credit side exceeds the total of debit side, show the excess of income over expenditure (surplus) on the debit side. If the total of debit side exceeds the total of credit side, the excess of expenditure over income (deficit) on the credit side of Income and Expenditure Account. If surplus add it to the Capital Fund and if deficit deduct from Capital Fund in the Balance Sheet.

Illustration: From the following details and notes attached relating to the Haryana Tennis Club, prepare the final accounts of the year ended 31st December 1998.

On January 1998 the club's assets are:

Freehold Club house Rs. 20,000; Equipment Rs. 1,400; club subscription in arrear Rs. 160; The club owed Rs. 800 to a firm for Christmas 1997 dance catering.

SUMMARY OF RECEIPT AND PAYMENTS FOR 1998

Receipts	Rs.	Payments	Rs.
To Cash in hand	1,520	By Catering-1997 dance	800
To Subscriptions	3,280	By 1998-dances and socials	1,900
To Locker Rent	200	By Band fees-1998 dances	500
To Receipts from dances and socials	2,780	By New lawn-mover	1,060
To Sale of used match tennis balls	300	By Repairs to tennis nets	380
To Sale of old lawn-mover	160	By Match tennis balls	620
		By Match expenses	340
		By Repairs and decoration of club house	1,300
		By Balance c/d	1,340
	8,240		8,240

Notes

(i) The book value on 1 January 1998 of the old lawn mover sold during the year was Rs. 60.

(ii) The club has 40 members and the subscription is Rs.80 each per annum. The subscriptions received in 1998 included those in arrear for 1997.

(iii) On 31 December, 1998 Rs. 220 was owed to Playfair Ltd. for tennis balls supplied.

(iv) Equipment as at 31 December 1998 to be depreciated by 15% p. a.

v) Tennis balls are regarded as revenue expenditure.

Solution

INCOME AND EXPENDITURE ACCOUNT
FOR THE YEAR ENDING ON 31 DECEMBER 1998

Expenditure		Rs.	Income		Rs.
To Band fees		500	By Subscriptions	3,280	
To Repairs to tennis nets		380	Less: Outstanding(1997)	160	
To Tennis balls	620			3,120	
Add: Outstanding	220	840	Add: Outstanding (1998)	80	3,200
To Match expenses		340	By Locker rents		200
To Repairs and decorations		1,300	By Receipts from dance	2,780	
To Depreciation on Equipment			Less: Expenses	1,900	880
(15% of 2,400)		360	By Sale of used match tennis balls		300
To Excess of income over expenditure		960	By Profit on sale of lawn mover		100
		4,680			4,680

BALANCE SHEET
AS ON 1.1.1990

Owing for catering	800	Cash in hand	1,520
Capital Fund (Balancing figure)	22,280	Equipment	1,400
		Freehold club house	20,000
		Subscriptions in arrear	160
	23,080		23,080

BALANCE SHEET
AS ON 31 DECEMBER 1998

Owing for Tenis balls		220	Cash in hand		1,340
Capital Fund	22,280		Equipment	2,400	
Add: Surplus	960	23,240	Less: Depreciation	360	2,040
			Freehold club house		20,000
			Subscriptions in arrear		80
		23,460			23,460

Illustration Prepare income and expenditure account and balance sheet form the following receipt and payment account of a nursing society.

Receipt and Payment Account

Receipts	$	Payments	$
To Balance at bank - 1-7-90	2,010	By Salaries of nurses	656

To Subscriptions	1,115	By Board, laundry and domestic help	380
To Fees from non members	270	By Rent, rates and taxes	200
To Municipal grant	1,000	By Cost of car	2,000
To Donation for building fund	1,560	By Car expenses	840
To Interest	38	By Drugs and incidental exp.	670
		By Balance c/d	1,247
	5,993		5,993

The society owns freehold land costing $8,000 on which it is proposed to build the nurse's hostel. A donation of $100 received to building fund was wrongly included in subscription account. A bill for medicine purchased during the year amounting to $128 was outstanding.

Solution:

Nursing Society
Income and Expenditure Account

Expenditures	$	Income	$
To Salaries of nurses	656	By Subscriptions 1,115	
To Board, laundry and domestic help	380	Less Wrong inclusion 100	1,015
To Rent, rates and taxes	200	By Fees from non members	270
To Car expenses	840	By Municipal grant	1,000
To Drugs and incidental exp.	670	By Interest	38
To Outstanding expenses	128	By Deficit	551
	2,874		2,874

Nursing Society
Balance Sheet on 31st December, 1991

Liabilities	$	Assets	$
Building fund 1,560		Cash	1,247
Add omission 100	1,660		
		Motor car	2,000
Outstanding expenses	128		
		Land	8,000
Capital fund 10,010			
Less deficiency 551	9,459		
	11,247		11,247

8.6 PREPARATION OF RECEIPTS AND PAYMENTS ACCOUNT FROM INCOME AND EXPENDITURE ACCOUNT

The practical steps involved in the preparation of a Receipts and Payments Account from an Income and Expenditure Account are:

Step I Put the ‘opening balances’ of cash/bank as the first item on the ‘Receipts side’ and ‘closing balances’ of cash/bank as the last item on the ‘Payments side’ of the Receipts and Payments Account.

If one of the two balances are given, the other balance will have to be ascertained.

Step II Ascertain ‘Revenue Receipts’ received during the current accounting period as under and show it on the receipts side of Receipts and Payments Account:

Revenue Income (account-wise) for the current year as per Income and Expenditure Account.

Add Income received in advance at the end of current year.

Add Income outstanding in the beginning of current year.

Less Income outstanding at the end of current year.

Less Income received in advance in the beginning of the current year.

Step III Ascertain ‘Revenue Payments’ made during the current accounting period as under and show it on the payments side of Receipts and Payments Account:

Revenue expenses (account-wise) for the current year as per Income and Expenditure Account

Add Expenses outstanding in the beginning of current year.

Add Expenses prepaid at the end of current year.

Less Expenses outstanding at the end of current year.

Less Expenses prepaid in the beginning of current year.

Step IV Ascertain all capital receipts and capital payments from the additional information or Balance Sheets or by preparing the accounts of capital items and show the capital receipts on the ‘Receipts side’ and the capital payments on the ‘Payments side’ of the Receipts and Payments Account.

8.7 SUMMARY

Non-profit making organizations include such voluntary associations of persons as are formed for the purpose of providing recreational facilities to its members or to promote art, culture, education, commerce, science, religion and other social and charitable purposes. At the end of accounting period, a non-profit making organisation also prepare its final accounts, which include namely (i) Receipts and Payments Account; (ii) Income and Expenditure Account; (iii) Balance Sheet. Receipts and Payments Account is a summary of cash transactions for a given period. All the receipts are entered on the debit side and all the payments are shown on credit side. At the end of accounting period, this account is balanced to ascertain the balance of cash in hand or at the bank or the overspent amount or bank overdraft. Income and Expenditure account of non-trading institutions equivalent to the Profit & Loss Account of the business concerns. It shows the classified summary of incomes, expenses and losses for current accounting period along with the excess of income over expenditure (i.e.

Surplus) or excess of expenditure over income (i.e. deficit). The surplus or deficit is being transferred to capital fund in the Balance Sheet. Balance Sheet of a non-profit making organisation is prepared in the usual way and contains all assets on right-hand side and liabilities on left-hand side.

8.8 KEYWORDS

Assets: Tangible objects or intangible rights owned by an enterprise.

Revenue Expenditure: A cost relating to the operations of an accounting period or benefits of which do not extend beyond that period.

Social Cost: The cost or loss to society resulting from the operations of an enterprise.

Social Benefit: The benefits or income of society resulting from the operations of an enterprise.

Legacy: Refers to the amount which one gets on account of a will.

Endowment Fund: The fund arising from a bequest or gift is known as endowment fund. The endowment fund is a capital receipt.

8.9 SELF ASSESSMENT QUESTIONS

1. What is Receipts and Payments Account? What are its features?
2. What is an Income and Expenditure Account? Who prepares it and why?
3. Distinguish between Receipts and Payments Account and Income and Expenditure Account. What steps are required for converting (a) Receipts and Payments Account into Income and Expenditure Account and (b) Income and Expenditure Account into Receipts and Payments Account.
4. Explain the meaning of the following terms and show how will you deal with them while preparing final accounts of a club. Support your answers with suitable examples.

(a) Donations, (b) Entrance fee, (c) Life membership fee, (d) Receipts for a sports fund and (e) Legacy

.

Practical Problems to solve

1. XYZ club has a bar that maintains a separate trading account for its trading activities. Which of the following is the treatment of profit or loss on bar trading activities?
   a) Profit and loss is credit in income statement
   b) Profit and loss to be presented in Receipt and payment account
   c) Profit and loss is added to capital fund.
   d) Profit and loss to be transferred as income and expenditure A/c.
2. Calculate the sports material to be debited to Income & Expenditure a/c. For the yr. ended 31-3-2007 on the basis of the following information. Amount paid for sports material during the yr. was Rs.19, 000

Particulars	1-4-2006 Rs.)	31.3.2007 (Rs.)
Stock of sports material	7,500	6,400
Creditors for sports material	2,00	2,600

a) Rs.20300
b) Rs.20700
c) Rs.20000
d) Rs.20500

3. A non-profit organization received Rs.10,000 as the entrance fee of a new member. If 20% of the fee has to be capitalized, what is the amount of fee needs to be shown in the income and expenditure account?
   b) Rs.9000
   c) Rs.8000
   d) Rs.2000
   e) Rs.5000
4. Prize fund Rs.10000, Interest on prize fund investments Rs.1000, Prize paid Rs.2000, Prize fund investment Rs.8000.What will be its treatment

Rs.20000 on liability side,Rs. 8000 on Assets side
Rs.1000 on liability side,Rs. 8000 on Assets side
Rs.1700 on liability side,Rs. 8000 on Assets side
Rs.9000 on liability side, Rs. 8000 on Assets side

5. Belle, a nongovernmental not-for-profit organization, received funds during its annual campaign that were specifically pledged by the donor to another nongovernmental not-for-profit health organization. How should Belle record these funds?

Increase in assets and increase in revenue
Increase in assets and increase in liabilities
Increase in assets and increase in deferred revenue.
Decrease in assets and decrease in fund balance.

6. Not-for-profit organisations have some distinguishing features from that of profit organisations. State any one of them.
7. What is the capital of a Non-Profit Organization generally known as?
8. Name any two accounts required to be prepared in Financial Statements by Not-For-Profit Organizations at the end of the year.
9. State the main aim of a not-for-profit organisation.

10 Write any four features of Receipt and Payment Account?

10. Calculate the amount of stationery to be posted to Income and Expenditure Account of Indian Cultural Society for the year ending 31st March, 2018 from the following information :

Particulars	1.4.2017	31.3.2018

	(Rs.)	(Rs.)
Stock of stationery	21,000	18,000
Creditors for stationery	11,000	23,000

Stationery purchased during the year ended 31^{st} March 2018 was Rs.75,000. Also, present the relevant items in the Balance Sheet of the society as at 31^{st} March 2018.

11 From the following information, calculate the amount of subscriptions to be credited to the income and expenditure account for the year 2007—08.

	Amt (Rs.)
Subscriptions received during the year	50,000
Subscriptions outstanding on 31st March, 2007	20,000
Subscriptions outstanding on 31st March, 2008	6,000
Subscriptions received in advance on 31st March, 2007	8,000
Subscriptions received in advance on 31st March, 2008 Subscriptions of Rs. 1,500 are still in arrears for the year 2006-07.	9,000

12 Find out the cost of medicines consumed during 2015-16 from the following information

Particulars	Amt (Rs)
Payment for purchase of medicines	3,70,000
Creditors for medicines purchased	
On 1st April, 2015	25,000
On 31st March, 2016	17,000
Stock of medicines	
On 1st April, 2015	62,000
On 31st March, 2016	54,000
Advance suppliers of medicines	
On 1st April, 2015	11,500
On 31st March, 2016	18,200

13 From the following Reciepts and Payments Accounts of Cricket Club and the additional information given, prepare the Income and Expenditure Account for the Year ending 31-12-2018 and Balance sheet as on that date:

RECEIPTS AND PAYMENTS ACCOUNT

for the year ending 31-12-2018

To bal. b/d	Rs.		Rs.
-Cash	3520	By Maintenance	6820
-Bank	27380	By Crockery Purchased	2650
-Fixed Deposit @ 6%	30000	By Match Expenses	13240
To Subscription (including	40000	By Salaries	11000

Rs. 6000 for 2017)			
TO Entrance fees	2750	By Conveyance	820
To Donation	5010	By Upkeep of Lawns	4240
To Interest on Fixed Deposits	900	By postage stamps	1050
To Tournament Fund	20000	By Purchase Of cricket goods	9720
To Sale of Crockery(book value Rs. 1200)	2000	By Sundry expenses	2000
		By Investments	5700
		By Tournament Expenses	18800
		By balance c/d:	
		-Cash	2200
		-Bank	23320
		Fixed Deposits	30000
	131560		131560

Additional Information:

Salary outstanding is Rs. 1000.

Opening Balance of Stock of Postage and Stationery and Cricket gods is Rs. 750 and Rs. 3210 respectively. Closing stock of the same is Rs. 900 and Rs. 2800 respectively.

Outstanding subscription for 2017 and 2018 is Rs. 6600 and Rs. 8000 respectively.

14 Receipt and Payment Account of Shankar Sports club is given below, for the year ended March 31, 2017

Receipt and Payment Account for the year ending March 31, 2017			
Receipts	Amount Rs	Payments	Amount Rs
Opening Cash in hand	2,600	Rent	18,000
Entrance fees	3,200	Wages	7,000
Donation for building	23,000	Billiard table	14,000
Locker rent	1,200	Furniture	10,000
Life membership fee	7,000	Interest	2,000
Profit from entertainment	3,000	Postage	1,000
Subscription	40,000	Salary	24,000
	……	Cash in hand	4,000
	80000		80000

Prepare Income and Expenditure Account and Balance Sheet with help of following Information:

Subscription outstanding on March 31, 2016 is Rs 1, 200 and Rs 2,300 on March 31, 2017, opening stock of postage stamps is Rs 300 and closing stock is Rs 200, Rent Rs 1,500 related to 2015 and Rs 1,500 is still unpaid.

On April 01, 2016 the club owned furniture Rs 15,000, Furniture valued at Rs 22,500

On March 31, 2016. The club took a loan of Rs 20,000 (@ 10% p.a.)

Problems:

1. From the following details of the City Club for the year ended 31st December 1990, prepare the Receipts and payments account for the same:

Cash (Jan. 1, 1990) in hand 200 at bank 3000	3,200
Subscriptions and donations received	1,500
Purchase of government securities	2,300
Sale of tickets for annual dinner	350
Expenses of annual dinner and entertainment	250
Interest on bank deposits	80
Dividends received	200
Contributions for flood & famine victims	50
Furniture purchased	200
Rent and hire charges paid	220
Postage, printing and stationery	40
Periodicals and newspaper	260
Secretary's honorarium and sundries	110
Cash in hand (31st Dec. 1990)	200

(Ans: Closing cash at Bank Rs. 1,700)

3. From the following particulars relating to Hindu Mission Charitable Hospital, prepare Income and Expenditure Account for the year ended 31st December, 1994 and Balance sheet on that date.

Receipts and Payments Account

For the year ended 31st December 1994

Receipts	Rs.	Payments	Rs.
To Cash in hand on		By Medicines	30,590
1st Jan. 1994	7,130	" Doctor's honorarium	9,000
" Subscriptions	47,996	" Salaries	27,500
" Donations	14,500	" Petty expenses	461
" Interest on investment		" Equipment	15,000
@ 7% for full year	7,000	" Expenses on Charity	750
" Proceeds from Charity		" Cash in hand on 31st	3,775
Show	10,450	December 1984	
	87,076		87,076

Additional information	1.1.94	31.12.94
	Rs.	Rs.
i) Subscription due	240	280
ii) Subscription received in advance	64	100
iii) Stock of medicines	8,810	9,740
iv) Estimated value of equipment	21,200	31,600
v) Building (cost less depreciation)	40,000	38,000
vi) Creditors for medicines	10,000	8,000

[Ans: Excess of Income over expenditure Rs.7,979; Balance sheet as at 31.12.94 Total-183395; capital fund as on 1.1.94 Rs.167316]

6. Dr. S.K. Sharma commenced practice as a dentist, investing Rs.50,000 in equipment, on 1st January 1993. The Receipts and Payments account for the year was as follows:

	Rs.		Rs.
To Fees	1,00,000	By Rent	6,000
" Miscellaneous receipts	200	" Salaries to assistants	15,000
" Equipment sold	4,000	" Journals	2,000
		" Library books	6,000
		" Equipment purchased	8,000
		" Drawings	24,000
		" Balance:	
		at Bank	43,000
		at hand	200
	1,04,200		**1,04,200**

Rs. 3000 of the fees were still outstanding. Equipment sold and purchased was on 1st October 1993, the cost of Equipment sold being Rs.6000. Depreciation on equipment is 20% and on library books 5%. Salary to assistants still payable is Rs.2000. Prepare the Receipts and Expenditure account and Balance Sheet relating to 1993. [Ans: Surplus - Rs. 63,709 Balance sheet total Rs. 91,700]

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Unit-3

Lesson-9
PARTNERSHIP ACCOUNTS

STRUCTURE

1.0 OBJECTIVES

After going through this lesson, you will be able to- •

Understand the meaning and accounting aspects of partnership firms

Differentiate between various types of partners and procedures during admission, retirement and dissolution of firm

• Know development of accounting books and closing procedure in case of changes in the partnership.

• Explain the importance of partnership accounting in the view point of legality.

Partnership is a form of organization for doing business. Under an agreement, two or more persons join together to do a business and share its profit. The business may be run by all or by one among them acting for all. Partnership accounts include not only finalization of accounts but also solving problems that are special in nature to partnership organization viz., appropriation of profits, admission of partner, death and retirement of partner, dissolution of partnership, insolvency of partners etc. Partnership accounts are governed by general principles of accountancy, partnership agreement (deed) and Partnership Act, 1932. The terms of the agreement among partners may be either verbal or in writing. If it is in writing, it is known as Partnership Deed. It is desirable to have it in writing. Following are the usual contents of the Partnership Deed.

Contents of Partnership Deed

1. Names and addresses of the firm and partners.
2. Nature of the business.
3. Date of commencement of partnership.

4. Duration of partnership.
5. Amount of capital contributed or to be contributed by each partner
6. Amount of drawings allowed by the firm to each partner.
7. Rules regarding operation of bank accounts.
8. Interest on partners capital and drawings.
9. Ratio in which profits and losses are to be shared.
10. Interest on loan by the partners to the firm.
11. Salaries, commission, etc. if payable to partners.
12. Methods of keeping accounts and audit.
13. Rights, duties and liabilities of the partners.
14. Accounting treatment in case of admission, retirement, death etc of a partner.
15. Mode of settlement of accounts on dissolution of the firm.
16. Method of settling disputes amongst the partners.

In case the Partnership Deed is silent on certain matters, the relevant provisions of the Partnership Act shall be applicable. Following are the provisions of the Partnership Act, which have a direct bearing on the accounting treatment of certain items, in case the Deed is silent on these utters.

1. Partners share profits or losses equally.
2. No interest is charged on partners' capital.
3. No interest is charged by the firm on partners' drawings.
4. No partner is entitled to salary or commission.
5. 6% interest is charged on partners' loan.

Appropriation of Profit

In a proprietary organization, the entire profit belongs to the proprietor alone, but in a partnership it has to be shared among all partners. So the profit shown by the profit and loss account is to be apportioned among partners according to the terms of partnership deed, or in case it is silent, according to the provisions of the Act.

Sometimes the Deed may provide salary to a partner, who is managing the firm, interest on partners' capital and interest on partners' drawings. These items are to adjusted and the remaining profits are to be appropriated among the partners. In this context, a Profit and Loss (Appropriation) Account is prepared to appropriate profits among partners.

Format of Profit and Loss (Appropriation) Account

		Rs.			Rs.
To Salary to partner			By Profit & Loss a/c (Net profit)		-------
	X — Y —	------	By Interest on drawings X — Y —		-------
To Interest on capital	X — Y —	-------			
To Reserve fund					
To Capital account	X — Y —	-------			
(Profits transferred)		------- -------			

Fixed and Fluctuating Capital

Capital accounts of partners are maintained either under fixed capital system or under fluctuating capital system. Under fixed capital system, a capital account and a current account is opened for each partner. A partner's original contribution is shown in his fixed capital account and all other entries like his share of profit, salary, drawings, interest on capital and interest on drawings are shown in his current account whereas in fluctuating capital system a partner's original contribution as well as other items are shown in his capital account. Here there is only one capital account for each partner.

Example 1.

On January 1, 1993, X, Y, Z entered into a partnership contributing Rs.3,00,000, Rs.2,00,000 and Rs.1,00,000 respectively and sharing the profits in the ratio 2:2:1. X and Y are entitled to an annual salary of Rs.30,000 and Rs.15,000 respectively. 5% interest on capital is to be allowed. Interest on drawings is to be charged at 6%. The drawings of X, Y and Z are Rs.1500, Rs.1000, Rs.500 per month respectively drawn at the end of every month. Profits for the year ended 1993, before the above adjustment were Rs.1,50,000. Show how the profit is distributed and also prepare the capital accounts (a) if ithey are fluctuating (b) if they are fixed.

Solution

Profit and Loss (Appropriation) Account (Fig.in rupees)

		Rs.			Rs.
To Partner's Salary			By Net Profit		1,50,000
	X 30,000 Y 15,000	45,000	By Interest on drawings	X 495 Y 330 Z 165	990
To Interest on capital	X 15,000 Y 10,000 Z 5,000	30,000			
To Capital account	X 30,396 Y 30,396 Z 15,198	75,990			
		1,50,990			1,50,990

Date	Particulars	X	Y	Z	Date	Particulars	X	Y	Z
1993	To Drawings	18000	12000	6000	1993				
1993 Dec. 31	To Interest on drawings	495	330	165	Jan. 1 Dec. 31	By Bank By Salary By Interest On Capital By P & L (App) A/c	3,00,000 2,00,000 15,000 30,396	2,00,000 15,000 10,000 30,396	1,00,000 5,000 15,198
		3,56,901	2,43,066	1,14,033					
		3,75,396	2,55,396	1,20,198			3,75,396	2,55,396	1,20,198

Capital Accounts (*If the capitals are fluctuating*)

(Fig. in Rupees)

Capital Accounts *(If the capitals are fixed)*

Fixed Capital Accounts *(Fig. in rupees)*

Date	Particulars	X	Y	Z	Date	Particulars	X	Y	Z
1993 Dec.31	To Balance c/d	3,00,000	2,00,000	1,00,000	1993 Jan.1	By Bank	3,00,000	2,00,000	1,00,000
		3,00,000	2,00,000	1,00,000			3,00,000	2,00,000	1,00,000

Current Accounts *(Also known as Drawings Account* *(Fig in Rupees)*

Date	Particulars	X	Y	Z	Date	Particulars	X	Y	Z
1993 Dec.31	To Drawings	18,000	12,000	6,000	1993	By Salary	30,000	15,000	---
	To Interest on drawings	495	330	165	Dec. 31	By Interest on Capital	15,000	10,000	5,000
	To Balance c/d	56,901	43,066	14,033		By P & L (App) A/c	30,396	30,396	15,198
							75,396	55,396	20,198
		75,396	55,396	20,198	1994 Jan. 1	By Balance b/d	75,396	55,396	20,198

Admission of a Partner

Meaning

An existing partnership firm may take up expansion/diversification of the business. In that case it may need managerial help or additional capital. An option before the partnership firm is to admit partner/partners, when a partner is admitted to the existing partnership firm, it is called admission of a partner.

According to the Partnership Act 1932, a person can be admitted into partnership only with the consent of all the existing partners unless otherwise agreed upon. On admission of a new partner, the partnership firm is reconstituted with a new agreement.

Example: Rekha and Nitesh are partners sharing profit in the ratio of 5:3. On April 1, 2006 they admitted Nitu as a new partner with 1/4th share in the profit of the firm. In this case, with the admission of Nitu as partner, the firm stands reconstituted. On the admission of a new partner, the following adjustments become necessary:

(i) Adjustment in profit sharing ratio;

(ii) Adjustment of Goodwill;
(iii) Adjustment for revaluation of assets and reassessment of liabilities;
(iv) Distribution of accumulated profits and reserves; and
(v) Adjustment of partners' capitals.

Adjustment in Profit sharing Ratio

When a new partner is admitted he/she acquires his/her share in profit from the existing partners. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner. The incoming partner acquires his/her share of future profits either incoming from one or more existing partner. The existing partners sacrifice a share of their profit in the favour of new partner, hence the calculation of new profit sharing ratio becomes necessary.

Sacrificing Ratio

At the time of admission of a partner, existing partners have to surrender some of their share in favour of the new partner. The ratio in which they agree to sacrifice their share of profits in favour of incoming partner is called sacrificing ratio. Some amount is paid to the existing partners for their sacrifice. The amount of compensation is paid by the new partner to the existing partner for acquiring the share of profit which they have surrendered in the favour of the new partner.

Sacrificing Ratio is calculated as follows:

Sacrificing Ratio = Existing Ratio – New Ratio

Following cases may arise for the calculation of new profit sharing ratio and sacrificing ratio:

(i) Only the new partner's share is given

In this case, it is presumed that the existing partners continue to share the remaining profit in the same ratio in which they were sharing before the admission of the new partner. Then, existing partner's new ratio is calculated by dividing remaining share of the profit in their existing ratio. Sacrificing ratio is calculated by deducting new ratio from the existing ratio.

Illustration 1

Deepak and Vivek are partners sharing profit in the ratio of 3 : 2. They admit Ashu as a new partner for 1/5 share in profit. Calculate the new profit sharing ratio and sacrificing ratio.

Solution:

Calculation of new profit sharing ratio:

Let total Profit = 1
New partner's share = 1/5
Remaining share = 1 – 1/5 = 4/5
Deepak's new share = 3/5 of 4/5 i.e. 12/25

Vivek's new share = 2/5 of 4/5 i.e. 8/25
Ashu's Share = 1/5
The new profit sharing ratio of Deepak, Vivek and Ashu is :
= 12/25 : 8/25 : 1/5 = 12 : 8 : 5/25 = 12 : 8 : 5

So Deepak Sacrificed = 3/5 – 12/25 = 15 – 12/25 = 3/25
Vivek Sacrificed = 2/5 – 8/25 = 10 – 8/25 = 2/25
Sacrificing Ratio = 3 : 2
Sacrificing ratio of the existing partners is same as their existing ratio.

(ii) The new partner purchases his/her share of the profit from the Existing partner in a particular ratio.

In this case : the new profit sharing ratio of the existing partners is to be ascertained after deducting the sacrifice agreed from his share. It means the incoming partner has purchased some share of profit in a particular ratio from the existing partners.

Illustration 2

Neha and Parteek are partners, sharing profit in the ratio of 5 : 3. They admit Nisha as a new partner for 1/6 share in profit. She acquires this share as 1/8 from Neha and 1/24 share from Parteek. Calculate the new profit sharing ratio and sacrificing ratio.

Solution

Neha's and Parteek existing ratio is 5 : 3
Neha's new share = 5/8-1/8 = 4/8 or 12/24
Parteek's new share = 3/8-1/24 = 8/24
Nisha's share = 1/8+1/24 =4/24
The new profit sharing ratio of Neha, Parteek and Nisha is 12/24 : 8/24 : 4/24
= 12 : 8 : 4 = 3 : 2 : 1

(ii) Sacrifice ratio = 1/8 : 1/24 or 3 : 1

(iii) Existing partners surrender a particular portion of their share in favour of a new partner.

In this case, sacrificed share of the each partner is to be ascertained. This ascertained by multiplying the existing partner share in the ratio of their sacrifice. The share sacrificed by the existing partners should be deducted from his existing share. Therefore, the new share of the existing partners is determined. The share of the incoming partner is the sum of sacrifice by the existing partners.

Illustration 3

Him and Raj shared profits in the ratio of 5:3. Jolly was admitted as a partner. Him surrendered 1/5 of his share and Raj 1/3 of his share in favour of Jolly. Calculate the new profit sharing ratio.

Solution :

Him surrenders 1/5 of his share, i.e., = 1/5 of 5/8 = 1/8

Raj surrenders 1/3 of his share, i.e., = 1/3 of 3/8 = 1/8

So, sacrificing ratio of Him and Raj is 1/8 : 1/8 or equal.

Him's new share = 5/8 – 1/8 = 4/8

and Raj's new share = 3/8 – 1/8 = 2/8

Jolly's New share = 1/8 + 1/8 = 2/8

New profit sharing ratio of Him's, Raj's and Jolly's is = 4/8 : 2/8 : 2/8 or 4 : 2 : 2 or 2 : 1 : 1.

Steps in solving a admission problem:

A person can be admitted into a partnership firm if all the existing partners agree to his Admission. A new partner is admitted to improve the business, as he may bring in additional capital or may possess business acumen. When admitted, the new partner has a right to his share of profit, as agreed, as well as to his share of assets in the firm. In case of admission of a new partner, the following accounting problems are encountered with:

1. Calculation of new profit sharing ratios and the sacrificing ratios.
2. Calculation of goodwill and its treatment.
3. Revaluation of assets and liabilities.
4. Distribution of undistributed reserves, profits or losses.
5. Adjustment of capital accounts.

I. Calculation of new profit sharing ratios and the sacrificing ratios

Calculation of new profit sharing ratios will depend on the terms of agreement among partners admitting the new partner. There are two variations in this regard.

1. The new partner is given his share of profit and the remaining share of profit is presumed to be divided between the old partners in the old profit sharing ratio.
2. He may acquire it in some agreed ratio from old partners.

Sacrificing Ratio

Sacrificing ratio is the difference between old profit sharing ratio and new profit sharing ratio. It will tell how much of share of profit is sacrificed by old partner due to admission of a new partner and giving him a share of profit. The following cases explain the calculation of new profit sharing ratios and sacrificing ratios.

Case 1

The new partner is given his share of profit and the remaining share of profit is presumed to be divided between the old partners in the old profit sharing ratios. X and Y are partners sharing profits and losses in the ratio of 3:2. They admit 'Z' to the partnership for 1/3 of profits. Calculate the new profit sharing ratio and sacrificing ratio.

Solution

'Z' is given 1/3 profits.
Therefore remaining share of profits = 1 – 1/3 = 2/3
2/3 of profits are to be shared between X and Y in the old profit sharing ratio.

Therefore,

X's share = 2/3 x 3/5 = 2/5
Y's share = 2/3 x 2/5 = 4/15
Z's share = 1/ 3

Therefore,

New profit sharing ratio X:Y:Z: 2/5 : 4/15 : 1/3 = 6:4:5

Profit ratio between X and Y remains the same. So sacrificing ratio of X and Y is nothing but the old profit sharing ratio.

Case 2(a)

A and B are partners sharing profits and losses in the ratio of 5:3. C is admitted to the partnership and he acquires 3/16 share of profit from A and 1/16 share of profit from B.
Calculate new profit sharing ratios among all partners and the sacrificing ratios between old partners.

A's new share of profit = 5/8 – 3/16
= 10-3/16
= 7/16
B's new share of profit = 3/8 – 1/16
= 6 – 1/16
= 5/16

C's new share of profit = 3/16 + 1/16
= 3 + 1/16

= 4/16

New profit sharing ratios= A:B:C = 7:5:4

Sacrificing ratios between A and B

A gives up (sacrifices) 3/16 share
B gives up (sacrifices) 1/16 share

Therefore
Sacrificing ratio = 3:1

Case 2(b)
M and N are partners sharing profits and losses in the ratio of 3:1. They admit '0' for 1/5 share in profits which he acquires equally from M and N. Calculate new profit sharing ratio and sacrificing ratio.
O gets 1/5 share.
(i.e.) 1/2 of 1/5 = 1/10 he gets it from M and N each.

Therefore,

M's new share = 3/4 – 1/10
= 15-2/20
= 13/20

N's new share = 1/4 - 1/10
= 5-2/20
= 3/20
O's share = 1/5 or 4/20
Therefore
New profit share ratio = M:N:O = 13:3:4
As the old partners give up their shares to new partners equally, the sacrificing ratio between M and N is 1:1.

Case 2(c)
P and Q are partners sharing profits and losses in the ratio of 3:2. They admit R for 1/5 share of profit which he acquires wholly from 'P'. Calculate the new profit sharing ratio and sacrificing ratio.
P's new share = 3/5 – 1/5

= 2/5
Q's new share = 2/5 (No change)
R's share = 1/5
New profit sharing ratio = 2:2:1
Here, P, alone gives his 1/5 share to R. So sacrificing ratio for P is 1/5.

Calculation and Treatment of goodwill

Meaning of Goodwill

Over a period of time, a business firm develops a good name and reputation among the customers. This help the business earn some extra profits as compared to a newly set up business. In accounting capitalised value of this extra profit is known as goodwill. For example, your firm earns say Rs 1200 and the normal profit was expected from your firm Rs 700. The rate of return is @ 10%. In this case goodwill is ascertained as under :

Step 1 : Excess profit = Actual profit – Desired normal profit
1200 – 700 = 500

Step 2 : Goodwill = 500 X100/10= Rs.5000

In other words, goodwill is the value of the reputation of a firm in respect of the profit earned in future over and above the normal profit. It may also be defined as the present value of the capacity to earn future profits. This means that a firm can be said to have goodwill only if it has capacity to earn profit in future. A firm earning only normal profits like similar firms cannot claim to have any goodwill.

Factors affecting the Goodwill

The factors affecting goodwill are as follows:

- Location : If the firm is located at a central place, resulting in good sale, the goodwill tends to be high.
- Nature of Business : A firm that produces high value products or having a stable demand is able to earn more profits and therefore has more goodwill.
- Efficient management : A well managed firm earns higher profit and so the value of goodwill will also be high.
- Quality : If a firm is known for the quality of its products the value of goodwill will be high.
- Market Situation : The monopoly condition to earn high profits which leads to higher value of goodwill.
- Special Advantages : The firm has special advantages like importing licenses, long term contracts for supply of material, patents, trademarks, etc. enjoy higher value of goodwill.

Goodwill is an intangible asset. The ability of a business to earn excess profit is due to its reputation. This reputation expressed in monetary terms is goodwill. A number of factors are responsible for good reputation like location, product, management, etc.

Goodwill is valued usually at the time of sale of business. But in the following cases also goodwill is valued.

1. When profit sharing ratios among existing partners is changed
2. Admission of a partner
3. Death or retirement of a partner
4. Amalgamation of two firms.

Following are the methods of valuing goodwill:

1. Average profits method
2. Super profits method
3. Capitalization method

I. Average Profits Method

In this method, goodwill is valued by multiplying the average profits of last few years by an agreed number.

Goodwill = Average profits x No. of years' purchase.

Example 1 Compute the value of goodwill on the basis of three years' purchase of the average profits of last 4 years. The profits of the last 4 years are:

1990 - Rs. 80,000

1991 - Rs. 90,000

1992 - Rs. 82,000

1993 -. Rs. 86,000

Solution

Average profits of last four years

80,000 + 90,000 + 82,000 + 86,000 /4

3,38,000/4 = Rs. 84,500

Value of goodwill = Rs. 84,500 x 3 = Rs. 2,53,500

Another variation of average profit method is weighted average method. Here weights are assigned to each year's profit and the weighted average profits is calculated. Here goodwill is Goodwill = weighted average profit x No. of years purchase

Example 2

Compute the goodwill of a firm on the basis of 3 years' purchase of weighted profits of last four years (assign weights 1, 2, 3 and 4 serially to the profits).
Profits of last 4 years are:
1990 - Rs. 40,000
1991 - Rs. 45,000
1992 - Rs. 50,000
1993 - Rs. 55,000

Solution

Year	Annual Profits	Weights	Product
1990	40,000	1	40,000
1991	45,000	2	90,000
1992	50,000	3	1,50,000
1993	55,000	4	2,20,000
		10	5,00,000

Weighted average profit = Total product /Total weight
= 5,00,000 /10 = Rs. 50,000
Value of goodwill = Wt. average profit x No. of years purchase
= 50,000 x 3 = Rs. 1,50,000.

2. Super Profits Method

Super profits are profits earned in excess of normal profits.
Goodwill under this method = Super profit x No. of years' purchase
Normal profit = Capital employed x normal rate of return

Example 3

From the following information, calculate goodwill using super profits method.

Year	Profit	Weights	Product
1	40000	1	40000
2	45000	2	90000
3	50000	3	150000
4	55000	4	220000
		10	500000

a) Capital employed in the business Rs.6,00,000
b) Normal rate of return 10%
c) Profits for the last 3 years were Rs.75,000; Rs.80,000; Rs.85,000

d) Goodwill is 4 years purchase of super profit Average profits = 75,000 + 80,000 + 85,000/3
= 2,40,000/3 = Rs. 80,000

Normal profit = Capital employed x normal rate of return
= 6,00,000 x 10/100 = Rs. 60,000

Super profit = Rs. 80,000 - Rs. 60,000 = Rs. 20,000

Goodwill = Rs. 20,000 x 4 = Rs. 80,000

Capitalization Method

Under this method goodwill is the difference between capitalized value of average profits at normal rate of return and actual capital employed.

Example : From the following, calculate goodwill:

a) Normal rate of return 10%

b) Average profits for last 3 years Rs.75,000; Rs.80,000; Rs.85,000

c) Total assets Rs.7,00,000 and total liabilities Rs.2,00,000

Solution :

Average profits = 75,000 + 80,000 + 85,000 3 /3 = Rs. 80,000

Capitalized value of average profits

= average profit x 100 / Normal rate of return

= 80,000 x 100/10 = Rs. 8,00,000

Capital employed = Total tangible asset - Total liabilities

= Rs. 7,00,000 - Rs. 2,00,000

= Rs. 5,00,000

Goodwill = Capitalized value of average profit at normal rate of return – capital employed

= Rs. 8,00,000 - Rs. 5,00,000 = Rs. 3,00,000

Treatment of Goodwill

When a new partner is admitted into a firm, the old partners give up a part of their share of profits in favour of the new partner. Also the new partner is going to enjoy the goodwill of the firm which was built up by the old partners. So the old partners have to be compensated either by payment of money by the new partner or by way of extra credits in their capital accounts.
There are three ways by which goodwill is dealt with when a new partner is admitted. They are

1. Premium Method
2. Revaluation Method
3. Memorandum Revaluation Method

1. Premium Method

Under this method, the new partner brings his share of goodwill and the same is shared by old partners in their profit sacrificing ratios. If the payment is made privately to old partners no entry is required in the books of accounts. But if the payment is made through the books the—following entries are passed.

1. Bank/cash a/c Dr –

    To goodwill a/c

[The amount of goodwill brought in by the new partner as premium]

2. Goodwill a/c Dr –

    To old partner's capital a/c (individually) –

[Goodwill brought in by new partner credited to old partners in their sacrificing ratios]

Sometimes the old partners may be allowed to withdraw their amount of goodwill (full or a part of it). The following entry is passed.

Old partners capital a/c Dr –

(individually)

To cash

[Amount of goodwill withdrawn by old partners]

Example

X and Y are partners in a business, sharing profits and losses @ 3:1. They admit Z for $1/5^{th}$ share. Z brings 1 s.10,000 as his capital and Rs.8,000 as goodwill. Pass Journal entry to record the transactions

(a) When goodwill amount is returned in the business

(b) When the entire amount of goodwill is withdrawn

(c) When 50% of the goodwill is withdrawn

Solution

(a) When goodwill is returned in the business

Bank/Cash a/c Dr 18000

To Z's capital a/c 10000

To goodwill a/c 8000

[Amount brought in by 'Z' for capital and goodwill]

Goodwill a/c Dr 8000

To X's capital a/c 6000

To Y's capital a/c 2000

Amount goodwill brought in by new partner credited to old partners' capital account their sacrificing ratios]

(b) In case the amount of goodwill is withdrawn, then apart from passing the two entries, the following additional entry is to be passed for withdrawal.

X's capital a/c Dr. 6000

Y's capital a/c Dr. 2000

To cash/bank a/c 8000

[The goodwill credited is withdrawn]

(c) In case 50% of the goodwill is withdrawn, the withdrawal entry is as below

X's capital a/c Dr

Y's capital a/c Dr

To cash/bank a/c 4000

[50% of goodwill credited is withdrawn]

Revaluation Method

When the incoming partner is not in a position to pay in cash for goodwill, then goodwill is raised in the books, by crediting the old partners' capital account in their old profit sharing ratio. There are two possibilities here:

1. No goodwill account appears in the books at the time of admission
2. When there is goodwill account at the time of admission

1. No goodwill account appears in the books at the time of admission

In such a case goodwill is to be brought into books at its agreed value by debiting the goodwill account and crediting the capital accounts of old partners in their old profit sharing ratio. Here the goodwill account will appear in the balance sheet. The following journal entry is passed.

Goodwill a/c Dr -

To old partners' capital account (individually) -

[Goodwill is raised by debiting goodwill a/c and crediting old partners' capital account in their old profit sharing ratio]

Example

X and Y are partners sharing profits and losses in the ratio of 3:1. They admit 'Z' for 1/5 share. 'Z' brings in Rs.20,000 for his capital, but is not in a position to bring cash for goodwill. The value of goodwill is agreed at Rs.12,000. No goodwill account appears in the books. Pass necessary entries.

Cash/bank a/c Dr 20000

To Z's capital account 20000

[Being the amount brought in by Z for his capital]

Goodwill a/c Dr 12000

To Xs capital a/c 8000

To Y's capital a/c 4000

[Goodwill account being raised in the books at its value by crediting the old partners' capital account in their old profit sharing ratio]

2. When there is goodwill account at the time of admission

In case at the time of admission of a partner there appears goodwill account in the books, then adjustment for goodwill in the old partners' capital account is made only for the difference between the agreed value of goodwill and the amount of goodwill appearing in the books.

If the agreed value of goodwill is more than the goodwill account appearing in the books, then goodwill account is to be further increased by crediting the old partners' capital account in their old profit sharing ratio.

If the agreed value is less than the goodwill appearing in the books then the excess value of goodwill is written back by debiting the old partners' capital account in the old profit sharing ratio.

Example

X and Y are partners of a firm sharing profits and losses in the ratio of 3:2. They admit Z for 1/5 share in profits. Z brings in Rs.20,000 as his capital. The value of goodwill is estimated at Rs. 20,000. Give journal entries under the following circumstances.

1. When there is no goodwill appearing in the books of the firm
2. When the goodwill account appears at Rs.10,000 in the books of the firm
3. When the goodwill account appears at Rs.30,000 in the books of the firm

Solution

(a) when there is no goodwill appearing in the books

Cash/Bank a/c Dr 20,000

To Z's capital account 20,000

[Being the capital introduced by Z]

Goodwill a/c Dr 20,000

To X's capital account 12,000

To Y's capital account 8,000

[Goodwill account is raised by crediting capital accounts of X and Y in their old profit sharing ratio]

(b) when the goodwill account appears at Rs.10000 in the books of the firm (Agreed value is more than the book value)

Cash/Bank a/c Dr 20000

To Z's capital account 20000

[Being the amount brought in by Z as capital]

Goodwill a/c Dr 10000

To X's capital a/c 6000

To Y's capital a/c 4000

[Goodwill account is raised to its agreed value of crediting the capital accounts of X and Y in their old profit sharing ratio]

(c) When goodwill account appears at Rs.30,000 (Agreed value is less than the book value)

Cash/Bank a/c Dr 20000

To Z's capital a/c 20000

[Being the amount brought in by Z as his capital]

X's capital a/c Dr 6000

Y's capital a/c Dr 4000

To goodwill a/c 10000

[Goodwill account appearing in the books is written off to the extent of Rs.10,000 to make it appear at Rs.20,000 by debiting the old partners' capital account in their old profit sharing ratio].

Memorandum Revaluation Method

If all partners decide not to show the goodwill account in the books, then they can write back the same by passing the following entry.

All partners' capital a/c (individually) Dr

To goodwill a/c –

[Goodwill a/c is written back by debiting the partners' capital account, including the new partner in the new profit sharing ratio].

Example

A and B are partners sharing profits and losses in the ratio of 5:4. They admit 'C' and the new profit sharing ratio is 4:3:2. 'C' brings Rs.20,000 as his capital. The value of goodwill is estimated at Rs.36,000. Give necessary entries in the books of the firm on C's admission assuming that the partners do not want goodwill to appear in the books.

1) Cash/bank a/c Dr 20000

To C's capital a/c 20000

[Being the cash brought in by 'C' as his capital]

2) Goodwill a/c Dr 36000

To A's capital a/c 20000

To B's capital a/c 16000

[Goodwill account raised in the books on C's admission by crediting the old partners' capital account in their old profit sharing ratio (i.e.) 5:4]

3) A's capital a/c Dr 16000
B's capital a/c Dr 12000
C's capital a/c Dr 4000
To goodwill a/c 36000
[Goodwill account is written back by delivering the partners capital account in their new profit sharing ratio]

Revaluation of Assets and Liabilities

At the time of admission of a partner into a partnership firm the assets and liabilities of the firm is revalued. The logic behind this exercise is to see that the new partner is not gaining due to understated assets and overstated liabilities or losing due to overstated assets and understated liabilities.

A revaluation (also known as Profit and Loss Adjustment Account) is opened and necessary entries are passed to bring the assets and liabilities to its real value at the time of admission.
Then the profit or loss arising out of revaluation of assets and liabilities is transferred to the capital accounts of the old partners in their profit sharing ratios. The following entries are passed to record the revaluation of assets and liabilities.

1) For increase in the value of assets
Assets a/c Dr –
To revaluation a/c
2) For decrease in the value of assets
Revaluation a/c Dr –
To assets a/c
3) For increase in the value of liabilities
Revaluation a/c Dr –
To liabilities a/c
4) For any decrease in the value of liabilities
Liabilities a/c Dr –
To revaluation a/c
5) For transfer of profit on revaluation
Revaluation a/c Dr –
To old partners capital a/c (individually)
6) For transfer of loss on revaluation
Old partners' capital a/c (individually) Dr –

To revaluation a/c

Sometimes the partners may decide not to alter the value of assets and liabilities but at the same time revalue the assets and liabilities and account for its profit/loss on revaluation. In such a Circumstance, a Memorandum Revaluation Account is prepared. First, entries are posted in this account for any increase/decrease in the value of assets/liabilities as explained before and the profit/loss is transferred to capital accounts of old partners. Then the entries posted for any increase or decrease in assets/liabilities are reversed and so the assets and liabilities are again brought to its original value. Any profit/loss arising out of reversal of entries for increase/decrease in the value of assets and liabilities are transferred to capital account of all partners in their new profit sharing ratio. Journal entries in this regard are:

In case of profit on revaluation

1. Memorandum Revaluation Account Dr –

To Old partners capital account (individually)

[Profit on revaluation transferred to old partners in their old profit sharing ratio]

2. All partners' capital account (individually) Dr –

To Memorandum revaluation a/c

[Profit previously credited is now returned back by debiting all partners' capital accounts in their new profit sharing ratios]

In case of loss on revaluation, the above entries are reversed.

3. Adjustment of undistributed profits, reserves or losses

When a new partner is admitted, profits, reserves or losses appearing in the books at the time of admission is to be distributed to old partners in the old profit sharing ratio. The following journal entries are relevant in this regard. For distributing profits and reserves

Profit and loss a/c Dr -

Reserve a/c Dr -

To old partners capital a/c (individually)

[Distribution of profits and reserves at the time of admission of a new partner to old partners in their old profit sharing ratio]

For distributing losses

Old partners capital a/c –(individually)

To profit & loss a/c (debit balance) –

[Losses at the time of admission of a partner distributed to old partner in the old profit sharing ratio]

4. Adjustments of capital accounts

At the time of admission of a partner, the partners may decide to have a balance in their capital accounts in proportion to their profit sharing ratio. So if they have excess or shortage of capital in relation to their profit sharing ratio, adjustment in their capital accounts are to be made. In case any partner has excess capital, the following entry is passed to correct his capital account in proportion to his profit sharing ratio:

Partners capital a/c Dr -

To cash/bank a/c –

[Excess capital withdrawn by the partner who is having excess capital] In case his capital falls short of the amount of capital, calculated in proportion to his profit sharing ratio, the following entry is passed:

Cash/Bank a/c Dr -

To Partners capital a/c –

[Cash is brought in by the partner to make his capital account in proportion to his profit sharing ratio]

Illustration problems

Illustration-1: Following is the Balance Sheet of Shashi and Ashu shari profit as 3 : 2.

Particulars	(Rs.)	Assets	(Rs.)
Creditors	18,000	Debtors 22,000 Less: Provision for DD 1,000	21,000
General reserve	25,000	Land and Building	18,000
Workmen's compensation fund	15,000	Plant and machinery	12,000
Capital : Shashi	15,000	Stock	11,000
Ashu	10,000	Bank	21,000
	83,000		83,000

1. On admission of Tanya for 1/6 th share in the profit it was decided that :

   (i) Provision for doubtful debts to be increased by Rs. 1,500.

   (ii) Value of land and building to be increased to Rs. 21,000.

   (iii) Value of stock to be increased by Rs. 2,500.

   (iv) The liability of workmen's compensation fund was determined to be Rs. 12,000.

   (v) Tanya brought in as her share of goodwill Rs. 10,000 in cash.

   (vi) Tanya was to bring further cash of Rs. 15,000 for her capital.

   Prepare Revaluation A/c, Capital A/cs and the Balance Sheet of the new firm

Solution :

Revaluation Account

Particulars	(Rs.)	Assets	(Rs.)
	1,500		
To Provision for D.D.			3,000
To Capital A/cs :		By Land and Building A/c	2,500
Shashi 3/5 2,400		By Stock	
Ashu 2/5 1,600	4,000		
	5,500		83,000

Partners' Capital Account

Particulars	Shashi	Ashu	Tanya	Particulars	Shashi	Ashu	Tanya
					15,000	10,000	–
				By balance b/d	15,000	10,000	–
				By general reserve			
				By workmen's compersation	1,800	1,200	–
To Balance e/d	40,200	26,800	15,000	A/c			
				By Revaluation A/c			
				By Bank A/c	2,400	1,600	–
				By Premium for goodwill	–	–	15,000
					6,000	4,000	–
	40,200	26,800	15,000		40,2000	26,800	15,000

Balance Sheet of the New Firm

Liabilities	(Rs.)	Assets	(Rs.)
	18,000	Debtors 22,000	
Creditors			
	12,000	Less: Provision for DD	19,000
Work compensation fund	40,200	1,000	21,000
Capital : Shashi	26,800	Land and Building	12,000
Ashu	15,000	Plant and machinery	13,500
Tanya		Stock	46,000
	1,12,000	Bank	1,12,000

Illustration-2: A, B and C are partners sharing profits and the ratio of 2:3:5. On 31st March 2015, their Balance Sheet was as follows.

Particulars	(Rs.)	Particulars	(Rs.)
Capital A 36,000 B 44,000 C 52,000 Creditors Bill payable Profit and Loss Account	1,32,000 64,000 32,000 14,000	Cash Bills receivable Furniture Stock Debtors Investments Machinery Goodwill	18,000 24,000 28,000 44,000 42,000 32,000 34,000 20,000
	2,42,000		2,42,000

They admit D int partnership on the following terms :

(i) Furniture and Machinery to be depreciated by 15%

(ii) Stock is revaluated at Rs. 48,000.

(iii) Goodwill to be valued at Rs. 24,000

(iv) Outstanding rent amount Rs. 1,800.

(v) Prepaid salaries Rs. 800.

(vi) D to being Rs. 32,000 towards his capital for 1/6 th share.

Prepare Revaluation Account, Partners Capital Accounts and Balance Sheet of the new firm.

Solution :

Revaluation account

Particulars	(Rs.)	Particulars	(Rs.)
To Fumiture A/c To Machinery A/c To Outstanding rent A/c	4,200 5,100 1,800	By Stock By Prepaid salaries A/c By Capital A/c (loss) : A 2/10 1,260 B 3/10 1,890 C 5/10 3,150	4,000 800 6,300
	11,100		11,100

Partners' Capital Account

Dr. **Cr.**

Particulars	A(Rs.)	B(Rs.)	C(Rs.)	D(Rs.)	Particulars	A(Rs.)	B(Rs.)	C(Rs.)	D(Rs.)
To Revaluation A/c	1,260	1,890	3,150	–	By balance c/d By P/L A/c	36,000	44,000	52,000	
To Goodwill A/c	4,000	6,000	10,000		By D's capital	2,800	4,200	7,000	

To A's capital				–	A/c				
To B's capital	–	–	–			800	1,200	2,000	
To C's capital	–	–	–	800					
To Balance c/d	–	–	–	1,200		–	–		32,000
	34,340	41,510	47,850	2,000	By Cash A/c				
				28,000					
	39,600	49,400	61,000	32,000		39,600	49,400	61,000	32,000

Revised Balance Sheet of the New Firm

Liabilities	(Rs.)	Assets	(Rs.)
Creditors	18,000		50,000
		Cash	24,000
Capital		Bill Receivable	23,000
A 34,340		Furniture	48,000
B 41,510		Stock	42,000
C 47,850		Debtors	32,000
D 28,000	1,51,700	Investment	28,900
Creditors	64,000	Machinery	800
Bills Payable	32,000	Prepaid salaries	
Outstanding rent	1,800		
	2,49,500		2,49,500

Illustration-3: A, B and C are partners sharing profits and losses in the ratio of 5:3:2. On 31st, March 2015 their Balance sheet was as follows:

Liabilities	(Rs.)	Assets	(Rs.)
Capital			18,000
A 36,000		Cash	14,000
B 44,000		Bill Receivable	44,000
C 52,000	1,32,000	Stock	42,000
Creditors	64,000	Debtors	94,000
Bills Payable	32,000	Machinery	20,000
General Reserve	14,000	Goodwill	
	2,32,000		2,32,000

They decided to admit D into the partnership on the following terms :

(i) Machinery is to be depreciated by 15%.

(ii) Stock is to be revalued at Rs. 48,000.

(iii) Outstanding rent is Rs. 1,900.

(iv) D is to bring Rs. 6,000 as goodwill and sufficient capital for a 2/5th share in the capitals of firm.

Prepare Revaluation A/c, Partner's Capital A/cs, Cash A/c and Balance Sheet of the new firm.

Revaluation Account

Dr. **Cr.**

Particulars	(Rs.)	Particulars	(Rs.)
		By Stock	4,000
	4,200	By Capital A/c (loss) :	
To Machinery A/c	5,100	A 5/10 6,000	
To Outstanding rent A/c	1,800	B 3/10z 3,600	
		C 2/10 2,400	12,000
	16,000		16,000

Partners' Capital Account

Particulars	A(Rs.)	B(Rs.)	C(Rs.)	D(Rs.)	Particulars	A(Rs.)	B(Rs.)	C(Rs.)	D(Rs.)
To Goodwill A/c	10,000	6,000	4,000	–	By balance b/d	36,000	44,000	52,000	
					By General reserve	7,000	4,200	2,800	
To Revaluation A/c	6,000	3,600	2,400	–	By Premium				
					By Cash A/c	3,000	3,800	1,200	
To Balance c/d	30,000	40,400	49,600	80,000		–	–	–	80,000
	46,000	50,000	56,000	80,000		46,000	50,000	56,000	80,000
					By balance b/d	30,000	40,400	49,600	80,000

Note : Combined capital of A, B and C for 3/5 (1-2/5) = Rs. 1,20,000

Thus total capital of the firm = $1,20,000 \times \frac{5}{3} = Rs.\ 2,00,000$

D's share of capital = $2,20,000 \times \frac{2}{5} = Rs.\ 80,000$

Revised balance sheet after admission of a partner

Liabilities	(Rs.)	Assets	(Rs.)
Creditors	64,000	Cash	1,04,000
Bill payable	22,000	Bill Receivable	14,000
Outstanding rent	1,900	Stock	48,000
Capital :		Debtors	42,000

A 30,000 B 40,400 C 49,600 D 80,000	2,00,000	Machinery	79,000
	2,87,900		2,87,900

Illustration-4: Following is the Balance Sheet of A, B and C sharing profits and losses in the ratio of 6:5:3 respectively.

Liabilities	(Rs.)	Assets	(Rs.)
Creditors	37,000	Cash	3,700
Bill payable	12,600	Debtors	52,920
General reserve	21,000	Stock	58,800
A's capital	70,000	Furniture	14,700
B's capital	59,800	Land and Building	90,300
C's capital	29,100	Goodwill	10,500
	2,31,000		2,31,000

They agreed to be take D into partnership giving 1/8th share in profits on the following terms:

(a) Furniture to be depreciated by Rs. 1,840 and Stock by 10%

(b) A provision of Rs. 2,640 to be made for an outstanding bill for repairs.

(c) That land and building be brought up to Rs. 1,19,700.

(d) That the goodwill is valued at Rs. 28,140.

(e) That D should bring in Rs. 35,400 as his capital and for his share of goodwill.

(f) After making the above adjustments the capital of old partners be adjusted in proportion to D's Capital by bringing in cash or excess to be paid off.

Prepare Revaluation Account, Capital Account of Partners and Balance Sheet of new firm.

Revaluation Account

Particulars	(Rs.)	Particulars	(Rs.)
To Furniture A/c	1,840		
To Stock A/c	5,880		
To Outstanding rent A/c	2,640		
To capital A/cs :		By Land and Building A/c	29,400
A 6/4 8,160			
B 5/14 6,800			
C 3/14 4,080	19,040		
	29,400		29,400

Partners' Capital Account

Particulars	A(Rs.)	B(Rs.)	C(Rs.)	D(Rs.)	Particulars	A(Rs.)	B(Rs.)	C(Rs.)	D(Rs.)
To Goodwill A/c	4,500	3,750	2,250	–		70,800	59,700	29,100	
					By balance b/d	9,000	7,500	4,500	
					By General reserve				
					By revaluation A/c	8,160	6,800	4,080	
					By Premium for goodwill A/c	]1,508	1,256	754	
					By Cash A/c				
To Balance c/d	95,646	79,705	47,823	31,882	Balance b/d	10,678	8,199	11,639	31,882
	1,00,146	81,455	50,073	35,400		100,146	83,455	50,073	35,400
						95,646	79,705	47,823	31,882

Revised Balance Sheet of the New Firm

Liabilities	(Rs.)	Assets	(Rs.)
Creditors	37,800		
Bills Payable	12,600		
Outstanding repairs	2,640	Cash	69,696
Capital		Debtors	52,920
A 95,646		Stock	52,920
B 79,705		Furniture	12,860
C 47,823		Land Building	1,19,700
D 31,882	2,55,056		
	3,08,096		3,08,096

Illustration-5: Sahaj & Nimish are partners in a firm. They share profits & losses in ratio of 2:1 . Since both of them are specially abled sometimes they find it difficult to run a business so admitted Gauri a common friend decided to help them 'Therefore, they admitted her into partnership for 1/3 share. She brought her share of goodwill in cash & proportionate capital. At the time her admission Balance Sheet of Sahaj & Nimish was as under.

Liabilities	(Rs.)	Assets	(Rs.)
Capital A/c		Machinery	1,20,000
Sahay 1,20,0000		Furniture	80,000

Nimish 80,000	2,00,000	Stock	50,000
General Reserve	30,000	Sundry Debtors	30,000
Creditors	30,000	Cash	20,000
Employees Provident Fund	40,000		
	3,00,000		3,00,000

It was decided to :

(a) Reduce the value of stock by Rs. 5,000

(b) Depreciate furniture by 10% and appreciate machinery by 5%.

(c) Rs. 3,000 of the debtors proved bad. A provision of 5% was to be created on Sundry Debtors for doubtful debts.

(d) Goodwill of the firm was valued at Rs. 45,000

Prepare Revaluation Account, Partner's Capital Accounts and Balance Sheet of reconstituted firm. Identify the values conveyed.

Solution :

Revaluation Account

Particulars	(Rs.)	Particulars	(Rs.)
To Stock A/c	5,000	By Machinery A/c	6,000
To Furniture	8,000	By Loss transferred to	
To Sundry Debtors	3,000	Sahay's capital A/c 7,567	
To provision for bad debts $(30,000 - 3000)\times\frac{5}{100}$	1350	Nimish's capital A/c 5783	11,350
	17,350		17,350

Partner's capital Account

Particulars	(Rs.) Sahay	(Rs.) Nimish	(Rs.) Gauri	Particulars	(Rs.) Sahay	(Rs.) Nimish	(Rs.) Gauri
				By Capital A/c	1,20,000	80,000	–
To Revaluation A/c	7,567	3783	–	By General Reserve	20,000	10,000	–
To balance c/d	1,42,433	91,217	1,16825	By Premium A/c			
				By Bank A/c	10,000	5,000	1,16,825
	1,50,000	95,000	1,16825		1,50,000	95,000	1,16825

Balance Sheet of New Firm

Liabilities	(Rs.)	Assets	(Rs.)

Capital A/c Sahay 1,42,000 Nimish 91,217 Gauri 1,16,825 Creditors Employees provident Fund	3,50,475 30,000 40,000	Machinery Furniture Stock Sundry Debtors 30,000 Less : Bad debts 3,000 Less : Provision 1,350 Cash Bank	1,26,000 72,000 45,000 25,650 20,000 1,31,825
	4,20,475		4,20,475

Illustration-6: Anthony and Boni were partners in a firm sharing profit in ratio o 5 : 3. Their Balance sheet as on 31-3-2015 was as follows:

Liabilities	(Rs.)	Assets	(Rs.)
Bank overdraft Creditors General reserve Capital Accounts: Anothony 1,50,000 Boni 1,00,000	60,000 50,000 48,000 2,50,000	Cash Debtors 100,000 Less: Provision 2,000 Bills Receivables Stock Building Land	20,000 98,000 38,000 40,000 1,50,000 62,000
	4,08,000		4,08,000

On 01.04.2015, they admitted Heena into partnership for 1/4th share in full profits of the firm. Assets and liabilities were revealed. Goodwill of the firm valued at Rs. 80,000.
Fill in the missing information/figure in the following ledger accounts and Balance Sheet.

Revaluation Account

Particulars	(Rs.)	Particulars	(Rs.)
To provision for bad debts A/c To Stock A/c To Profit transferred to ____________ ____________	3,000 2,000 –	By Land A/c	

Partner's Capital Account

Particulars	Anthony	Boni	Heena	Particulars	Anthony	Boni	Heena
To balance c/d	–	–	80,000	By Balance A/c By Gen. Reserve	– –	– –	– –

				By Rev. A/c By Premium A/c for Goodwill By	– – –	– – –	– – –

Balance Sheet As at 01.04.2015

Liabilities	(Rs.)	Assets	(Rs.)
Bank Overdraft	60,000		–
Creditors	50,000	Cash	–
Capital A/c		Debtors	38,000
Anthony –		Bill Receivable	–
Boni –		Stock	1,50,000
Heena 80,000	–	Building	68,200
	–	Land	–

Solution :

Revaluation Account

Particulars	(Rs.)	Particulars	(Rs.)
To provision for bad debts A/c	3,000		
To Stock A/c	2,000		
To Profit transferred to		By Land A/c	6,200
Anthony's Capital A/c 750			
Bonis Capital A/c 450	1,200		
	6,200		6,200

Partner's capital Accounts

Particulars	Anthony	Boni	Heena	Particulars	Anthony	Boni	Heena
				By Balance A/c	1,50,000	1,00,000	–
				By Gen. Reserve	30,000	18,000	–
To balance c/d	193,250	1,25,950	80,000	By Rev. A/c	750	450	–
				By Premium A/c for Goodwill	12,500	7,500	–
				By Cash A/c	–	–	80,000
	1,93,250	1,25,950	80,000		1,93,250	1,25,950	80,000

Balance Sheet As at 01.04.2015

Liabilities	(Rs.)	Assets	(Rs.)
Bank Overdraft	60,000	Cash	1,20,000
Creditors	50,000	Debtors 1,00,000	
Capital A/cs		Less: Provision 5,000	95,000
Anthony 1,93,250		Bill Receivable	38,000
Boni 1,25,950		Stock	38,000
Heena 80,000		Building	1,50,000
	3,99,200	Land	68,200
	5,09,200		5,09,200

Problems to practice:

1. A and B are partners in a firm sharing profits and losses in the ratio of 3:2. They decide to admit C into partnership with 1/4 share in profits. C will bring in Rs. 30,000 for capital and the requisite amount of goodwill premium in cash. The goodwill of the firm is valued at Rs, 20,000. The new profit sharing ratio is 2:1:1. A and B withdraw their share of goodwill. Give necessary journal entries?
2. Arti and Bharti are partners in a firm sharing profits in 3:2 ratio, They admitted Sarthi for 1/4 share in the profits of the firm. Sarthi brings Rs. 50,000 for his capital and Rs. 10,000 for his 1/4 share of goodwill. Goodwill already appears in the books of Arti and Bharti at Rs. 5,000. the new profit sharing ratio between Arti, Bharti and Sarthi will be 2:1:1. Record the necessary journal entries in the books of the new firm?

[Hint: Existing goodwill written-off in old profit sharing ratio]

3. X and Y are partners in a firm sharing profits and losses in 4:3 ratio. They admitted Z for 1/8 share. Z brought Rs. 20,000 for his capital and Rs. 7,000 for his 1/8 share of goodwill. Goodwill already appears in the books at Rs. 40,000. Show necessary journal entries in the books of X, Y and Z?

4. Aditya and Balan are partners sharing profits and losses in 3:2 ratio. They admitted Christopher for 1/4 share in the profits. The new profit sharing ratio agreed was 2:1:1.

Christopher brought Rs. 50,000 for his capital. His share of goodwill was agreed to at Rs. 15,000. Christopher could bring only Rs. 10,000 out of his share of goodwill. Record necessary journal entries in the books of the firm?

5. Amar and Samar were partners in a firm sharing profits and losses in 3:1 ratio. They admitted Kanwar for 1/4 share of profits. Kanwar could not bring his share of goodwill premium in cash. The Goodwill of the firm was valued at Rs. 80,000 on Kanwar's admission. Record necessary journal entry for goodwill on Kanwar's admission.

6. Mohan Lal and Sohan Lal were partners in a fiirm sharing profits and losses in 3:2 ratio. They admitted Ram Lal for 1/4 share on 1.1.2013. It was agreed that goodwill of the firm will be valued at 3 years purchase of the average profits of last 4 years which were Rs. 50,000 for 2013, Rs. 60,000 for 2014, Rs. 90,000 for 2015 and Rs. 70,000 for 2016. Ram Lal did not bring his share of goodwill premium in cash. Record the necessary journal entries in the books of the firm on Ram Lal's admission when:
   a) Goodwill already appears in the books at Rs. 2,02,500.
   b) Goodwill appears in the books at Rs. 2,500.
   c) Goodwill appears in the books at Rs. 2,05,000.

7. Rajesh and Mukesh are equal partners in a firm. They admit Hari into partnership and the new profit sharing ratio between Rajesh, Mukesh and Hari is 4:3:2. On Hari's admission goodwill of the firm is valued at Rs. 36,000. Hari is unable to bring his share of goodwill premium in cash. Rajesh, Mukesh and Hari decided not to show goodwill in their balance sheet. Record necessary journal entries for the treatment of goodwill on Hari's admission.

8. Amar and Akbar are equal partners in a firm. They admitted Anthony as a new partner and the new profit sharing ratio is 4:3:2. Anthony could not bring this share of goodwill Rs. 45,000 in cash. It is decided to do adjustment for goodwill without opening goodwill account. Pass the necessary journal entry for the treatment of goodwill?

9. Given below is the Balance Sheet of A and B, who are carrying on partnership business on 31.12.2016. A and B share profits and losses in the ratio of 2:1.

Balance Gbeet of A and B as at March 31, 2016

	Liabilites	Amount	Assets	Amount	

Bills Payable		10,000	Cash in Hand	10,000
Creditors		58,000	Cash at Bank	40,000
Outstanding Expenses		2,000	Sundry Debtors	60,000
			Stock	40,000
Capitals:			Plant	1,00,000
A	1,80,000		Buildings	1,50,000
B	1,50.000	3,30,000		
		4.OO.OOO		4.OO.OOO

C is admitted as a partner on the date of the balance sheet on the following terms:

(i) C will bring in Rs. 1,00,000 as his capital and Rs. 60,000 as his share of goodwill for 1/4 share in the profits.

(ii) Plant is to be appreciated to Rs. 1,20,000 and the value of buildings is to be appreciated by 10%.

(iii) Stock is found over valued by Rs. 4,000.

(iv) A provision for bad and doubtful debts is to be created at 5% of debtors.

(v) Creditors were unrecorded to the extent of Rs. 1,000.

Pass the necessary journal entries, prepare the revaluation account and partners' capital accounts, and show the Balance Sheet after the admission of C.

(Ans : Gain of Revaluation Rs. 27,000. Balance Sheet Rs. 5,88,OOO)

10. Leela and Meeta were partners in a firm sharing profits and losses in the ratio of i5:3. In April 2017 they admitted Om as a new partner. On the date of Om's admission the balance sheet of Leela and Meeta showed a balance of Rs. 16,000 in general reserve and Rs. 24, OOO (Cr) in Profit and Loss Account. Record necessary journal entries for the treatment of these items on Om's admission. The new profit sharing ratio between Leela, Meeta and Om was 5:3:2.

11. Amit and Viney are partners in a firm sharing profits and losses in 3:1 ratio. On 1.1.2017 they admitted Ranjan as a partner. On Ranjan's admission the profit and loss account of Amit and Viney showed a debit balance of Rs. 40,000. Record necessary journal entry for the treatment of the same.

12. A and B share profits in the proportions of 3/4 and 1/4. Their Balance Sheet on March 31, 2016 was as follows:

Balance Sheet of A and B as at March 31. 2016

Liobitities	Amount (Rs.)	Assets	&/TtOLtFt£ (RS•)
Sundry creditors	41,500	Cash at Bank	26,500
Reserve fund		Bills	
Capital Accounts	4,000	Receivable	3,000
		Debtors	16,000
A	301900	Stock	20,000
B	16,000	Fixtures	1,000
		Land & Building	25,000
	91.500		91.500

On April 1, 2017, C was admitted into partnership on the following terms:

(a) That C pays Rs. 10,000 as his capital.

(b) That C pays Rs. 5,000 for goodwill. Half of this sum is to be withdrawn by A and B.

(c) That stock and fixtures be reduced by 10% and a 5%, provision for doubtful debts be created on Sundry Debtors and Bills Receivable.

(d) That the value of land and buildings be appreciated by 20%.

(e) There being a claim against the firm for damages, a liability to the extent of Rs. 1,000 should be created.

(f) An item of Rs. 650 included in sundry creditors is not likely to be claimed and hence should be written back.

Record the above transactions (journal entries) in the books of the firm assuming that the profit sharing ratio between A and B has not changed. Prepare the new Balance Sheet on the admission of C.

(Ans : Gain on Revaluation Rs. 1600. Balance Sheet Total Rs. 1,05,950).

13. A and B are partners sharing profits and losses in the ratio of 3: 1. On I* April. 2017 they admitted C as a new partner for 1/4 share in the profits of the fiirm. C brings Rs. 20,000 as for his 1/4 share in the profits of the firm. The capitals of A and B after all adjustments in respect of goodwill, revaluation of assets and liabilities, etc. has been worked out at Rs. 50,000 for A and Rs. 12,000 for B. It is agreed that partner's capitals will be according to new profit sharing ratio. Calculate the new capitals of A and B and pass the necessary journal entries assuming that A and B brought in or withdrew the necessary cash as the case may be for making their capitals in proportion to their profit sharing ratio?

14. Pinky, Qumar and Roopa partners in a firm sharing profits and losses in the ratio of 3:2:1. S is admitted as a new partner for 1/4 share in the profits of the firm, whichs he

gets 1/8 from Pinky, and 1/ 16 each from Qmar and Roopa. The total capital of the new firm after Seema's admission will be Rs. 2,40,000. Seema is required to bring in cash equal to 1/4 of the total capital of the new firm. The capitals of the old partners also have to be adjusted in proportion of their profit sharing ratio. The capitals of Pinky, Qumar and Roopa after all adjustments in respect of goodwill and revaluation of assets and liabilities have been made are Pinky Rs. 80,000, Qumar Rs. 30,000 and Roopa Rs. 20,000. Calculate the capitals of all the partners and record the necessary journal entries for doing adjustments in respect of capitals according to the agreement between the partners?

15. Azad and Babli are partners in a firm sharing profits and losses in the ratio of 2: 1. Chintan is admitted into the firm with 1/4 share in profits. Chintan will bring in Rs. 30,000 as his capital and the capitals of Azad and Babli are to be adjusted in the profit sharing ratio. The Balance Sheet of Azad and Babli as on March 31, 2016 (before Chintan's admission) was as follows:

Balance Gheet of A and B as on 51.05.2016

Liabilities		*Amount*	*Assets*	*Amount*
Creditors		8,000	Cash in hand	2,000
Bills payable		4,000	Cash at bank	10,000
General reserve		6,000	Sundry debtors	8,000
Capital accounts:			Stock	10,000
Azad	50,000		Furniture	5,000
Babli	32,000	82,000	Machinery	25,000
			Buildings	40,000
		1.00.000		1.00.000

It was agreed that:

i) Chintan will bring in Rs. 12,000 as his share of goodwill premium.

ii) Buildings were valued at Rs. 45,000 and Machinery at Rs. 23,000.

iii) A provision for doubtful debts is to be created A 6% on debtors.

iv) The capital accounts of Azad and Babli are to be adjusted by opening current accounts.

Record necessary journal entries, show necessary ledger accounts and prepare the Balance Sheet after admission.

(Ans : Gain or Revaluation Rs. 2,520. Balance Sheet Rs. 1,44,520).

16. Ashish and Dutta were partners in a firm sharing profits in 3:2 ratio. On Jan. 01, 2015 they admitted Vimal for 1/5 share in the profits. The Balance Sheet of Ashish and Dutta as on March 31, 2016 was as follows:

Liabilities	Amount (Rs.)	Assets		&/TtOLtFt£ (RS•)
Ashish Capital	80,000	Land & Building		35,OOO
Dutta's Capital	35,000	Plant		45,OOO
Creditors	15,000	Debtors	22,OOO	
Bills Payable	10,000	Less : Provision	2,OOO	20,000
		Stock		35,OOO
		Cash		5,OOO
	1.40.OOO			1.40.OOO

It was agreed that:

i) The value of Land and Building be increased by Rs. 1i5,00O.

ii) The value of plant be increased by 10,000.

iii) Goodwill of the firm be valued at Rs. 20,000.

iv) Vimal to bring in capital to the extent of 1/5"' of the total capital of the new fiirm.

Record the necessary journal entries and prepare the Balance Sheet of the firm after Vimal's admission.

(Ans : Gain on Revaluation Rs. 25,000. Balance Sheet Total Rs. 2,05,000).

17. The following is the Balance Sheet of a partnership firm on 31-12-1991.

Liabilities	Rs.	Assets	Rs.
Capitals		Sundry Assets	33,000
X	18,000	Cash	5,000
Y	12,000	Goodwill	6,000
Reserves	6,000		
Creditors	8,000		
	44,000		**44,000**

Z is admitted as a third partner on 01-01-1992 with a fifth share in the future profits of the firm. He is to bring Rs. 10000 in cash of which Rs.2000 is to be treated as premium for goodwill. Show journal entries if

(a) Goodwill account is to appear in the balance sheet at full value

(b) Goodwill account is fully wiped off the balance sheet.

18. Ram and Raghu share profits -irr-the proportion of three-fourth and one-fourth. The Balance

Sheet of the firm on 31 December, 1989 was us under:

Liabilities	Rupees	Assets	Rupees
Sundry creditors	4,150	Cash at bank	2,250
Capital accounts		B/R	300
Ram	3,000	Book debts	1,600
Raghu	1,600	Stock	2,000
		Furniture	100
		Building	2,500
	8,750		8,750

On January 1990 Peter was admitted into partnership on the following terms:

a) Peter pays Rs.1000 as capital and Rs.500 as goodwill for 1/5 share. Half of the amount of goodwill is to be withdrawn by Ram and Raghu. b) Stock and furniture be reduced by 10% and 5% respectively. Provision for doubtful debts be created on book debts and B/R at 5%. c) Value of buildings be increased by 20%. d) A liability to the extent of Rs.100 be created in respect of a claim for damages against the firm. e) An item of Rs.65 included in sundry creditors is unlikely to be claimed. You are required to prepare a Profit and Loss Adjustment Account and Balance Sheet of the new firm.

18. Rama and Sugriva are partners in a firm carrying on the business of Ravana bath. They shared profits and losses in the ratio of 3:2. The following was their balance sheet on 31-12-1976.

Liabilities	Rupees	Assets	Rupees
Capital accounts		Goodwill	20,000
Rama	1,00,000	Plant	45,000
Sugriva	75,000	Furniture & fitting	12,500
Creditors	85,000	Investments (cost)	25,000
Bills payable	5,000	Stock	57,500
		Bills receivable	10,000
		Cash in hand and at bank	40,000
	2,65,000		2,65,000

On 1st January, 1977 they agreed to admit Vibhishana as a partner on the following terms:

a) The new profit sharing ratio shall be Rama 2/5ths, Sugriva 2/5ths and Vibhishana 1/5ths.

b) Vibhishana is to bring his capital of Rs.50,000 in cash and to pay his share of goodwill in the firm. Goodwill for this purpose is to be valued at 2 years purchase of the previous 4 years profits. The profit for the previous 4 years were:

1971 - 25,000 ;1972 - 22,500 ;1975 - 25,000 ;1976 - 27,500

c) The other assets are to be revalued as follows: Rs. Plant 52,500

Furniture & fittings 10,000 ; Investments 22,000 ; Stock 63,000 ; Debtors 50,000

It was decided for the purpose of Balance sheet that the value of assets except cash shall remain unchanged. You are required to pass the necessary journal entries recording the above transactions and to prepare the opening balance sheet of the new firm.

RETIREMENT OF A PARTNER

Retirement of a partner means ceasing to be partner of the firm. A partner may retire (i) of there is agreement of this effect (ii) all partners give consent (iii) At will by giving written notice.

Introduction

Like admission and changes in profit sharing ratio in case of retirement or death also the existing partnership deep comes to end and the new once comes into exist- tense among the remaining partner. There is not much difference in the accounting treatment at the time of retirement or in the event of death.

Amount due to Retiring/Deceased Partner (To be credited to his capital account)

- Credit Blanca of his capital.
- Credit Balance of his current account (if any).

- Share of Goodwill. (By gaining partners)
- Share of Reserves of Undistributed profits.
- His share in the profit on revaluation of assets and liabilities.
- Share in profits up to the date of Retirement/Death. (By p & L suspense A/c)
- Interest on capital if involved.
- Salary if any

Deduction from the above sum (to be debited to capital account)

- Debit balance of his current account (if any)
- Share of existing Goodwill to be written off.
- share of accumulated loss.
- Drawing and interest on drawings (if any)
- Share of loss on account of Revaluation of assets and liabilities.
- His share of business loss up to the date of Retirement/Death (To p & L) suspense A/C)

Accounting Treatment

1. Calculation of new profit sharing ratio and gaining ratio
2. Treatment of goodwill.
3. Evaluation a/c preparation with the adjustment in the respect of unrecorded assets /liabilities.
4. Distribution of reserves and accumulated profits/loss.
5. Ascertainment of share of profit/loss till the date of retirement. death.
6. Adjustment of capital if required.
7. Settlement of the Accounts due to Retired/Deceased partner.

New profit Sharing Ratio & Gaining Ratio

New profit Sharing Ratio: it is the ratio in which the remaining partners share future profits after retirement/death.

Gaining ratio: it is the ratio in which the continuing partners have acquired the share from the outgoing partner. Gaining Ratio = New Ratio -Old Ratio.

Calculation of the two ratios.

Following situations may arise

1. When no information about new ratio or gaining ratio is given in question

In this case it considered that the share of the retraining partner is acquired the remaining partners in the old ratio. Then no need to calculate the new paining ratio as it will be the same as before.

2. Gaining ratio is given which is different than the old ratio in this New share of continuing partner = has old share + gained from outgoing partner.
3. if the new ratio is given the Gaining ratio = New Ratio -Old Ratio

TREATMENT OF GOODWILL

According to accounting standards – 10, Good will account can't be raised as only purchased goodwill is recorded in books. Therefore only adjustment entry is done for goodwill
Steps to be followed
1. When old good will appears in the books then first of all this is writer in the old ratio. Remember Old Goodwill old Ratio
All Partner's capital A/C Dr.
To Good Will A/c
2. After written off of goodwill adjustment of retiring partner's share goodwill will be made through the following journal entry.
Remaining Partner's Capital, A/C Dr. (in gaining
To Retiring/Deceased Partner's Capital A/c
Hidden Goodwill
Sometimes goodwill is not given in the question directly, But if a firm agrees to pay a sum which is more than retiring partner's balance in capital also after making all adjustment with respect to resaves, revaluation of assets and liabilities etc. then cases amount is treated as his share of goodwill (known as hidden goodwill).

3. Revaluation of Assets and Reassessment of Liabilities

Revaluation A/c is prepared in the same way as in the case of admission of a new partner. Profit and loss on revaluation is transferred among all the partners in old ratio.

4. Adjustment of Reservation and Surplus (Profits)

(Appearing in the Balance Sheet – Liability Side)

(a) General Reserve A/cDr.
Reserve Fund A/cDr.
Profit & Loss A/c (Credit Balance)Dr.
To all partners Capital/Current A/c (in old ratio)

(b) Specific Funds – If the specific funds such as workmen's compensation funds or investment fluctuation fund are in excess of actual requirement, the excess will be transferred to the Capital A/c in old ratio.

Workmen Compensation Fund A/cDr.
Investment Fluctuation Funds A/cDr.
To All Partner's Capital A/cs

(c) For distributing accumulated losses
(i.e. P & L A/c debit balance shown on the Asset side of Balance Sheet)
All partner's Capital/Current A/cDr. (in old ratio)
To P & L A/c
Disposal of the Amount Due to the Retiring Partner
This outgoing partners A/c is settled as per the terms of partnership deed. Three cases may be there as given below –

1. When the retiring partner is paid full amount either in cash or by cheque.
Retiring Partner's Capital A/cDr.
To Cash Bank A/c
2. When the retiring partner is paid nothing in cash then the whole amount due is transferred to his loan A/c
Retiring Partner's Capital A/cDr.
To retiring partner's Loon A/c
3. When Retiring Partner is partly paid in cash and the remaining amount in treated Loan.
Retiring Partner's Capital A/cDr. (Total Amount due)
To Cash Bank A/c (Amount Paid)
To Retiring Partner's Loan A/c (Amount of Loan)

Settlement of loan of the Retiring Partner

Loan of the retiring partner is disposed off accordingly of the pre decided term and conditions among the partners. Normally the Principal amount is paid in few equal installments. In such cases interest is credited to the Loan A/c on the basic of the amount outstanding at the beginning of each year and the amount paid it debited to loan A/c. The following Journal entries are done

a. For interest on Loan.
Interest A/cDr.
To Retiring partner's Loan A/c

b. For the payment of installment.
Retiring Partner's Loan A/cDr.
To Cash/Bank A/c (including interest)

Adjustment of Capitals

At the time of retirement/death, the remaining partners may decide to adjust their capitals in their new profit sharing Ratio. Then

· The sum of their capitals will be treated as the total capital of the new firm which will be divided in their New Profit Sharing Ratio.

Excess of Deficiency of capital in the individual capital A/c is calculated.

· Such excess or shortage is adjusted by withdrawal or contribution in case or transferring to their current A/cs.

Journal Entries

(a) For excess Capital withdrawn by the Partners

Partner's capital A/cDr.

To Cash/Bank A/c

(b) For deficiency, cash will be brought in by the partner

Cash/Bank A/cDr.

To Partner's capital A/c

DEATH OF A PARTNER

Accounting treatment in the case of death is same as in the case of return except the following:

1. The deceased partners claim is transferred to his executer's account.

2. Normally the retirement takes place at the end of the Accounting pried but the death may occur at any time. Hence the claim of deceased part shall also include his share or pro2. Normally the retirement takes place at the end of the Accounting pried but the death may occur at any time. Hence the claim of deceased part shall also include his share or profit or loss, interest on capital drawings if any from the date of the last balance sheet to the date his death.fit or loss, interest on capital drawings if any from the date of the last balance sheet to the date his death.

1. Calculation of profit/Loss for the intervening Period.

It is calculated by any one of the two methods given below:

a. On Time Basis : In this method proportionally profit for the time period is calculated either on the basis of last year's profit or on basis of average profits of last few years and then deceased profit share is calculated based on his share of profits.

b. On Turnover or Sales Basis : In this method the profits upto the date of death for the current year are calculated on the basis of current year's sales upto the date of death by using the formula.

Profits for the current year upto the date of death =

(Sales of the current year upto the date of death/total sales of last year)Profit for the last year.

The from this profit the deceased partner's share of profit is calculated.

A partner of a firm may decide to retire due to various reasons like ill-health, old age etc. He retires on the basis of retirement terms of a partner set out in the Partnership Deed. When a partner retires, the other partners enter into a fresh agreement and continue the business.
When a partner retires, the following accounting problems are to be looked into.

1. Calculation of new profit sharing ratio and profit gaining ratio.
2. Treatment of goodwill.
3. Revaluation of assets and liabilities.
4. Distribution of reserves/profit or losses.
5. Adjustment of capital accounts of continuing partners.
6. Ascertaining amount payable to the retiring partner and the mode of payment of the amount.

1. Calculation of new profit sharing ratio and profit gaining ratio of continuing partners

When a partner retires from a firm, the continuing partner may agree upon the new profit sharing ratio among themselves, otherwise they acquire the share of profit of the retiring partner in their profit sharing ratio. Profit gaining ratios is the difference between new profit sharing ratios and old profit sharing ratio of old partners.

Case 1

A, B and C are partners sharing profits and losses in the ratio of 4:3:3. B retires. Calculate the new profit sharing ratio, also calculate profit gaining ratio.

Solution

New profit sharing of A and C is 4:3 as there in no agreement on future profit sharing ratio, it is presumed the continuing partners purchase the retiring partner's share in their old profit sharing ratio (i.e.) 4:3. Therefore, the profit gaining ratio is also 4:3 between A:C.

Case 2

A, B and C are partners and share profits and losses in the ratio of 3:2:2. B retires from the partnership. A and C decide to share the future profits equally. Ascertain new profit sharing ratio and profit gaining ratio.

New profit sharing ratio between A and C is 1:1.

Profit gaining ratio for A = $1/2 – 3/7$

$= (7-6)/14 = 1/14$

Profit gaining ratio for B = $1/2 – 2/7$

$= (7-4)/14 = 3/14$

Profit gaining ratio between A & C is 1:3.

2. Goodwill Treatment

When a partner retires from a firm, the other partners stand to gain a share of his future profits. So the retiring partner has to be compensated by way of extra credit for his share of goodwill.

There are four ways for treating goodwill at the time of retirement. They are

1. Goodwill is raised in the books for its full value by crediting all partners capital account in the old profit sharing ratio.
2. Goodwill raised in the books as above is written off by debiting the capital accounts of the continuing partners in the new profit sharing ratio.
3. Goodwill may be raised in the books only to the extent of retiring partner's share and is written off by debiting the continuing parterns' capital accounts in the profits giving ratio.
4. Without raising goodwill, capital accounts of partners are adjusted for goodwill.

Example

A, B and C are partners in a firm sharing profits and losses in the ratio of 3:2:1. 'B' retires from the firm. The future profit sharing ratio of A and C is 2:1. The value of goodwill is estimated at Rs.42,000. Pass entries for the treatment of goodwill in each of the above cases.

Case 1

Goodwill is raised in the books for its full value by crediting all partners' capital accounts in their profit sharing ratio. Here the goodwill account will appear in the balance sheet an asset.

Goodwill a/c Dr 42000
    To A's capital a/c 21000
    To B's capital a/c 14000
    To C's capital a/c 7000
[Goodwill is raised for its full value by crediting all the partners' capital a/c in the old ratio]

Case 2

Goodwill raised and written off

a) Goodwill a/c Dr 42000
    To A's capital a/c 21000
    To B's capital a/c 14000
    To C's capital a/c 7000
[Goodwill raised to its full value crediting the capital accounts in the old ratio]

b) A's capital a/c Dr 28000
    B's capital a/c Dr 14000
        To goodwill a/c 42000
[Goodwill raised is written off by debiting the capital accounts of continuing partners in the new ratio]

Case 3

Goodwill raised to the extent of the retiring partners share and written off.

a) Goodwill a/c Dr 14000

To B's capital a/c 14000

[Goodwill raised to the extent of retiring partner's share]

b) A's capital a/c Dr 7000

C's capital a/c Dr 7000

To goodwill a/c 14000

[Goodwill raised is written off in the profit giving ratio]

Case 4

Without raising goodwill account in the book, when adjustment for goodwill is made.

A's capital a/c Dr 7000

C's capital a/c Dr 7000

To B's capital a/c 14000

[Retiring partner's capital account is credited with his share of goodwill by debiting the capital accounts of continuing partners in their profit sharing ratio]

3. Revaluation of Assets and Liabilities

When a partner retires the assets and liabilities are revalued so that he does not suffer or gain because of over/under stated assets and liabilities. Profit or loss arising on the revaluation of assets and liabilities is distributed to all partners in their profit sharing ratio. In case the continuing partners decide to show the value of assets and liabilities in the old value and not in the revalued value, they prepare Memorandum Revaluation Account.

4. Distribution of Reserves/Profits or Losses

Any balance of reserves/profits or losses on the date of retirement of a partner is distributed to all partners (including the retiring partner) in the old profit sharing ratio. The following entries are used in this regard.

For distribution of reserves/profits

Reserves/Profit & Loss a/c Dr

To all partners capital a/c (individually)

For distribution of losses

All partners capital account (individually) Dr

To profit & Loss (Dr) a/c

]

5. Adjustments of capital accounts of continuing partners

The continuing partners may decide to have their balance of capital accounts in proportion to their profit sharing ratio. In such a case they bring in cash or withdraw cash in order to make their capitals in proportion to the profit sharing ratio.

6. Ascertaining the account payable to the retiring partner and the mode of payment of the amount:

The capital account of the retiring partner is prepared on the date of retirement to arrive at the amount due to him. The usual credit entries in his account are:

1. Credit balance of his capital a/c
2. Credit balance of his current a/c
3. His share of goodwill
4. His share of accumulated profits and reserves
5. His share of profit on revaluation
6. His share of profit up to the date of retirement
7. Interest on capital up to the rate of retirement
8. His share of joint life policy

The usual debit entries in the account are

1. Debit balance of his capital account
2. Debit balance of his current account
3. His share of accumulated losses
4. His share of loss on revaluation
5. His share of loss up to the date of retirement
6. His drawings upto the date of retirement
7. Interest on his drawings upto the date of retirement

The account, after passing all relevant entries, is closed on the date of his retirement, and the balance (usually credit) is transferred to his loan account. Later the loan account is paid off as per the terms of retirement.

Ex-1: A, B and C are partners sharing profit and loss in the ratio of then on retirement of the gaining ratio/new, ratio will be

Solution: On A's Retirement 2: 1

On B's Retirement 3: 1

On C' s retirement 3:1

Ex-2: A, B, & C share profit in the ratio 3:2:1 on C's death his taken by A & b in the rate of 2:1 Calculate new ratio.

Solution: in this case gaining ratio = 2:1 (given)

A's old share = 3/6 B's old share = 2/6 & C's share = 1/6

A's gain =2/3 of c's share 2/3 *1/6 =2/18

B's gain = 1/3 of C's share =1/3 *1/6 =1/18

A’s new share = A’s old + gain
=2/6 +1/18 = 11/18
B, s new share = B’s old share + B’s gain
=2/6 + 1/18= 7/18
New ratio =11:7

Ex-3: A, B, C are partners in the ratio of 3:2:1 C retires & A & B decide to share future profit in the ratio of 5:3
Solution. A’s Gain = 5/8 – 3/6 = 3/24
B’s gain =3/8-3/6=3/24
Gaining ratio =3 :1

Distinction between the Sacrificing and Gaing Ratio

Basic	Sacrificing Ratio	Gaining Ratio
1. Meaning	It is the ratio in which the old partners surrender a part of their share of profits in favour of a new partner.	It is the ratio in which the remaining partners acquire the outgoing partner’s share of profit
2. When Calculated	At the time of admission of new partner	At the time retirement or death of a partner.
3. Formula	Sacrificing Ratio = Old Ratio – New ratio	Gaining Ratio = New Ratio – Old Ratio
4. Purpose I	New partners share of goodwill is divide between old partners in this ratio.	Retiring or deceased partner’s share of goodwill is paid by the continuing partners in the ratio.

Ex-4: M. N. & p are partners in a firm P retires & the goodwill of firm is valued at 30000. M & N decide to share future profits in the ratio of pass necessary adjustment entries.
1. if goodwill A/c already appears in books at 18000
2. When no goodwill A/c appears in the books.

Solution :
Old ratio of M, n &p= 1:1:1 (sharing ratio in not given it true as equal) New ratio = 3:2
M’s gain = 3/5 1/3 = 4/15
N’s gain = 2/5 – 1/3 1/15
Gaining ratio = 4:1

Ps share of goodwill = $30{,}000 \times \frac{1}{3}$ = Rs. 10,000

Journal

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	M's capital A/c Dr. N's capital A/c Dr. P's capital A/c Dr. To Goodwill A/c (Being the existing goodwill written off in old ratio i.e. 1:1:1)		9000 6,000 6,000	18,000
	M's capital A/c Dr. N's capital A/c Dr. To P's Capital A/c (Being adjustment made for goodwill on retirement in giving ratio i.e., 4 : 1)		8,000 2,000	10,000

Case 2 : When No goodwill already appears in the books then only second entry will be done.

Ex-5: R, S & T are partners in a firm sharing profit & loss in the ratio of 2 : 2 : 1. T Retires and his balance in capital a/c after adjustment for reserve & revaluation of assets & liabilities comes out to be Rs. 50000. Rs. & S agree to pay him Rs. 60000. Give journal entry for the adjustment of goodwill.

Solution :

New ratio between R & S = gaining ratio = 2:2 or 1:1

T's share of goodwill (hidden) = 60000- 50000 = 10000

Hence adjustment entry is

Journal

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	R's capital A/c Dr. To T's capital A/c Dr. To T's capital A/c (T's share of goodwill adjustment in gaining ratio i.e. 1:1)		5,000 5,000	10,000

Ex-6 : X, Y and Z are partners in a firm sharing profits and losses in the ratio of 2:1:1, Y retires on 31st march, 2011. On that date, there was a balance Rs. 24,000 in general reserve and Rs. 16,000 in profit and loss A/c of the firm. Give Journal entries.

Solution:

Journal

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	General Reserve A/c Dr.			
	P & L A/c Dr.			
	To X's capital A/c Dr.		24,000	20,000
	To Y's capital A/c		16,000	10,000
	To Z's capital A/c			10,000
	(Reserve & Surplus amount distributed in old ratio on Y's retirement)			

Ex-7 : P, Q and R are partner's sharing profits and losses in the ratio 3:2:1. P retires and on that date there was workmen's compensation fund amount Rs. 30,000. In the Balance Sheet. But actual liability on this account was for Rs. 12,000 on that date. Give Journal Entry.

Solution:

Excess amount in Workmen's Compensation Fund = Rs. 30,000 – Rs. 12,000 = Rs. 18,000 (Cr.)This will be transferred to all partner's Capital A/c in old ratio

Journal

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Workmen Compensation Fund A/c Dr.			
	To P's capital A/c			9,000
	To Q's capital A/c			6,000
	To R's capital A/c		30,000	3,000
	To Claim for workmen compensation fund A/c			12,000
	(Excess amount in Workmen Compensation Fund capital A/cs in old ratio) is transferred to parties			

Ex- 8 : A, B and C are equal partners. A retires and on that date there was a debit balance of L 15,000 in P & L A/c. Give Journal entry.

Solution :

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	A's capital A/c Dr.		5,000	

	B's capital A/c	Dr.		5,000	
	C's capital A/c	Dr.		5,000	
	To P & L A/c				15,000
	(Loss in P&L A/c written off (in old ratio) on A's retirement)				

Ex-9 : A, B and C are partners in a firm. B retires from the firm on the Jan 2015. On the date of his retirement Rs. 66,000 were due to him. It was decided that the payment will be done in 3 equal yearly installments together with interest @ 10% p.a. on the unpaid balance, Prepare B's Loan A/c.

Solution :

B's Loan A/c

Date	Particulars	L.F	Rs.	Date	Particulars	L.F	Rs.
2015 Dec 31	Bank A/c (22,000+6600)		28,600	2015	B's Capital A/c		66,000
	Balance c/d		44,000	Dec 31	By Interest A/c (10% of 66,000)		6,600
			72,600				72,600
2016 Dec 31	Bank A/c		26,400	2015 Jan 1	Balance b/d		44,000
	Balance c/d		22,000		Br. Interest A/c (10% of 44,000)		4,400
			48,400				48,400
2017 Dec 31	Bank A/c (Final Payment)		24,200	2017 Jan 1	Balance b/d		22,000
				Dec 31	Interest A/c (10% of 22,000)		2,200
			24,200				24,200

Ex 10: X, Y and Z are partners in a firm sharing profits in the ratio of 2:2:1 X retires and after all adjustments the Capital A/cs of the Y and Z have a balance of Rs. 70,000 and Rs. 50,000 respectively. They decided to adjust their capitals in new profit sharing ratio by withdrawing or bringing cash. Give necessary Journal entries and show your working clearly.

Solution:

The capital of the new firm

= Total Capital of Y and Z after adjustments

= 70,000 + 50,000

= 1,20,000

	Y (Rs.)	Z (Rs.)

	80000	40,000
New Capital based on New Ratio i.e. 2:1 (total being 1,20,000)		
Existing capital after adjustments	70,000	50,000
Cash is being brought or paid off	10,000 (brought in)	10,000 (to be paid)

Journal Entries

	Particulars	L.F	Debit (Rs.)	Credit (Rs.)
1.	Bank A/c Dr. To Y's Capital A/c (Amount to be brought in by Y)		10,000	10,000
2.	Z's Capital A/c Dr. To Bank A/c (Amount to be withdrawn by Y)		10,000	10,000

EX-11 : A, B and C are partner sharing profits in the ratio of 3:2:1. A on 31st July 2015. The profits of the firm for the year ending 31st March 2015 year Rs. 42000. Calculate A's share for the period from 1st April to 31st July 2015 on basis of last year's profits. Pass necessary journal entry also.

Solution : A's Profit = Preceding year's profit $\times$ Proportionate Period $\times$ Share of A

$$Rs.\ 42,000 \times \frac{4}{12} \times \frac{3}{6}$$

Rs. 7,000

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
2015 July, 31	Profit and Loss Suspense a/c Dr. To A's Capital A/c (A's share of profit transferred to his capital A/c		7,000	– 7,000

Ex-12 : If in the – 1 given above the sales for the last year are Rs. 2,10,000 and for the current year upto 31st July are say Rs. 90,000 then Profits from 3st April to 31st July 2015.

Solution : = $\frac{90,000}{2,10,000} \times 42,000$ **=** Rs. 18,000

A's share = Rs. $18,000 \times \frac{3}{6}$ **=** 9,000

Journal Entry will be

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
2015 July, 31	P&L Suspense A/c Dr. To A's Capital A/c (Being A's share of profit till date of his death transferred to his capital A/c		9,000	9,000

Comprehensive Illustrations

Problem 1: (Preparation of balance sheet of the reconstituted firm) Vijay, Vivek and Vinay are partners in a firm sharing profits in 2:2:1 ratio, On 31.3.2015 Vivek retires from the firm. On the date of Vivek's retirement the balance sheet the firm was as follows: Balance Sheet of Vijay, Vivek and Vinay

Particulars	(Rs.)	Assets	(Rs.)
Creditors	54,000		55,000
Bill Payable	24,000		
Outstanding Rent	4,400	Bank	
Provision for Legal	12,000	Debtor 12,000 Less: Provision	11,200
Cluim		for	18,000
Capital :		Doubtful 800	8,200
Vijay 92,000		Stock	1,94,000
Vivek 60,000		Furniture	
Vinay 40,000	1,92,000	Premises	
	2,86,400		2,86,400

On Vivek's retirement it was agreed that :

i. Premises will be appreciated by 5% and furniture will be appreciated by Rs. 2,000 Stock will be depreciated by 10%

ii. Provision for bad debts was to be made at 5% on debtors and provision legal damages to be made for Rs. 14,400.

iii. Goodwill of the firm is valued at Rs. 48,000.

iv. Rs. 50,000 from Vivek's Capital A/c will be transferred to his Loan A/c and balance will be paid by cheque.

Prepare revaluation a/c, partners Capital A/cs and Balance Sheet of Vijay Vinay after Vivek's retirement.

Solution :

Revaluation Account

Particulars		(Rs.)	Assets	(Rs.)
To Stock		1,800	By Premises	9,700
To Provision for legal Claim		2,400	By Furniture	2,000
To Profit Transferred			By Provision For doubtful debts	200
Vijay	3,080			
Vivek	3,080			
Vinay	1,540	7,400		
		11,900		11,900

Partner's Capital Accounts

Particulars	Vijay	Vivek	Vinay	Particulars	Vijay	Vivek	Vinay
Vivek's Capital	12,800	–	6,400	By Balance b/d	92,000	60,000	40,000
Vivek's Loan	–	50,000	–	By Revaluation A/c	3,080	3,080	1,540
Bank	–	32,280	–	By Vijay's Capital	–	12,800	–
Balance c/d	82,280	–	35,140	By Vinay's Capital	–	6,400	–
	95,080	82,280	41,540		95,080	82,280	41,540

Balance Sheet As at 31st March 2015

Liabilities	(Rs.)	Assets		(Rs.)
Creditors	54,400			
Bill Payable	24,000	Bank		22,920
Outstanding Rent	4,400	Debtors	12,000	
Provision for legal claims	14,400	Less provision	600	11,400
Vijay's	50,000	Stock		16,200
Vivek's	82,280	Furniture		10,000
Vinay's	35,140	Premises		2,03,700
	2,64,220			2,64,220

Working Note :

1. New Provision of bad debts on debtors (5%) = 5% of Rs. 12,000 = 600 provision Rs. 800 as given in the balance Sheet. Excess of Rs. 200 is profit transferred to revaluation A/c

2. Goodwill of the firm = 48,000 Vivek share = $48,000\times\frac{2}{5}$ =Rs. 19,200 be given Vijay & Vinay in Gaining Ratio i.e. 2:1

Goodwill contributed by Vijay = $Rs.19,200\times\frac{2}{3}$ = Rs. 12,800.

Goodwill contributed by Vijay = $Rs.19,200\times\frac{1}{3}$ = Rs. 6,400.

3. Vivek's total amount due on retirement = Rs 82,280
Less: amount transferred to his loan A/c = Rs. 50,000
Amount to be paid by cheque = Rs. 32,280

Problem 2: (Death of a partner) M, N and 0 were partners in a firm sharing profits and losses equally. Their Balance Sheet on 31-12-2014 was as follows:

Liabilities		(Rs.)	Assets	(Rs.)
Capitals :				60,000
M	70,000		Plant and machinery	30,000
N	70,000		Stock	95,000
O	70,000	2,10,000	Sundry Debtors	40,000
General Reserve		30,000	Cash at Bank	35,000
Creditors		20,000	Cash in Hand	
-		2,60,000		2,60,000

N died on 14th March, 2015. According to the Partnership Dead, executers on the deceased partner are entitle to :

(i) Balance of partner's capital A/c

(ii) Interest on capital @ 5% p.a.

(iii) Share of goodwill calculated on the basis of twice the average of past there years profits.

(iv) Share of profits from the closure of the last accounting year till the date of the death on the basis of twice the average of three completed year's profit before death. Profits for 2012, 2013 and 2014 were Rs. 80,000, Rs. 90,000 and Rs. 1,00,000 respectively. Show the working for deceased partner's share of goodwill and profits till the date of his death. Pass the necessary journal entries and prepare N's Capital A/c to be renderer to his executers.

Solution :

Journal

Date	Particulars	L.F	Debit (Rs.)	Credit (Rs.)
2015 March, 14th	General Reserve A/c Dr. To N's Capital A/c (Being transfer of N's share of general reserve of his Capital A/c)		10,000	10,000
	Interest on Capital A/c Dr. To N's Capital A/c (Being interest 5% p.a. credited to N's Capital A/c upto 14/03.2010)		700	700
	M's Capital A/c Dr. O's Capital A/c Dr. To N's Capital A/c (Being goodwill adjusted in gaining ratio i.e. 1:1)		30,000 30,000	60,000
	Profit and Loss Suspense's A/c Dr. To N's Capital A/c (Being the transfer to N's share of profit to his capital A/c)		12,000	12,000
	N's Capital A/c Dr. To N's Executor A/c (Being the transfer of amount due to N's executor A/c)		1,52,700	1,52,700

N's Capital A/c

Particulars	(Rs.)	Particulars	(Rs.)
To N's Executors A/c	1,52,700	By Balance b/d	70,000
		By General Reserve A/c	10,000
		By Interest on Capital A/c $\left(70,000\times\frac{5}{100}\times\frac{73}{365}\right)$	700
		By M's Capital A/c	30,000
		By O's Capital A/c	30,000
		By Profit & Loss $\left(90,000\times2\times\frac{73}{365}\times\frac{1}{3}\right)$	12,000
	1,52,700		1,52,700

Working Note :

1. Calculation of Goodwill

Average profit for 3 years

$$\frac{(Rs.\ 80,000+90,000+1,00,000)}{2} = \text{Rs. } 90,000$$

Goodwill of the firm = Average Profit $\times$ No. Of year of Purchase

= $90,000 \times 2$ = Rs. 1,80,000

Total N's Share in Goodwill = $1,80,000 \times \frac{1}{3}$ **=** 60,000

2. Time from the date of last balance Sheet (31st December, 2014) to the date of death (14th March, 2015)

= 31 days of January + 28 days of Feb (2015 is not a leap year) + 14 days of March = 73 days

Payment for deceased : Partner payment for deceased partner either in lump sum or in installments.

a. When payment is made in full (lump sum)

Accounting entry in this case will be

Deceased Partner's Executor A/c Dr.

To Bank A/c

b. When Payment is made in installments. When payment is made in installments interest is paid on installments at agreed price or @ 6% per annum.

Journal entries are :

(i) When interest is allowed

Interest A/c Dr.

To Deceased Partner's Executor A/c

(ii) When instalment is paid :

Deceased partner's Executors A/c Dr.

To Bank A/c (interest & instalment amount)

Problem 3 : The balance sheet of PQ & R as 31st Dec.2012 was as follows.

Liabilities		(Rs.)	Assets	(Rs.)
Bill Payable		20,000	Cash at Bank	1,58,000
Employees Provident Fund		50,000	Bills Receivable	8,000
Workmen compensation reserve		90,000	Stock	90,000
Loan		1,71,000	Sundry Debtors	1,60,000
Capitals Accounts:			Furniture	20,000
P	2,27,500		Plant & Machinery	65,000
Q	1,52,500		Building	3,00,000
R	1,20,000	5,00,000	Advertisement Suspense	30,000
		8,31,000		8,31,000

The profit ratio was 3:2:1 R died on 30th April 2013. The partnership deed provides that :

a. Goodwill is to be calculate on the basis of 3 years purchase of preceding 5 years average profits. The profits were 2012. Rs. 2,40,000, 2011 Rs. 1,60,000, 2010 Rs. 2,00,000 2009 Rs. 1,00,000 and 2008. Rs. 50,000.

b. Deceased partner should be given share of profits upto the date of death on the basis of previous your profits.

c. The assets have been revalued as under Stock Rs. 1,00,000 Debtors Rs. 3,50,000. A bill for Rs. 6000 was found worthless.

d. A sum of Rs. 72,333 was paid immediately to R's executor & balance is paid in two equal installments (annual) with interest of 10% p.a. on outstanding amount. 1st installment was paid on 30th April 2014.

Prepare Revolution account & R's Executor account till it is finally settled. Accounts are closed on 31st December each year.

Solution :

Revaluation Account

Particulars		(Rs.)	Particulars	(Rs.)
To provision for Doubtful debts		10,000		
To Furniture		5,000		
To Plant & Machinery		15,000		
To Bill Receivable		6,000	By Stock	10,000
To Profits transferred to			By Building	50,000
P's capital A/c	12,000			
Q's capital A/c	8,000			
R's capital A/c	4000	24,000		
		60,000		60,000

R's Capital A/c

Date	Particulars	(Rs.)	Date	Particulars	(Rs.)
30.4.13	To advertisement A/c $\left(30,000 \times \frac{1}{6}\right)$	5,000	1.1.13	By Balance b/d	1,20,000
				By workmen Compensation reserve	15,000
				By Revaluation A/c	4,000
				By P's Capital A/c (goodwill)	
	To R's Executor A/c	2,22,333		By Q's capital A/c (goodwill)	45,000
				By P&L Suspense A/c	30,000

					13,333
		2,27,333			2,27,333

R's Executor Account

Date	Particulars	(Rs.)	Date	Particulars	(Rs.)
3.4.13	To Bank A/c	72,333	30.4.13	By R's capital A/c	2,22,333
31.12.13	To Balance c/d	1,60,000	31.12.13	By interest A/c $\left(10\% \, on 1,50,000 \times \frac{8}{12}\right)$	10,000
		2,32,333			2,32,333
			1.1.14	By Balance b/d	1,60,000
30.4.14	To Bank A/c 75000 15,000 -	90,000	30.4.14	By interest A/c $\left(\frac{10}{100} \times 1,50,000 \times \frac{4}{12}\right)$ 5000 Add $\left(\frac{10}{100} \times 75,000 \times \frac{8}{12}\right)$ 5000	10,000
31.12.14	To Balance c/d	80,000			
		1,70,000			1,70,000
			1.1.15	By Balance b/d	80,000
30.4.15	To Bank A/c 75,000 Add Interest 7,500	82,500	30.4.15	By interest A/c $\left(\frac{10}{100} \times 75,000 \times 4\right)$	2,500
		82,500			82,500

Working Note :

Average Profit = 2,40,000 + 1,60,000+2,00,000+1,00,000+50,000 = Rs. 1,50,000 Goodwill = $Rs. 1,50,000 \times 3$ = Rs. 4,50,000

R's share = $4,50,000 \times \frac{1}{6} Rs. 75,000$

Contribution by P&Q in ratio 3:2

P's share = $\frac{3}{5} \times 75000$ = 45000 Q's share $\frac{2}{5} \times 75,000$ Rs. 30,000

R's share of profits = $2,40,000 \times \frac{4}{12} \times \frac{1}{6}$ = Rs. 13,333

Problem-4: C, P and S were partners sharing profits 2/5, 3/10 and 3/10 respectively. Their balance sheet on 31st December 1983 was as follows.

Liabilities	Rs.	Assets	Rs.
Capital Accounts		Building	18,000
P 16000		Plant	14,000
B 12000		Motor Car	4,000
C 10000	38,000	Stock	10,000
Reserve	5,000	Debtors 7000	
Bills payable	2,000	(-) Provision 1000	6,000
Creditors	8,000	Cash at Bank	1,000
	53,000		53,000

P retires on that date on the terms:

(a) The goodwill of the firm is to be valued at Rs.7000

(b) Stock and building are to be appreciated by 10%

(c) Plant and motor car are to be depreciated by 10%

(d) Liability for the payment of gratuity to workers Rs.2000 is not recorded in the books, but the same is to be provided for

(e) Provision for bad debts is no more necessary

(f) It is decided not to maintain goodwill account in the books

(g) The amount payable to P is to be paid in 3 equal annual instalments beginning from

You are required to prepare

(i) Revaluation account

(ii) Partners' capital accounts

(iii) New balance sheet of M/s. L and S

(iv) P's loan account for 1984.

Solution

Revaluation Account

	Rs.		Rs.
Dec. 31, 1983		Dec. 31, 1983	
To Plant	1,400	By Stock	1,000
To Motor Car	400	By Buildings	1,800
To Liability for payment of gratuity	2,000	By Provision for bad	2,000
	3,800		3,800

[

Note: There is no profit or loss on revaluation]

Capital Accounts

	C (Rs.)	P (Rs.)	S (Rs.)		C (Rs.)	P (Rs.)	S (Rs.)
Dec. 31, 1983				Dec. 31, 1983			
To Goodwill (goodwill written back)	4,000		3,000	By Balance b/d	16,000	12,000	10,000
To Balance c/d	16,800	----	10,600	By Goodwill	2,800	2,100	2,100
To P's loan a/c	----	15,600	----	By Reserve	2,000	1,500	1,500
	20,800	15,600	13,600		20,800	15,600	13,600

Balance sheet of M/s. L and S as on 31-12-1983

Liabilities	Rs.	Assets	Rs.
Capital Account		Buildings	19,800
C 16,800		Plant	12,600
S 10,600	27,400	Motor Cars	3,600
P's loan account	15,600	Stock	11,000
Bills payable	2,000	Debtors	7,000
Creditors	8,000	Cash at Bank	1,000
Liability for payment of gratuity	2,000		
	55,000		55,000

P's loan account for 1984

	Rs.		Rs.
Jan. 1, 1983		Jan. 1, 1983	
To Cash	5,200	By Balance b/d	15,600
Dec. 31, 1984		Dec. 31, 1984	
To Balance c/d	11,440	By Interest	1,040

Death of a Partner

When a partner dies, the partnership comes to an end, but other partners may carry on the business by entering into a new agreement. The amount due to the deceased partner is ascertained as per the terms of Partnership Deed and as similar lines when a partner retires.

The amount due to the deceased partner on the date of death is paid to the executors of the deceased partner, immediately or in instalments. Retirement of a partner is a planned event and usually a partner will retire on the date of closing of the accounts of the firm. On the other hand a partner may die on any date during the accounting period. So he is entitled to his share of profit up to the date of death. The profit for the accounting period during which a partner dies, is ascertained on the date of death, (without closing the books) on the basis of average profits of past years, which is set in the Partnership Deed. Then his shares of profit upto the date of death is arrived at and credited in his account. In case of death, treatment of goodwill, revaluation of assets and liabilities, distribution of reserves/profits etc are done on similar lines when a partner retires. But goodwill is valued on the basis of the terms provided in the Partnership Deed in this regard. Moreover Sec.37 of the Partnership Act, is a relevant section in case of death, which says, the executors of the deceased partners would be entitled, at their choice, to interest at 6% p.a. on the amount due from the date of death to the date of payment or to that portion of profit which is earned by the firm with the help of the amount due to the deceased partner. A retiring partner is also eligible for such a benefit under this section.

Another important accounting aspect in case of death of a partner is the treatment of Joint Life Policy. The firm takes a life insurance policy on the joint lives of its partners in order to pay off the executors of the deceased partner without affecting the financial position of the firm.

Accounting for Joint Life Policy is done in three different ways. They are

1. Premium paid is treated as an expense
2. Joint life policy is shown in the balance sheet at its surrender value by treating it as an asset.
3. Joint life policy is treated as an asset and a reserve viz. joint life policy reserve is maintained.

1. Premium paid is treated as an expense

When premium paid is treated as an expense it is written off at the end of the year, by transferring it to Profit and Loss Account. In case a partner dies, the policy amount is credited to all partners including the deceased partner in their profit sharing ratio. The relevant entries are:

a) When premium is paid

Premium on JLP a/c Dr -

To Bank/cash -

[Payment of JLP premium]

At the end of the year the premium account is closed by transferring it to Profit & loss a/c.

b) Profit and loss account Dr -

To Premium on JLP a/c -

[Profit and loss account is cleared)

On the death of a partner, the policy amount receivable is credited to all partners in their profit sharing ratio.

Insurance Co. a/c Dr -

To Partners' capital a/c (individually) -

[Policy amount receivable is distributed to all partners in their profit sharing ratio]

When policy amount is received, the following entry is made:

Bank a/c Dr -

To Insurance Co. -

[Receipt of policy amount from Insurance Co.]

2. JLP is treated as an asset at its surrender value

When JLP is treated as an asset, then the following entry is passed at the time of payment of JLP premium

JLP a/c Dr - XXX

To Bank a/c - XXX

[Payment of premium is debited to JLP a/c and it is treated as an asset]

At the end of the year, the amount in excess of surrender value is transferred to profit and loss account. The relevant entry is

Profit and loss a/c Dr XXX

To JLP a/c - XXX

[Premium paid in excess of surrender value is treated as loss and transferred to profit and loss a/c]

So every year joint life policy account appears in the balance sheet at its surrender value. On the death of a partner the policy amount in excess of the surrender value is a gain and is distributed to all partners in their profit sharing ratio. The relevant entries are

a) Insurance Co. a/c Dr -

To JLP a/c

[Amount due by the insurance company on the death of a partner]

b) JLP a/c Dr -

To All partners' capital a/c (individually) -

[Balance of amount in the JLP a/c is distributed to all partners in their profit sharing ratio]

c) Bank a/c Dr -

To Insurance Co. a/c

[Receipt of money from the Insurance Company]

3. Joint Life Policy is treated as an investment and a reserve viz. JLP reserve, is maintained

The relevant entries are

a) Joint life policy a/c Dr -

To Bank -

[Payment of premium]

b) Profit and loss a/c Dr -

To JLP reserve a/c

[An amount equal to the premium paid is debited to profit and loss account and a joint life policy reserve account is created]

Then JLP account and JLP reserve account are mutually adjusted so as to leave a balance in each account equal to the surrender value of the policy. The following entry is passed for this:

Joint life policy reserve a/c Dr -

To Joint life policy account

[Mutual adjustment entry so that both the accounts show a balance which is equal to the surrender value]

The above entries are passed every year. On the death of a partner, the balance of joint life policy reserve account is closed by transferring it to Joint Life Policy Account, and the amount received as the policy amount is credited to all partners in their old profit sharing ratio and joint life policy account is also closed. The following entries are passed.

a) Joint life policy reserve account Dr -

To joint life policy account

[On the death of a partner JLP reserve is closed by transferring it to Joint life policy account]

b) Insurance Co. a/c Dr -

To Joint life policy a/c

[Policy amount due on the death of a partner]

c) Joint life policy a/c Dr -

To all partners capital a/c (individually) -

[Joint life policy account is closed by transferring it to all partners' capital a/c in their profit sharing ratio]

d) Bank a/c Dr -

To Insurance Co. a/c –

[Receipt of policy amount from the Insurance Co.]

Illustration 6

X, Y and Z carried on business in partnership, profits being divisible to X 1/2; Y 1/3; Z 1/6. The balance sheet on 31-12-1986 showed their capitals to be X - Rs. 20,000; Y - Rs.15,000; Z - Rs.10,000 ,

On 31-03-1987 X died and you are asked to prepare the executor's account of X having regard to the following facts:

1. The firm insured the partners' life severally X for Rs.10000, Y for Rs.7500 and Z for Rs.5000. The premiums have been charged to profit and loss account and the surrender value on 31-03-1987 amounted in each case to one-half of the sum assured.

2. Capitals carried interest at 6% p.a.

3. X's drawings from 01-01-1987 to the date of death were Rs.3500.

4. X's share of profits for the portion of the current financial year for which he lived was to be taken at the sum. Calculate on the average of the last three completed years and goodwill was

to be raised on the basis of two years purchase of the average profits of those three years. The annual profits of last three years were Rs.7500, Rs.8000 and Rs.9000 respectively.

Workings: X's claim

(1) Joint life policies

X's policy - Rs.10000; 1/2 of 10000 = Rs.5000

Y and Z policies Surrender value = 1/2 (7500 + 5000) = 1/2x 12500= 6250

X's share = 6250 x 1/2 = Rs.3125

(2) Interest on capital

Rs. 20000 x 6/100 x 3/12 = 300

(3) Share of profit

X's share of profit for 3 months on the average profits of last 3 years

Average profit = (7500 + 8000 +9000)/3 = Rs.8167

X's share = 8167 x 1/2 x 1/4 = Rs.1021

(4) Share of goodwill

Average profits x 2 = 8167 x 2 = 16334

X's share of goodwill = Rs.8167 (16334 x 1/2)

Solution

Executor's Account of X

	Rupees		Rupees
March 31, 1987		March 31, 1987	
To drawings	3,500	By balance b/d	20,000
To balance c/d	24,113	By joint life policy	5,000
		By interest on capital	300
		By goodwill	8,167
		By profit and loss suspense a/c	1,021
		By Y and Z's capital a/c	3,125
		(Share of surrender value of X and Y policies)	
	37,613		37,613

Problems to practice:

Problem on Retirement

1. A, B and C are partners in a trading concern sharing profits and losses equally. C decided to retire with effect from 31-12-1982. The following is the summarized balance sheet of the firm as on that date:

	Rs.		Rs.
Capital Accounts		Buildings	20,000
A 25000		Plant and machinery	10,000
B 20000		Patents	15,000
C 15000	60,000	Stock	12,500
Trade creditors	20,000	Debtors	15,000
		Cash at bank	7,500
	80,000		80,000

The following revised value of assets was agreed upon: goodwill Rs .20000; Building Rs .27500; Plant and machinery Rs.9000; Patents Rs.13250. It was also agreed to create a bad debts reserve at 5% on debtors. Show the revaluation account, capital accounts of A and B (assuming any balance due to C is transferred to his loan account) and opening balance sheet of A and B.

Problems on Death of a partner

2. Jaswant, Karji and Charji were partners in the firm of Fire Works Company, their profits sharing proportion being 4, 3 and 2 respectively. Their Balance Sheet as at 30th June 1977, on which date Jaswant died is as follows:

	Rupees		Rupees
Bank Overdraft	5,000	Cash	1,000
Creditors	2,000	Debtors	10,000
Workmen's Accident Fund	9,000	Stock	16,000
Partners Account:		Motor Car	2,000
Jaswant - 7,000		Furniture	1,000
Karji - 4,000		Plant and Machinery	20,000
Charji - 3,000	14,000	Land & Factory	30,000
Capital Accounts			
Jaswant - 20,000			
Karji - 20,00			
Charji - 10,000	50,000		
	80,000		80,000

The partnership agreement provided that on the death of a partner:

(i) The firm shall be continued by the other partners,

(ii) Goodwill to be computed on the basis of two years' profits on the average of the three preceding years,

(iii) Fixed and Floating Assets to be revalued and

(iv) The amount ascertained to be due to the deceased partner's legal representative to be retained as Loan to the firm, one-third of the amount plus interest at 6 percent per annum of the balance outstanding being paid on 30th June each year until fully repaid.

The profit of three preceding accounting years which ended on 31st March, were Rs.30,000; Rs.45,000 and Rs.60,000 respectively. On revaluation as at 30th June 1977, the amounts for Land and Factory, Plant and Machinery, Furniture, Motor Cars and Stock came to Rs.60,000; Rs.80,000; Rs.3,000; Rs.5,000 and Rs.21,000 respectively. While the Debtors were considered good at the book figure less 10 percent reserve for doubtful debts.

You are asked to give effect to the foregoing in the books of the firm and prepare:

(a) Revaluation Account

(b) Revised Balance Sheet as at 30-06-1977

(c) The legal representative's loan account for the three years ended 30-06- 1980 [Calculation to be made to the nearest rupee].

3. Sanil, Nitish, Sapna were partners in a firm sharing profits and losses in the proportion of 1/2, 1/3 and 1/6 respectively. Their Balance Sheet as on 31st March, 2012 was as follows:

Balance Sheet as on 31-03-2012

Liabilities	**Amount Rs**	**Assets**	**Amount Rs**
Bills Payable	30,000	Machinery	40,000
Capitals:		Furniture	5,000
Sanil	80,000	Sundry Assets	60,000
Nitish	50,000	Stock	30,000
Sapna	30,000	Debtors	32,000
		Bank	23,000
	1,90,000		**1,90,000**

Sapna decided to retire on 1st April 2012 on following terms:-

1) Goodwill of the firm will be valued at Rs 30,000/-

2) Furniture was taken over by Sanil for Rs 4,700/-

3) Make a provision for unpaid expenses Rs 1,700/-

4) Out of the amount due to Sapna Rs 7,500/- to be paid by cheque and the remaining amount to be transferred to her loan account.

4. Pai, Amba and Manoj are partners in a firm sharing profit and losses in the proportion to their capitals. Their Balance Sheet as on 31.3.2012 is as follow:

Balance Sheet as on 31st March, 2012

Liabilities	Amount Rs	Assets	Amount Rs
Capitals		Cash	3,000
Pai	30,000	Stock	12,000
Amba	30,000	Debtors	20,000
Manoj	15,000	Plant	13,000
Creditors	7,000	Building	20,000
Outstanding Expenses	15,000	Motor Van	31,000
Profit and Loss A/c	20,000	Goodwill	18,000
	1,17,000		**1,17,000**

On the above date Pai retired and the following adjustments have been agreed upon

1) Goodwill was revalued at Rs 15,000

2) Assets and Liabilities were revalued as under debtors Rs 17,000 stock at 90% of book value Building Rs 35,000 Plant Rs 11,500 Motor Van Rs 29, 500, Outstanding expenses Rs 18,000

3) Amba and Manoj contributed additional capital of Rs 20,000 and Rs 10,000 respectively

4) Balance due to Mr. Pai is transferred to his loan account after paying him Rs 1,000/-

Prepare:- Profit and Loss adjustment A/c,. Partner's Capital A/c's and Balance Sheet of new firm

5. Shailesh, Anil and Das were partners sharing profits and losses in the ratio at 3:3:2. Their Balance Sheet as on 31.3.2012 is as below:

Balance Sheet as on 31st March, 2012

Liabilities	Amount Rs	Assets	Amount Rs
Capitals		Building	10,000
Shailesh	11,000	Machinery	10,700
Anil	15,000	Furniture	10,000
Das	8,000	Debtors	5,000
Bills Payable	1,900	Stock	6,600
Creditors	9,000	Cash	6,600
Reserve fund	4,000		
	48,900		**48,900**

In 1st April, 2012 Mr. Das retired from the firm on following terms:

1) Shailesh and Anil's share in reserve fund should be continued in new firm.

2) Goodwill of the firm is to be valued at Rs 4,000 however only Das's share in it is to be raised in the books and written off immediately

3) Assets to be revalued as under stock Rs 6,300 machinery Rs 10,000 furniture Rs 10,200

4) R.D.D. to be maintained at 10% on debtors

5) Rs 100 to be written off from creditors

6) The amount payable to Mr. Das is to be transferred to his loan account

Prepare:- Profit and Loss adjustment A/c, Partners capital A/c and Balance Sheet of New firm on 1/04/2012

6. Shedge, Mayekar and Raut were partners sharing profits and losses in the ratio of 4: 3: Their Balance Sheet on 31st March 2012 was as given below:-

Balance Sheet as on 31st March, 2012

Liabilities	Amount Rs	Assets	Amount Rs
Capitals		Furniture	4,200
Shedge	15,000	Stock	13,000
Mayekar	10,000	Debtors	10,000
Raut	10,000	Bill Receivable	18,000
Creditors	8,000	Cash/Bank	2,000
Bank Overdraft	10,000	Profit and Loss A/c (Loss)	5,800
	53,000		**53,000**

Raut retired from the business on above date and it was agreed that the amount due to Raut to be paid immediately by availing overdraft facility

1) His share of goodwill was raised at Rs 3,500

2) Revalue furniture Rs 4,000 and stock Rs 16,000

3) Create R.D.D. at 5% on Debtors.

4) Make provision for outstanding printing bill Rs 6,000. Prepare profit and loss adjustment A/c, Capital A/c and Balance Sheet of continuing partners assuming that goodwill is written off by the continuing partners.

7. Sathe, Deshpande and Madlani were partners sharing profits and losses in the ratio of 5:2:3. Their Balance Sheet was as follows:

Balance Sheet as on 31st March, 2012

Liabilities	Amount Rs	Assets		Amount Rs
Capitals		Plant and Machinery		50,000
Sathe	70,000	Building		1,00,000
Deshpande	80,000	Motor Van		20,000
Madlani	50,000	Stock		30,000
Creditors	25,000	Debtors	36,000	
Bills Payable	12,000	*Less*: R.D.D.	2,000	34,000
Reserve Fund	25,000	Cash		28,000
	2,62,000			**2,62,000**

Deshpande retired on that date on the following terms:

1) Plant to be depreciated by 10% and Motor Van by 20%.

2) Stock to be appreciated by 10% and building by 20%.

3) R.D.D. is no longer necessary

4) Provision is to be made for Rs 8,000 being compensation to worker

5) The goodwill of the firm to be valued at Rs 40,000 and Deshpande's share in it should be raised.

6) Both the remaining partners decided to write off the goodwill

7) Amount payable to Shri. Deshpande to be kept as his Loan

Prepare:

1) Profit and Loss Adjustment Account

2) Partner's Capital Accounts

3) New Balance Sheet

DISSOLUTION OF PARTNERSHIP FIRM

Before the dissolution of the partnership, let us understand the difference between the 'dissolution of the partnership' and the 'dissolution of the partnership firm'. Dissolution of partnership means the end of the partnership business and dissolution of partnership firm means the end of partnership business along with the firm. The dissolution of a partnership firm means termination of every contractual relationship between the partners and that all the operations which are being performed in a company are suspended and all the assets and liabilities are settled and disposed off.

Now the question arises when the partnership is going to be dissolved? There can be different reasons for the dissolution of a partnership as when a new partner is added or when a partner is dead or leaves the partnership, etc and the remaining partners can continue their business. And when there is a change in the partners so the prior partnership comes to an end and the new partnership takes place with the liability and assets of the old one.

The partnership may be dissolved due to the following reasons:

- Due to the death of the partner.
- Due to the admission of a new partner.
- Due to the retirement of a partner.
- Due to the bankruptcy of a partner.
- Due to the expiry of the partnership period, if the partnership is for a particular period.

Modes of Dissolution

There are some modes by which a partnership can be dissolved and those are:

By an act of partners: when a partner agrees to dissolve a partnership at a particular time. Partners can come into an agreement regarding a particular time period maybe five years. In which partners can end the agreement at the end of the five years. Sometimes partners can dissolve it in the middle of the time period under specific conditions.

By operation of law: a partnership is the consequence of an agreement which is governed by law. Therefore if any unlawful activity is performed so it will be dissolved. You can make a valid partnership for illegal work.

By the court's decree: a partnership can be dissolved by the court and the court will only allow under these conditions:

If the partner is incapable to work;

If the partner is mentally unstable;

If the partner misbehaves which creates a bad impact on the partnership;

If there is a breach of the agreement by a partner.

Statement of dissolution: dissolution can be done by filing the statement to the state's secretary. The form must contain the information regarding the partnership name, date and reason of dissolution.

Rights after Dissolution

Section 46 of the Indian Partnership Act, 1932 deals with the rights of partners after dissolution. After the dissolution of the partnership, partners have certain rights regarding the same:

- Right to an equitable lien: on the dissolution of the firm, every partner is entitled to certain rights like the right to have the property of the firm used in payments of debts and liabilities and rights to have surplus distributed among all the partners.
- Right to return of premium: at the time of the partnership, partners pay an amount in the form of premium when the partnership dissolves. Partners get that premium according to the agreement.
- Rights where partnership contract is revoked for fraud or for other reasons: if a partner agrees to join a firm by fraud or by misrepresentation by the other partners, or if he finds so he has the right to put an end to the partnership agreement.
- Right to restrain the use of the firm's name or property: after the dissolution of the partnership, the partner has a right to stop other partners from using the same name of the firm.
- The right to earn personal profit by using the firm's name: if on the dissolution, the partner has a right to use the name of the firm as he buys goodwill of the firm and can earn profit from it.

Liabilities after Dissolution

Section 45 of the Indian Partnership Act, 1932 deals with the liability for acts of partners done after the dissolution. Liabilities are:

The partners continue to be liable to the third party until the public notice of the dissolution is given, it will not be applied to the partner who is dead or the partner who is insolvent or to the sleeping partner or to the retired partner. After the dissolution of the partnership, the partner is liable to pay his debt and to wind up the affairs regarding the partnership. After the dissolution, partners are liable to share the profit which they have decided in agreement or accordingly.

Dissolution of partnership means coming to an end of the relation known as partnership, between various partners. when one or more partners cease to be partners but others continue the business in partnership, there is dissolution of partnership between the outgoing partners on the one hand and the remaining partners on the other. the remaining partners as between themselves still continue as partners. For example, when the firm consists of A, B and C and A retires, there is dissolution of partnership between A and others but partnership as between B and C is not dissolved. In such a case, there is dissolutuion of partnership between some of the partners only, but there is no dissolution of the firm.

According to s 39, when the dissolution of partnership between all the partners of the firm occurs, this is called dissolution of the firm. For example, when in a firm consisting of A,B and C all of them cease to be partners with one another, it amounts to dissolution of the firm.
A firm may be dissolved in the following ways:

a. By agreement;
b. Compulsory dissolution;
c. On happening of certain contingencies;
d. By notice;
e. By the court.
a. Dissolution by agreement (s 40)

A firm may be dissolved either-
i) with the consent of all the partners, or
ii) in accordance with a contract between the partners.
As partners can create partnership by making a contract as between themselves, they are also similarly free to end this relationship and thereby dissolve the firm by their mutual consent. When all the partners so agree, they may dissolve the firm at any time they like.
Sometimes there may have been a contract between the partners indicating as to when and how a firm may be dissolved, a firm can be dissolved, in accordance with such a contract. For instance, if the contract between the partners provides that on a 6 month's notice by a partner the firm may be dissolved, then in accordance with this contract, a partner could give 6 month's notice and get the firm dissolved.

b. Compulsory dissolution (s 41)
S 41 mentions certain events on the happening of which there is compulsory dissolution of the firm. Such dissolution is compulsory and if the partners want to continue in partnership by agreeing to the contrary they cannot possibly do that. S 41 is as under:
41. Compulsory dissolution.- A firm is dissolved -
a) by the adjudication of all the partners or of all the partners but one as insolvent, or
b) by the happening of any event which makes it unlawful for the business of the firm to be carried on or for the partners to carry it on in partnership: Provided that, where more than one separate adventure or undertaking is carried on by the firm, the illegality of one or more shall not of itself cause the dissolution of the firm in respect of its lawful adventures and undertakings.

According to s 41, therefore, compulsory dissolution occurs under the following circumstances:

i) When all the partners or all except one are adjudicated insolvent, the firm is compulsorily dissolved. we have already noted that when a partner is adjudicated insolvent, he ceases to be a partner. therefore, when all the partners or all except one adjudicated insolvent, there is no question of persons remaining partners with one another and therefore, there has to be dissolution of the firm.

ii) if the business of the though lawful when the firm came into existence, subsequently becomes unlawful, there has to be dissolution of the firm, this provision is based on the rules of the law of contract, for a valid contract the object and consideration have to be lawful as defined in section 23, Indian Contract Act further provides that when the contract to do an act becomes unlawful after making the contract, such a contract becomes void. For enample, a number of persons join together as partners to sell liquor in a certain area. subsequently, the government imposes prohibition in that area and the sale of liquor is banned. as soon as the sale of liquorin that area becomes unlawful, the firm is dissolved.

If the firm was carrying on more than one adventures or undertakings, the illegality of one or more of them shell not of itself result in the dissolution of the firm in respect of those adventures or undertaking which are still lawful.

There is also compulsory dissolution of the firm if some event happens because of which it becomes unlawful for the partners . to continue as partners with each other. For example, two partners reside and carry on trade in two different countries. If war breaks between these two countries and the further commercial intercourse between the two partners thereby becomes against public and thus unlawful, there is compulsory dissolution of the firm.

(3) DISSOLUTION ON HAPPENING OF CERTAIN CONTINGENCIES {42}

Section 42 mentions certain contingencies of which the firm is dissolved, unless there is a contract to the coutray. Unlike the dissolution under section 41, which is compulsory, the dissolution contemplated under section 42 is not compulsory, Even on the happining of the contingencies mertioned in section 42, partners may agree that the firm will not be dissolved, but the business of the firm will be continued as before. the contingencies mentioned in the section are :

(I) Expiration of the partnership term,

(II) Completion of the adventure,

(III) Death of a partner, and

(IV) Insolvency of a partner.

(I) EXPIRATION OF THE PARTNERSHIP TERM: When the partnership had been constituted for a fixed term, it continues obviously for the contemplated term and would be dissolved on the expiry of such term . if the partners so like they may agree to the contrary and continue the business even beyond that time. such an agreement may be express or implied if a will . Unless otherwise agreed, the same mutual rights and duties continue for the extended period as they we there before the expiry of the term.

(II) COMPLETION OF THE ADVENTURE: Partnership created for some specific adventures or undertakings come to an end on the completion of such adventures or undertakings. thus, when the partnership was created specifically for carrying out contract of construction of a road and the road was completed on 24 .7.63 and final bill prepared on 18. 2. 65, the partnership stood dissolved on 18. 2. 65. the suit for dissolution filed withen 3 years of 18. 2. 65 was held to be within time.

There can, however,be an agreement by which the partnership may not be dissolved and the business may be continued for some other adventures or undertakings after the completion of the earlier ones. unless otherwise agreed, the same mutual rights and duties between the partners continue in respect of their relationship for the new adventures and undertakings also [S 17 (c)].

(III) DEATH OF A PARTNER: Death of a partner results in the dissolution of the firm unless the remaning partners agree to the contary this provision is applicable when there are more than two partners in a firm, where on the death of them the others may agree to still continue the same old firm without its being dissolved. if there are only two partners and they agree that on the death of one of them , the firm would not be dissolved but will continue with the surviving partner and the heir of the deceased partner, the agreement is meaningless because on the death of one of them remains only one partner. There is no partnership to which somebody eise could be introduced. if the heir of the deceased partner is to carry on the business in partnership with the surviving partner. it will be a new partnership for which an agreement between the two persons to create partnership has to be entered into . In Mt. Sughra v. Babu (AIR 1952 All 506), it was held that when a firm consisted of just two partners, a term in their contract not to dissolve the firm on the death of one of them was invalid. Agarwala J. observed :

" In the case of partnership consisting of only two partners, no partnership remains on the death of one of them and, therefore, it is coctradiction in terms to say that there can be a contract between two partners to the effect that on the death of one of them, the partnership will not be dissolved but will continue."

The same view has also been adopted by the Madras High Court and considered to be the poper view, by the supreme court in Commissioner of Income Tax v. Seth Govindram (AIR 1966 S.C.24). In that case A and B entered into a partnership in 1943 to work a sugar mill. it was agreed between them that on the death of either of them the firm should not be dissolved but the legal heir or nominee of the deceased should not be taken in his place. A died in 1945. it was held that on A 's death, the original partnership between A and B has come to an end and the same partnership could not continue with A's widow taking A's place, or A's son claiming that he become a partner in pursuance to the agreement between A and B in 1943. it was observed that there is a possibility that in pursuance of the wishes or the directions of the deceased partner, the surviving partner may enter into a new partnership with the heir of deceased partner, but that would constitute a new partnership and not the continueance of the old one.

(IV) **INSOLVENCY OF PARTNER:** When a partner is adjudicated insolvent, he ceases to be a partner. the firm is also dissolved unless there is an agreement between the remaining partners to the contray. this provision has to be read alongwith Sec. 41(a) which states that when all or all except one partner become insolvent, there is compulsory dissolution of the firm . if , therefore, there are only two partners and one of them is adjudicated insolvent, there is compulsory dissolution under section 41 and there is no question of there being a contract to the contrary making the firm to continue.

Suit for dissolution of firm and rendition of accounts: The plaintiff along with 8 other had entered into a partnershiop. Deed of reconsititution of partnership showed him as partner of firm. his expulsion from firm not bdempowoosrm if et ered by the contract between partners was not valid. plea that plaintiff was not a partner also failed, but since the firm stood dissolved on seving of the summons to defendants after filing of suit, plaintiff was only entitled to seek for rendition of accounts of firm for a period of 3 years prior to filing of suit (Shivraj Reddy and Brothers v S. Raghuraj Reddy, AIR 2002 N.O.C. 120 A.P.)

DISSOLUTION OF FIRM DUE TO DEATH OF PARTNER: Where the deed of partnership did not contain clause that remaining partner could carry on the business thereafter , held that on the death of partner the firm stood dissolved. as there was no proof of fresh agreement or business being done subsequently, the same would not tantamount to continue of earlier partnership (Shivraj Reddy and Brothers v S. Raghuraj Reddy, AIR 2002 N.O.C. 120 A.P.).

(4) Dissolution by notice in Partnership at will [section 43] When the partnership is at will as defined in section 7, the partners are not bound to remain as partners or continue the partnership for any fixed period. According to section 43, such a firm may be dissolved by any partner giving notice in weiting to all the other partners of his intention to dissolve the firm . the

notice must clearly and in unambiguous terms indicate the intention of the partner giving notice to dissolve the firm. Dissolution by a notice under this section will be valid even though one of the partner to whom the notice is given is insane. when the partnership was originally constituted for a fixed term, but the partners continue the business even after the expiry of the term, unless otherwise agreed, the partnership is now deemed to be a partnership at will and therefore, it can now be dissollution once giving cannot be withdrawn unless the other partner agree to the same.

The notice for dissolution is statutory requirement, and therefore the requirements of section 43 has to be satisfied. therefore, if a partner writes a letter to his lawyer, who also happens to be his arbitrator, indicating that the dispute relating to the dissolution is to be referred to arbitration, that will not result in the dissolution of the firm, as in such a case there is no intention to dissolve the firm by notice to other partner. If the partnership agreement stipulates the dissolution of partnership in a manner as may be mutually agreed between parties, it cannot be said to be partnership at will. such a partnership not being a partnership at will cannot be dissolved unilaterally by one partner giving notice to other partner, under section 43 of the partnership Act. Although a partnership at will can be dissolved by a notice, there is, however, nothing which prevents the dissolution of such partnership under the other provisions of the Act. Thus, a partnership at will could also be dissolved by mutual consent, insolvency or death of a partner.

DATE OF DOSSOLUTION

The partner giving a notice for the dissolution of a partnership at will may mention the date from which he wants the dissolution to be effective. if that is so, the firm will be dissolved from the date mentioned in the notice . if no such date hase been mentioned, the dissolution will take effect from the date of the communication of the notice. A partner could give such a notice without going to the court, but if a partner so like, he may effect the dissolution by going to the court. In such a case partnership will be deemed to be dissolved when the summons accompanied by a copy of the plaint is served on the defendant, where there is only one defendant, and on all defendants, when there are several defendants.. since a partnership will be deemed to be dissolved only from one date, the date of dissolution would have to be regarded to be the one on which the last summons were served.

IN harish kumar v Bachan Lal, there was a partnership at will entered into though partnership deed date 30 . 3 . 1954 . on 18 .7 . 1971 the partners decided not to transact any business thereafter, and the continuance of the business was stopped. it was held that the date of dissolution of the firm was 18 . 7 .1971, when the continuance of further business was stopped, anad the suit for rendition of accounts filed more than three years after the date of dissolution was barred by Article 5 of the Limitation Act.

DISSOLUTION OF PARTNERSHIP AT WILL BY OTHER MODES THAN NOTICE

It has been noted above that a partnership at will can be dissolved by a notice in writing byone partner to all others indicating his intention to dissolve the firm . in such a case,consent of other partner is not required. however, this provision does not preclude the partners to dissolve a partnership at will with the consent of all the partners. A partnership at will may also be dissolved on the death of a partner. if a partner dies before the dissolution could become effective by a notice of a partnership at will ,the dissolution would take place from the date of the death of a partner and the rights of the partners will be the same as they would have been on the dissolution by the death of a partner (McLeod v Dowling 43 T.L.R. 655).

(5) Dissolution by the court [s 44]

S 44 mentions ceratin grounds on which a suit can be filed for the dissolution of a firm. the provision is as follows:

Dissolution by the Court.—At the suit of a partner, the Court may dissolve a firm on any of the following grounds, namely:—

(a) that a partner has become of unsound mind, in which case the suit may be brought as well by the next friend of the partner who has become of unsound mind as by any other partner;

(b) that a partner, other than the partner suing, has become in any way permanently incapable of performing his duties as partner;

(c) that a partner, other than the partner suing, is guilty of conduct which is likely to affect prejudicially the carrying on of the business, regard being had to the nature of the business;

(d) that a partner, other than the partner suing, wilfully or persistently commits breach of agreements relating to the management of the affairs of the firm or the conduct of its business, or otherwise so conducts himself in matters relating to the business that it is not reasonably practicable for the other partners to carry on the business in partnership with him;

(e) That a partner, other than the partner suing, has in any way transferred the whole of his interest in the firm to a third party, or has allowed his share to be charged under the provisions of rule 49 of Order XXI of the First Schedule to the Code of Civil Procedure,
1908 (5 of 1908) or has allowed it to be sold in the recovery of arrears of land revenue or of any dues recoverable as arrears of land revenue due by the partner;

(f) that the business of the firm cannot be carried on save at a loss; or

(g) on any other ground which renders it just and equitable that the firm should be dissolved.

The need for dissolution by the court arises when all the partners do not want the dissolution. the partner or partners who want dissolutin can file a suit and the other partners may contest the same . it may be noted that section 44, which permits a partner to invoke the jurisdiction of the court for the bdissolution of the firm,is not subject to contract between the partners permitted under section 11 . therefore,a partner can always file a suit the dissolution of the firm if his case is covered under section 44.

a suit for diissolution can be filed only when one or the other ground mentioned in section 44 is there . even when there is a valid ground for filing the suit for dissolution and a pertner accordingly files the suit, the court is not bound to decree dissolution as this section clearly provides that "At the suit of partner, the court may dissolve the firm." the grounds which justify the filing of suit by a partner for the dissolution of the firm as mentioned in Section 44 are as under

(a) Unsoundness of mind: When a partner becomes of unsound mind, nither can he protect his own interest nor can he perform his duties as a partner. therefore,when a partner becomes of unsound mind, a suit for the dissolution of the firm can be filed. such a suit may be filed either on behalf of the partner who has become of unsound mind, or by any other partner.

(b) Permanent incapacity to perform duties: When a partner becomes permanently incapable of performing his duties as a partner that is a good ground for applying to the court for the dissolution of the firm. when the incapacity is not permanent, the court would not grant relief. in Whitwell v Arthur (35 Beav. 340) ,one partner filed asuit for the dissolution of the firm when the other suffered from the paralytic attack and was thereby incapacitated from performing his duties as a partner. It was found from medical evdience that the incapacity was not likely to be permanent as thedefendant's health was improving. the court did not grant the dissolution of the firm.

When a partner becomes permanently incapable of performing his duties, the suit for dissolution can be files only by any other partner, and not by the partner who suffers from the incapacity.

(c) CONDUCT INJURIOUS TO THE PARTNERSHIP BUSINESS: When a partner is guilty of conduct which is likely to effect prejudicially the carrying on the business of the firm, the court may dissolve thefirm on that ground . Misconduct need not be with regard to the partnership business, but the conduct should be such as should prejudicially affact the partnership business. the Act of adultery by a partner in a firm of bankers has been considered to be no ground for seeking dissolution by the other partners but that may be so if it is a firm of medical practitioners. conviction for a breach of trust, or the adultery by one partner, with another partner's wife are grounds for the dissolution of the firm. The suit for dissolution cannot be brought by the guilty partner. it can only be brought by a partner other than the one who is guilty of conduct discussed above.

(d) PERSISTENT BREACH OF PARTNERSHIP AGREEMENT: When a partner wilfully and persistently commits breach of agreements relating to the management of the affairs of the firm, or so conducts himself in matters relating to the firm's business that it is not reasonably practicable for the other partners to carry on the business in partnership with him, a suit for the dissolution of the firm may be filed. In Harrison v. Tenant, one of the partners in a firm of solicitors ignored the ohter twe partners and declined to settle their disputes by mutual

consultation. It was held that the conduct of one of the partners being destructive of mutual confidence, which could not be restored, was a valid ground for the dissolution of the firm. similarly, when due to frequent quarrels, there is no hope of mutual coperation, or a partner prepares false accounts and enters in the accounts smaller sums of money than actually received from the customers. or when a partner refuses to render accounts and take away the books of accounts, or a partner misuses partnership funds for paying personal debts, the court may order dissolution.
The suit for dissolution in this case also cannot be filed by the guilty partner. only a partner other than him may file a suit.

(e) TRANSFER OF THE WHOLE OF A PARTNER'S INTEREST: When a partner has transferred the whole of his interest in the firm to a third party, it can be aground on which the court may sissolve the firm. similar would be the position when a partner has allowed his share to be charged under the provisions of the Civil Procedure Code, or has allowed it to be sold in the recovery of the arrears of the land revenue or any dues as arrears of land revenue. it is necessary that the transfer must be of the whole of the partner's interest rather than merely apart of it. for dissolution in this case also the suit can be filed only by a partner other than the one whose interest has been transferred.

(f) WHEN THE BUSINESS CAN BE CARRIED ON ONLY AT A LOSS: The object of every partnership is to make profits. if it appears that the business of the firm cannot be carried on except at a loss, any of the partners may apply to the court for the dissolution of the firm.

(g) WHEN DISSOLUTOIN IS JUST AND EQUITABLE: The court has been given very wide power of dissolution. Apart from ordering the dissolution of the firm on the ground stated above, the coutr has been vested with the power of dissolving the firms on any other ground whiuch renders it just and equitable that the firm should be dissolved. In Abbot v. Crump (1870 5 Beng L.R. 109) , adultery by one partner with another partner's wife was held to be a good ground for the dissolution of the firm by the court. When the partnership deed provides for appointment of arbitrator for referring disputes to him, such arbitrator has also the power to decide as to wheather a firm may be dissolved or not.

ACCOUNTS OF THE DISSOLVED FIRM

On the dissolution of a firm, a partner can ask for the accounts of the dissolved firm. the right of a partner to ask for accounts of the dissolved firm from other partner is a substantive right, and it can be enforced by filing a suit In Budh Prakash v. Santosh Pal Dubish (AIR 1998 All 84), it has been held that once a suit has been filed to enforce the right, the withdrawal of suit by the partner amounts to abandonment of that vested right. After that such right cannot be claimed by filing another suit. thus, a fresh suit cannot be maintained unless there is fresh cause of action .

COURT HAS JURISDICTION WHERE CAUSE OF ACTION ARISES

It may be noted that a suit for dossolution and accounts can be maintaied in a court withen whose jurisdiction cause of action has arisen in whole or in part, though that court has no jurisdiction over the assets of the firm which are immovable properties. When a suit has filed seeking dissolution of the firm and accounts and certain movable properties belonging to the partner suing for dissolution, the said suit would not be barred as without jurisdiction, on the ground that certain inmovable properties belonging to the firm were situated beyond the territorial juridiction of the court in which the suit for dissolution was filed.

LIABILITY FOR ACT DONE AFTER DISSOLUTION [section 45]

It has has been noted above that when a partner ceases to be apartner by retirement or expulsion, his liability for the Acts of the firm done after such retirement or the expulision, towards the third parties can still arise untill a public notice of the fact is given. S 45 incorporates a similar provisionn in case of dissolution. It states that notwithstanding the dissolution of a firm, the partners 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, untill Public notice is given of the dissolution. the reason for such a liability is thatthe third party ,who knew of their partnership and of mutual agency, can continue to presume that the mutual agency between such persons continues until public notice of the end of that mutual agency is given.

VALIDITY OF ACKNOWLEDGMENT BY ONE PARTNER IN SUIT FOR RECOVERY BY BANK AGAINST PARTNERSHIUP FIRM

Where the facts showed that one of the partners, Defendant No. 2 had categorically informed bank about disputes between partners.Held, that acknowledgment of balance consideration by other partner, Defendant No. 3 thereafter will not bind a partner, Defendant No . 2 (Union Bank of India v Sonywell Electronics, AIR 2001 Del. 386).

PUBLIC NOTICE

According to section 72, a public notice means a notice in the official Gazette, in at least one vernacular newspaper circulation in theb district where the firm to which it relates has its place or principal place of business, and if the firm is registered, to the registrar of firms concerned.
Therefore, merely publication of the notice in a local newspaper is not sufficient, and such a notice doed not above the outgoing partner from liability towards a third person.

Such a notice may be given by any partner.
In the following cases, the liability of the partners does not arise after the date of dissolution even though no public notice of dissolution of the firm has been given.

(1) when a partner dies, his estate is not liable for the acts done after his death. No public notice is needed on the death of a partner because the fact of death of a partner because the fact of death of a partner is deemed to have come to the knowledge of the persons who knew him.

(2) the position of a partner who is adjudicated insolvent is similar to that of a deceased partner. in his case also, no public notice is neede and his estate is not laible for the acts done after the dissolution of the firm.

(3) No public notice is needed in case of a retired partner who was not known to be a partner to the third party dealing with the firm. this provision is similar to the one contained in proviso to s 32 (3).

Illustration-1:

Ankit, Bobby and Kartik were partners in a firm sharing profits in the ratio 4:3:3. The firm was dissolved on 31-3-2018. Pass the necessary Journal entries for the following transactions after various assets (other than cash and bank) and third party liabilities had been transferred to Realisation Account:

(i) The firm had stock of □ 80,000. Ankit took over 50% of the stock at a discount of 20% while the remaining stock was sold off at a profit of 30% on cost.

(ii) A liability under a suit for damages included in creditors was settled at □ 32,000 as against only □ 13,000 provided in the books. Total creditors of the firm were □ 50,000.

(iii) Bobby's sister's loan of □ 20,000 was paid off along with interest of □ 2,000.

(iv) Kartik's Loan of□ 12,000 was settled at □ 12,500.

Sol:

In the Books of Firm

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
(*i*)	Ankit Capital A/c	Dr.		32,000	
	Cash/Bank A/c	Dr.		52,000	
	To Realisation A/c				84,000
	(Being half stock sold & half stock taken by Anil)				
(*ii*)	Realisation A/c	Dr.		69,000	
	To Cash/Bank A/c				69,000
	(Being creditor and contingent liabilities settled)				
(*iii*)	Realisation A/c	Dr.		22,000	
	To Cash/Bank A/c				22,000
	(Being Bobby's sister's loan paid off along with interest)				
(*iv*)	Kartik's Loan A/c	Dr.		12,000	
	Realisation A/c	Dr.		500	
	To Cash/Bank A/c				12,500
	(Being Kartik's loan paid off)				

Illustration-2:

The firm of R, K and S was dissolved on 31.3.2019. Pass necessary journal entries for the following after various assets (other than cash and Bank) and the third party liabilities had been transferred to realisation account.

(i) K agreed to pay off his wife's loan of □ 6,000.

(if) Total Creditors of the firm were □ 40,000. Creditors worth □ 10,000 were given a piece of furniture costing □8,000 in full and final settlement. Remaining creditors allowed a discount of 10%.

(iii) A machine that was not recorded in the books was taken over by K at □ 3,000 whereas its expected value was □ 5,000.

(iv) The firm had a debit balance of □ 15,000 in the profit and loss A/c on the date of dissolution.

Sol:

JOURNAL

Date	Particulars		L.F.	Dr. Amount (₹)	Cr. Amount (₹)
(*i*)	Realization A/c	Dr		6,000	
	To K's Capital A/c				6,000
	(Being wife's loan discharged by the partner)				
(*ii*)	Realization A/c	Dr		27,000	
	To Bank A/c				27,000
	(Being balance creditor's paid at a discount of 10% after part payment through furniture)				
(*iii*)	K's Capital Account	Dr		3,000	
	To Realization A/c				3,000
	(Being unrecorded machine taken over by a partner)				
(*iv*)	R's Capital A/c	Dr		5,000	
	K's Capital A/c	Dr		5,000	15,000
	S's Capital A/c	Dr		5,000	
	To Profit and Loss A/c				
	(being debit balance of Profit and Loss distributed amongst partners)				

Illustration-3:

Ravi and Mukesh were partners in a firm sharing profits and losses equally. On 31st March, 2019 their firm was dissolved. On the date of dissolution their Balance Sheet showed stock of ₹ 60,000 and creditors of ₹ 70,000. After transferring stock and creditors to realisation account the following transaction took place:

(i) Ravi took over 40% of total stock at 20% discount.

(ii) 30% of total stock was taken over by creditors of ₹ 20,000 in full settlement.

(iii) Remaining stock was sold for cash at a profit of 25%.

(iv) Remaining creditors were paid in cash at a discount of 10%.

Pass necessary journal entries for the above transactions in the book of the firm.

Sol:

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
(*i*)	Ravi's Capital A/c Dr.	19,200	–
	To Realisation A/c	–	19,200
	(Being 40% of the total stock taken over by Ravi at 20% discount)		
(*ii*)	No Entry		
(*iii*)	Cash A/c Dr.	22,500	–
	To Realisation A/c	–	22,500
	(Being stock sold for cash)		
(*iv*)	Realisation A/c Dr.	45,500	–
	To Cash A/c	–	45,000
	(Being creditors paid in cash at a discount of 10%)		

Illustration-4:

Singh and Jain were partners in a firm sharing profits and losses in the ratio of 3 : 7. On 31st March, 2019 their firm was dissolved. On the date of dissolution the Balance Sheet showed stock of □ 90,000 and creditors of□ 1,00,000. After transferring the assets (other than cash in hand and cash at bank) and third party liabilities to realisation account the following transactions took place:

(i) Singh took over 50% of the total stock at 10% discount.

(if) 20% of the total stock was taken over by creditors of□ 20,000 in full settlement.

(iii) Remaining stock was sold for cash at 10% loss.

(iv) Remaining creditors were paid by cheque at a discount of 5%.

Pass necessary journal entries for the above transactions in the books of the firm.

Sol:

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
(*i*)	Singh's Capital A/c Dr. To Realisation A/c (Being 50% of the total stock taken over by Singh at 10% discount)	40,500 –	– 40,000
(*ii*)	No Entry		
(*iii*)	Cash A/c Dr. To Realisation A/c (Being stock sold for cash)	23,300 –	– 24,300
(*iv*)	Realisation A/c To Bank A/c (Being creditors paid in cash at a discount of 5%)	76,000 –	– 76,000

Illustration-5:

The book value of assets (other than cash and bank) transferred to Realisation Account is □ 1,00,000. 50% of the assets are taken over by a partner Atul, at a discount of 20%. 40% of the remaining assets are sold at a profit of 30% on cost; 5% of the balance being obsolete, realised nothing and remaining assets are handed over to a creditor, in full settlement of his claim. You are required to record the journal entries for realisation of assets.

Sol:

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Realisation A/c Dr. To various Assets A/c (Being transfer of various assets other than cash and bank to realisation A/c at their book value)		1,00,000	1,00,000
	Atul's Capital A/c Dr. To Realisation A/c (Being 50% of the Assets taken over by Atul at 20% discount)		40,000	40,000
	Cash/Bank A/c Dr. To Realisation A/c (Being sale of the remaining 40% assets @ 30% profit on cost)		26,000	26,000
	(No entry is required for transfer of assets to the creditors in full settlement of his claims)			

Working Notes:

(*i*) Total Assets = ₹ 1,00,000

Taken over by Atul = 50%

$$₹\ 1,00,000 \times \frac{50}{100} = ₹\ 50,000$$

Remaining Assets = ₹ 1,00,000 – ₹ 50,000 = ₹ 50,000

Atul takes over the assets of ₹ 50,000 @ 20% discount

$$= ₹\,50{,}000 - \left(₹50{,}000 \times \frac{20}{100}\right)$$

$$= ₹\,50{,}000 - ₹\,10{,}000 = ₹\,40{,}000$$

(*ii*) 40% assets are sold out of the remaining assets @ 30% profits on cost:

$$\text{Remaining Assets} = ₹\,50{,}000$$

$$\text{Assets sold} = ₹\,50{,}000\,\frac{40}{100} = ₹\,20{,}000$$

Assets sold at 30% profits on cost:

$$= ₹\,20{,}000 + ₹\,20{,}000 \times 30\%$$

$$= ₹\,20{,}000 + ₹\,20{,}000 \times \frac{30}{100}$$

$$= ₹\,20{,}000 + ₹\,6{,}000 = ₹\,26{,}000$$

(*iii*) $$\text{Remaining Assets} = ₹\,50{,}000 - ₹\,20{,}000 = ₹\,30{,}000$$

$$\text{5\% Assets are becoming value less} = ₹\,30{,}000 \times \frac{5}{100} = ₹\,1{,}500$$

Illustration-6:

A and B who were sharing profits and losses in the ratio of 3:1 respectively decide to dissolved the firm on March 31, 2014 at which date some of the balances were as follows:

A's capital □ 2,00,000, B's capital □ 20,000 (debit balance). Profit and Loss A/c □ 16,000 (debit balance! Trade Creditors □ 60,000, Loan from Mrs. A □ 20,000, Cash at Bank □ 4,000. Assets (other than cash at bank) realised □ 1,10,000 and all creditors were paid off less 5% discount. Realisation expenses amounted to □ 1,000. Prepare Memorandum Balance sheet.

Sol:

Memorandum Balance Sheet

Liabilities	(₹)	Assets	(₹)
Trade creditors	60,000	Cash at Bank	4,000
Loan from Mrs. A	20,000	B's Capital	20,000
A's capital	2,00,000	Profit and Loss A/c	16,000
		Other Sundry assets (b/f/)	2,40,000
	2,80,000		2,80,000

Illustration-7:

Journalise the following transactions regarding realisation expenses:

(a) Realisation expenses amounted to 2,500.

(b) Realisation expenses amounting to 3,000 were paid by Ashok, one of the partners.

(c) Realisation expenses 2,300 borne by Tarun, personally.

(d) Amit, a partner was appointed to realise the assets, at a cost of 4,000. The actual amount of realisation amounted to 3,000.

Sol:

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
(*a*)	Realisation A/c	Dr.		2,500	
	To Cash/Bank A/c				2,500
	(Being for the payment of realisation expenses)				
(*b*)	Realisation A/c	Dr.		3,000	
	To Ashok's Capital A/c				3,000
	(Being realisation expenses paid by a partner on the behalf of the firm)				
(*c*)	No entry is required.				
(*d*)	(*i*) Realisation A/c	Dr.		4,000	
	To Amit's Capital A/c				4,000
	(Being remuneration paid to Amit for the dissolution of the firm undertaken)				
	(*ii*) Amit's Capital A/c	Dr.		3,000	
	To Cash/Bank A/c				3,000
	(Being actual expenses on dissolution paid off)				

Illustration-8:

L and M were partners in a firm sharing profits in the ratio of 2 : 3. On 28.2.2016 the firm was dissolved. After transferring assets (other than cash) and outsider's liabilities to realisation account you are given the following information:

(i) A creditor of 1,40,000 accepted building valued at 1,80,000 and paid to the firm 40,000.

(ii) A second creditor for 30,000 accepted machinery valued at 28,000 in full settlement of his claim.

(iii) A third creditor amounting to 70,000 accepted 30,000 in cash and investments of the book value of 45,000 in full settlement of his claim.

(iv) Loss on dissolution was 4,000.

Pass necessary journal entries for the above transactions in the books of firm assuming that all payments were made by cheque.

Sol:

In the Books of L and M

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
(*i*)	Bank A/c	Dr.		40,000	
	To Realisation A/c				40,000
	(Being building accepted by creditors and balance paid by him)				
(*ii*)	No Entry				
(*iii*)	Realisation A/c	Dr.		30,000	
	To Bank A/c				30,000
	(Being cash paid to creditor)				
(*iv*)	L's Capital A/c	Dr.		1,600	
	M's Capital A/c	Dr.		2,400	
	To Realisation A/c				4,000
	(Being loss on dissolution distributed to partners))				

Illustration-9:

A, B and C were partners sharing profits and losses in the ratio of 2 : 2 : 1. Their Balance Sheet as at 31st March, 2018 was as follows :

Balance Sheet of A, B and C as at 31st March, 2018

Liabilities		Amount (₹)	Assets		Amount (₹)
Capitals :			Cash at Bank		3,00,000
A	7,50,000		Sundry Debtors	1,95,000	
B	3,00,000		*Less* : Provision for Bad Debts	5,000	1,90,000
C	2,50,000	13,00,000	Stock		3,00,000
Creditors		2,00,000	Fixed Assets		7,10,000
		15,00,000			15,00,000

On the above date they dissolved the firm and following amounts were realised :
Fixed Assets □ 6,75,000; Stock □ 3,39,000; Debtors □ 1,35,000; Creditors were paid □ 1,85,000 in full settlement of their claim. Expenses on Realisation amounted to □ 19,000. Pass the necessary journal entries on the dissolution of the firm.

Sol:

Journal

Date	Particulars		LF	Dr. (₹)	Cr. (₹)
(*a*)	Realisation A/c	Dr.		12,05,000	
	To Fixed Assets A/c				7,10,000
	To Stock A/c				3,00,000
	To Debtors A/c				1,95,000
	(Assets transferred to realisation A/c)				
(*b*)	Sundry Creditors A/c	Dr.		2,00,000	
	Provision for Doubtful Debts A/c	Dr.		5,000	
	To Realisation A/c				2,05,000
	(Liabilities transferred to Realisation A/c)				
(*c*)	Bank A/c	Dr.		11,49,000	
	To Realisation A/c				11,49,000
	(Assets realised)				
(*d*)	Realisation A/c	Dr.		2,04,000	
	To Bank A/c				2,04,000
	(Realisation Exp. & Creditors paid in full settlement)				
	OR				
	(a) Realisation A/c	Dr.		1,85,000	
	To Bank A/c				1,85,000
	(Creditors paid in full settlement)				19,000
	(b) Realisation A/c	Dr.		19,000	
	To Bank A/c				19,000
	(Realisation Exp. Paid)				

			L.F.	Dr.	Cr.
(*e*)	A's Capital A/c	Dr.		22,000	
	B's Capital A/c	Dr.		22,000	
	C's Capital A/c	Dr.		11,000	
	To Realisation A/c				55,000
	(Loss on realisation debited to Partners' Capital A/c)				
(*f*)	A's Capital A/c	Dr.		7,28,000	
	B's Capital A/c	Dr.		2,78,000	
	C's Capital A/c	Dr.		2,39,000	
	To Bank A/c				12,45,000
	(Partners' A/c settled on dissolution)				

Illustration-10:

Pradeep and Rajesh were partners in a firm sharing profits and losses in the ratio of 3:2. They decided to dissolve their partnership firm on 31st March, 2018. Pradeep was deputed to realize the assets and to pay off the liabilities. He was paid □ 1,000 as commission for his services. The financial position of the firm on 31st March, 2018 was as follows:

Balance Sheet as at March 31, 2018

Liabilities		Amount (₹)	Assets		Amount (₹)
Creditors		80,000	Building		1,20,000
Mrs Pradeep's Loan		40,000	Investment		30,600
Rajesh's loan		24,000	Debtors	34,000	
Investment Fluctuation Fund		8,000	Less : Provision for Doubtful Debts	4,000	30,000
			Bills Receivable		37,400
Capitals:			Bank		6,000
Pradeep	42,000		Profit and Loss A/c		8,000
Rajesh	42,000	84,000	Goodwill		4,000
		2,36,000			**2,36,000**

Following terms and conditions were agreed upon:

(i) Pradeep agreed to pay off his wife's loan.
(ii) Half of the debtor's realized □ 12,000 and remaining debtors were used to pay off 25% of the creditors.
(iii) Investment sold to Rajesh for □ 27,000
(iv) Building realized □ 1,52,000
(v) Remaining creditors were to be paid after two months, they were paid immediately at 10% p.a. discount
(vi) Bill receivables were settled at a loss of □ 1,400
(vii) Realization expenses amounted to □ 2,500
Prepare Realization Account.

Sol:

Dr. Realisation Account Cr.

Particulars		Amount (₹)	Particulars		Amount (₹)
To building		1,20,000	By Provision on Debtors		4,000
To Investment		30,600	By Creditors		80,000
To Debtors		34,000	By Mrs Pradeep's Loan		40,000
To Bills Receivable		37,400	By Investment Fluctuation Fund		8,000
To Goodwill		4,000	By Bank A/c		
To Pradeep's Capital A/c		40,000	Debtors	12,000	
To Bank A/c (expenses)		2,500	Building	1,52,000	
To Bank A/c (creditors)		59,000	Bill Recievable	36,000	2,00,000
To Pradeep's Capital A/c		1,000	By Cash A/c		27,000
To Partner's Capital A/cs:					
Pradeep	18,300				
Rajesh	12,200	30,500			
		3,59,000			**3,59,000**

Working Notes:

Payment to creditors = (₹80,000 – ₹ 20,000) – {₹ 60,000 × (10/100) × (2/12)} = ₹ 60,000 – ₹ 1,000 = ₹ 59,000

*½ mark each for transferring assets and liabilities to realization account

Illustration-11:

Parth and Shivika were partners in a firm sharing profits in the ratio of 3 : 2. The Balance Sheet of the firm on 31st March, 2014 was as follows:

Liabilities		(₹)	Assets	(₹)
Sundry Creditors		80,000	Bank	1,72,000
Shivika's sister's load		20,000	Debtors	27,000
Capitals:			Stock	50,000
Parth	1,75,000		Furfiiture	2,20,000
Shivika	1,94,000	3,69,000		
		4,69,000		4,69,000

On the above date the firm was dissolved. The assets were realized and the liabilities were paid off as follows:

(a) 50 % of the furniture was taken over by Parth at 20% less than book value. The remaining furniture was sold for □ 1,05,000.

(b) Debtors realised □ 26,000.

(c) Stock was taken over by Shivika for 29,000.

(d) Shivika's sister's loan was paid off along with an interest of □ 2,000.

(e) Expenses on realisation amounted to □ 5,000.

Prepare Realisation Acount, Partners' Capital Accounts and Bank Account.

Sol:

Realisation A/c

Particulars	(₹)	Particulars		(₹)
To Stock	50,000	By Shivika's Sister Loan By Sundry Creditors		20,000
To Debtors	27,000	By Bank – assets realised:		80,000
To Furniture	2,20,000	Furniture	1,05,000	
To Bank (Sundry creditors)	80,000	Debtors	26,000	1,31,000
To Bank (Sister Loan + Interest)	22,000	By Parth's Capital A/c (Furniture)		88,000
To Bank (Exp.)	5,000	By Shivika's Capital A/c (Stock)		29,000
		By Capital A/c: (Loss)		
		Parth	33,600	
		Shivika	22,400	56,000
	4,04,000			4,04,000

Dr.		Partners' Capital Accounts			Cr.
Particulars	**Parth (₹)**	**Shivika**	**Particulars**	**Parth**	**Shivika**
To Realisation A/c	88,000	–	By Balance b/d	1,75,000	1,94,000
To Realisation A/c	–	29,000			
To Realisation A/c	33,600	22,400			
To Bank A/c	53,400	1,42,600			
	1,75,000	1,94,000		1,75,000	1,94,000

Dr.		Bank Account		Cr.
Particulars		**(₹)**	**Particulars**	**(₹)**
To Bal. b/d		1,72,000	By Realisation (loan + interest)	22,000
To Realisation (assets realised)			By Realisation (creditors)	80,000
Furniture	1,05,000		By Realisation A/c (expenses)	5,000
Debtors	26,000	1,31,000	By Parth's Capital A/c	53,400
			By Shivika's Capital A/c	1,42,600
		3,03,000		3,03,000

Illustration-12:

E, F and G were partners in a firm sharing profits in the ratio of 2 : 2 : 1. On March 31,2017, their firm was dissolved. On the date of dissolution, the Balance Sheet of the firm was as follows:

Balance Sheet as at March 31, 2017

Liabilities		**(₹)**	**Assets**	**(₹)**
Capitals:			G's Capital	500
E	1,30,000		Profit and Loss Account	10,000
F	1,00,000	2,30,000	Land and Building	1,00,000
Creditors		45,000	Furniture	50,000
Outstanding Expenses		17,000	Machinery	90,000
			Debtors	36,500
			Bank	5,000
		2,92,000		2,92,000

F was appointed to undertake the process of dissolution for which he was allowed a remuneration of □ 5,000. F agreed to bear the dissolution expenses. Assets realized as follows:

(i) The Land & Building was sold for □ 1,08,900.

(ii) Furniture was sold at 25% of book value.

(iii) Machinery was sold as scrap for □ 9,000.

(iv) All the Debtors were realized at full value.

Creditors were payable on an average of 3 months from the date of dissolution. On discharging the Creditors on the date of dissolution, they allowed a discount of 5%.

Pass necessary Journal entries for dissolution in the books of the firm.

Sol:

E, F and G
Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Reallsation Account	Dr.		2,76,500	
	To Land and Building Account				1,00,000
	To Furniture Account				50,000
	To Machinery Account				90,000
	To Debtors Account				36,500
	(Individual Assets accounts closed by transferring their balances to Reallsation Account)				
	Creditors Account	Dr.		45,000	
	Outstanding Expenses Account	Dr.		17,000	62,000
	To Realisation Account				
	(Individual External Liabilities Accounts closed by transferring their balances to Realisation Account)				
	Bank Account	Dr.		1,66,900	
	To Realisation Account				1,66,900
	(Assets realized and debtors collected)				
	Realisation Account	Dr.		59,750	
	To Bank Account				59,750
	(Creditors paid at a discount of 5% and payment of outstanding expenses)				
	Realisation Account	Dr.		5,000	
	To F's Capital Account				5,000
	(Remuneration paid to F for undertaking dissolution process)				
	E's Capital Account	Dr.		44,940	
	F's Capital Account	Dr.		44,940	

	G's Capital Account Dr.		22,470	
	To Realisation Account			1,12,350
	(Loss on Realisation transferred to partners' Capital Accounts)			
	E's Capital Account Dr.		4,000	
	F's Capital Account Dr.		4,000	
	G's Capital Account Dr.		2,000	
	To Profit and Loss Account			10,000
	(Profit and Loss Account transferred to partners' Capital Accounts)			
	Bank Account Dr.		24,970	
	To G's Capital Account			24,970
	(Final payment received from G)			
	E's Capital Account Dr.		81,060	
	F's Capital Account Dr.		56,060	
	To Bank Account			1,37,120
	(Final payment made to E and F)			

Illustration-13:

Give the necessary journal entries for the following transactions on dissolution of the firm of Aman and Rajat on 31 st March, 2016, after the transfer of various assets (other than cash) and the third party liabilities to Realisation Account. They shared profits and losses in the ratio of 2 : 1.

(a) There was a bill of exchange of ₹ 10,000 under discount. The bill was received from Derek who became insolvent.

(b) Bills payable of ₹ 30,000 falling due on 30th April, 2016 were discharged at ₹ 29,550.

(c) Creditors of ₹ 30,000 took over stock of ₹ 10,000 at 10% discount and the balance was paid to them in cash.

(d) There was an old typewriter which had been written off completely. It was estimated to realize ₹ 600. It was taken away by Rajat at 25% less than the estimated price.

(e) Aman agreed to take over the responsibility of completing dissolution at an agreed remuneration of ₹ 1,000 and to bear all realization expenses. Actual realisation expenses ₹ 800 were paid by the firm.

(f) Loss on realization was ₹ 54,000.

Sol:

Books of the Aman and Rajat Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	(a) Realisation A/c	Dr.		10,000	
	To Bank A/c				10,000
	(Payment of a dishonoured B/R under discount)				
	(b) Realisation A/c	Dr.		29,550	
	To Bank A/c				29,550
	(Bills payable discharged)				
	(c) Realisation A/c	Dr.		21,000	
	To Bank A/c				21,000
	(Creditors took over stock and balance paid in cash)				
	(d) Rajat's capital A/c	Dr.		450	
	To Realisation A/c				450
	(Unrecorded old typewriter taken over By Rajat)				
	(e) (i) Realisation A/c	Dr.		1,000	
	To Aman's Capital A/c				1,000
	(Remuneration given to Aman for completing dissolution work)				
	(ii) Aman's Capital A/c	Dr.		800	
	To Bank A/c				800
	(Expenses paid by the firm but borne by Aman)				
	(f) Aman's Capital A/c	Dr.		36,000	
	Rajat's Capital A/c	Dr.		18,000	
	To Realisation A/c				54,000
	(Loss on realization)				

Problems to practice:

1. A, B and C were partners sharing profits in the ratio of 3 : 1:1. The balance sheet on 31st March, 2009, the date on which they dissolve their firm, was as follows

Balance Sheet
as at 31st March, 2009

Liabilities		Amt (₹)	Assets		Amt (₹)
Capital A/cs			Other Assets		17,000
A	27,500		Stock		7,800
B	10,000		Debtors	24,200	
C	7,000	44,500	(−) Provision For Doubtful Debts	(1,200)	23,000
Loan		1,500	Bill Receivables		1,000
Creditors		6,000	Cash		3,200
		52,000			52,000

It was agreed that:

(i) A to take over bills receivable at Rs 800, debtors amounting to Rs 20,000 at Rs 17,200 and the creditors of Rs 6,000 were to be paid by him at this figure.
(ii) B is to take over all stock for Rs 7,000 and some other assets at Rs 7,200 (being 10% less than the book value).
(iii)C to take over remaining sundry assets at 90% of the book value and assume the responsibility of discharge of loan together with accrued interest of Rs 300.
(iv)The expenses of realisation were Rs 270. The remaining debtors were sold to a debt collecting agency at 50% of the book value. Prepare realisation account, partners' capital account and cash account.

2. Aman and Harsh were partners in a firm. They decided to dissolve their firm. Pass necessary Journal entries for the following after various assets (other than Cash and Bank) and third party liabilities have been transferred to Realisation Account:
(a) There was furniture worth □ 50,000. Aman took over 50% of the furniture at 10% discount and the remaining furniture was sold at 30% profit on book value.
(b) Profit and Loss Account was showing a credit balance of □ 15,000 on the date of dissolution.
(c) Harsh's loan of □ 6,000 was discharged at □ 6,200.
(d) The firm paid realisation expenses amounting to □ 5,000 on behalf of Harsh who had to bear these expenses.
(e) There was a bill for 1,200 under discount. The bill was received from Soham who proved insolvent and a first and final dividend of 25% was received from his estate.
(f) Creditors, to whom the firm owed □ 6,000, accepted stock of □ 5,000 at a discount of 5% and the balance in cash.

3. Ganesh and Chandan were partners sharing profits and losses in the proportion of 3:2. They dissolve the partnership firm on 31st March, 2011 when their position was as follows:

Balance Sheet as on 31st March, 2011

Liabilities	Amount Rs	Assets		Amount Rs
Sundry Creditors	25,000	Debtors	1,12,500	
Bank overdraft	20,000	Less: R.D.D.	12,500	1,00,000
Reserve Fund	30,000	Stock		2,25,000
Capital Accounts:		Furniture		50,000
Ganesh	2,30,000	Motor Car		75,000
Chandan	1,50,000	Cash in hand		5,000
	4,55,000			**4,55,000**

The Assets realised as follows: Debtors Rs 90,000, Stock Rs 2,00,000, and Goodwill Rs 25,000, Motor Car was taken over by Ganesh for Rs 70,000 and Furniture by Chandan for Rs 60,000.
The Creditors were paid Rs 22,500 in full settlement. The expenses of realisation amounted to Rs 10,000. Pass necessary journal entries in the books of the firm.

4.Rose and Lily shared profits in the ratio of 2:3. Their Balance Sheet on March 31, 2017 was as follows:

Balance Sheet of Rose and Lily as on March 31, 2017

Liabilities	Amount Rs	Assets		Amount Rs
Creditors	40,000	Cash		16,000
Lily's loan	32,000	Debtors	80,000	
Profit and Loss	50,000	*Less*: Provision for doubtful Debts	3,600	76,400
Capitals:				
Lily	1,60,000	Inventory		1,09,600
Rose	2,40,000	Bills Receivable		40,000
		Buildings		2,80,000
	5,22,000			5,22,000

Rose and Lily decided to dissolve the firm on the above date. Assets (except bills receivables) realised Rs 4,84,000. Creditors agreed to take Rs 38,000. Cost of Realisation was Rs 2,400. There was a Motor Cycle in the firm which was bought out of the firm's money, was not shown in the books of the firm. It was now sold for Rs 10,000. There was a contingent liability in respect of outstanding electric bill of Rs 5,000, Bill Receivable taken over by Rose at Rs 33,000.
Show Realisation Account, Partners Capital Account, Loan Account and Cash Account.

5. Shilpa, Meena and Nanda decided to dissolve their partnership on March 31,2017. Their profit sharing ratio was 3:2:1 and their Balance Sheet was as under:

Balance Sheet of Shilpa, Meena and Nanda as on March 31, 2017

Liabilities	Amount Rs	Assets	Amount Rs
Capitals:		Land	81,000
Shilpa	80,000	Stock	56,760
Meena	40,000	Debtors	18,600

Bank loan	20,000	Nanda's Capital Account	23,000
Creditors	37,000	Cash	10,840
Provision for doubtful debts	1,200		
General Reserve	12,000		
	1,90,200		1,90,200

The stock of value of Rs 41,660 are taken over by Shilpa for Rs 35,000 and she agreed to discharge bank loan. The remaining stock was sold at Rs 14,000 and debtors amounting to Rs 10,000 realised Rs 8,000. land is sold for Rs 1,10,000. The remaining debtors realised 50% at their book value. Cost of Realisation amounted to Rs 1,200. There was a typewriter not recorded in the books worth Rs 6,000 which were taken over by one of the Creditors at this value. Prepare Realisation Account.

6. Surjit and Rahi were sharing profits (losses) in the ratio of 3:2, their Balance Sheet as on March 31, 2017 is as follows:

Balance Sheet of Surjit and Rahi as on March 31, 2017

Liabilities	Amount Rs	Assets	Amount Rs
Creditors	38,000	Bank	11,500
Mrs. Surjit loan	10,000	Stock	6,000
Reserve	15,000	Debtors	19,000
Rahi's loan	5,000	Furniture	4,000
Capital's:		Plant	28,000
Surjit	10,000	Investment	10,000
Rahi	8,000	Profit and Loss	7,500
	86,000		86,000

The firm was dissolved on March 31, 2017 on the following terms:

1. Surjit agreed to take the investments at Rs 8,000 and to pay Mrs. Surjit's loan.
2. Other assets were realised as follows:

Stock	Rs	5,000
Debtors	Rs	18,500
Furniture	Rs	4,500
Plant	Rs	25,000

3. Expenses on Realisation amounted to Rs 1,600.
4. Creditors agreed to accept Rs 37,000 as a final settlement.

You are required to prepare Realisation Account, Partners' Capital Account and Bank Account.

7.Rita, Geeta and Ashish were partners in a firm sharing profits/losses in the ratio of 3:2:1. On March 31, 2017 their balance sheet was as follows:

Liabilities		**Amount Rs**	**Assets**	**Amount Rs**
Capitals:			Cash	22,500
Rita	80,000		Debtors	52,300
Geeta	50,000		Stock	36,000
Ashish	30,000	1,60,000	Investments	69,000
Creditors		65,000	Plant	91,200
Bills payable		26,000		
General reserve		20,000		
		2,71,000		2,71,000

On the date of above mentioned date the firm was dissolved:

1. Rita was appointed to realise the assets. Rita was to receive 5% commission on the rate of assets (except cash) and was to bear all expenses of Realisation,
2. Assets were realised as follows:

	Rs
Debtors	30,000
Stock	26,000
Plant	42,750

3. Investments were realised at 85% of the book value,
4. Expenses of Realisation amounted to Rs 4,100,
5. Firm had to pay Rs 7,200 for outstanding salary not provided for earlier,
6. Contingent liability in respect of bills discounted with the bank was also materialised and paid off Rs 9,800,

Prepare Realisation Account, Capital Accounts of Partners' and Cash Account.

8. Anup and Sumit are equal partners in a firm. They decided to dissolve the partnership on December 31, 2017. When the balance sheet is as under:

Balance Sheet of Anup and Sumit as on December 31, 2017

Liabilities	**Amount Rs**	**Assets**	**Amount Rs**
Sundry Creditors	27,000	Cash at bank	11,000

Reserve fund		10,000	Sundry Debtors	12,000
Loan		40,000	Plants	47,000
Capital			Stock	42,000
Anup	60,000		Lease hold land	60,000
Sumit	60,000	1,20,000	Furniture	25,000
		1,97,000		1,97,000

The Assets were realised as follows:

	Rs
Lease hold land	72,000
Furniture	22,500
Stock	40,500
Plant	48,000
Sundry Debtors	10,500

The Creditors were paid Rs 25,500 in full settlement. Expenses of Realisation amount to Rs 2,500.

Prepare Realisation Account, Bank Account, Partners Capital Accounts to close the books of the firm.

9. Ashu and Harish are partners sharing profit and losses as 3:2. They decided to dissolve the firm on December 31, 2017. Their balance sheet on the above date was:

Balance Sheet of Ashu and Harish as on December 31, 2017

Liabilities		**Amount Rs**	**Assets**	**Amount Rs**
Capitals:			Building	80,000
Ashu	1,08,000		Machinery	70,000
Harish	54,000	1,62,000	Furniture	14,000
Creditors		88,000	Stock	20,000
Bank overdraft		50,000	Investments	60,000
			Debtors	48,000
			Cash in hand	8,000
		3,00,000		3,00,000

Ashu is to take over the building at Rs 95,000 and Machinery and Furniture is take over by Harish at value of Rs 80,000. Ashu agreed to pay Creditor and Harish agreed to meet Bank overdraft. Stock and Investments are taken by both partner in profit sharing ratio.

Debtors realised for Rs 46,000, expenses of Realisation amounted to Rs 3,000. Prepare necessary ledger Account.

10. Sanjay, Tarun and Vineet shared profit in the ratio of 3:2:1. On December 31,2017 their balance sheet was as follows:

Balance Sheet of Sanjay, Tarun and Vineet as on December 31, 2017

Liabilities		Amount Rs	Assets	Amount Rs
Capitals:			Plant	90,000
Sanjay	1,00,000		Debtors	60,000
Tarun	1,00,000		Furniture	32,000
Vineet	70,000	2,70,000	Stock	60,000
Creditors		80,000	Investments	70,000
Bills payable		30,000	Bills receivable	36,000
			Cash in hand	32,000
		3,80,000		3,80,000

On this date the firm was dissolved. Sanjay was appointed to realise the assets. Sanjay was to receive 6% commission on the sale of assets (except cash) and was to bear all expenses of Realisation. Sanjay realised the assets as follows: Plant Rs 72,000, Debtors Rs 54,000, Furniture Rs 18,000, Stock 90% of the book value, Investments Rs 76,000 and Bills receivable Rs 31,000. Expenses of Realisation amounted to Rs 4,500.

Prepare Realisation Account, Capital Accounts and Cash Account

11. Anil and Sunil were partners sharing profits and losses in the ratio of 3:2. Their Balance Sheet as on 31st March, 2009.

Balance Sheet as on 31st March, 2009

Liabilities	Amount Rs	Assets	Amount Rs
Capital Account		Bank	30,000
Anil	50,000	Stock	25,000
Sunil	30,000	Debtors	70,000
Current Account		Plant	45,000
Anil	15,000	Building	35,000
Sunil	10,000		
Creditors	87,000		
Bills payable	13,000		

	2,05,000		**2,05,000**

The firm was dissolved on the above date and the assets realised as under:

1) Stock Rs 20,000, Debtors Rs 60,000, Plant Rs 40,000 and Building Rs 30,000.

2) Anil agreed to pay off the bills payable.

3) Creditors were paid in full.

4) Dissolution expenses were Rs 7,000.

12. Mahesh, Suresh and Jayesh were partners of the firm. They decided to dissolve the firm on 31st March, 2012. Their Balance Sheet as on that date was as under:

Balance Sheet as on 31st March, 2012

Liabilities	Amount Rs	Assets		Amount Rs
Creditors	18,000	Cash at Bank		9,600
Loan	4,500	Sundry Assets		51,000
Capitals		Debtors	72,600	
Mahesh	82,500	Less: R.D.D.	3,600	69,000
Suresh	30,000	Stock		23,400
Jayesh	21,000	Furniture		3,000
	1,56,000			**1,56,000**

The firm was dissolved as follows:

1) Mahesh will accept furniture for Rs 2,000 and agreed accept the debtors of book value of Rs 60,000 at on agreed value of Rs 51,000.

2) Suresh will accept stock at an agreed value Rs 20,000, and Sundry Assets of Book value Rs 24,000 at Rs 23,500.

3) Jayesh will accept remaining Sundry Assets for Rs 25,000 He will further accept the liability of loan along with due interest at 12% p.a.

Interest for three months on this loan was outstanding and was not recorded in the books.

4) Expenses of dissolution were Rs 1,000 and outstanding expenses of Rs 1,200 were to be paid from the firm.

5) The remaining debtors were realised Rs 7,000.

13. Gautam, Viral and Ashwin were Partners sharing profits and losses equally. Their Balance sheet as on 31st December, 2011 was as follows:

Balance Sheet as on 31st December, 2011

Liabilities	Amount Rs	Assets	Amount Rs
Capital Accounts:		Building	73,900
Gautam	75,000	Furniture	44,100
Virat	45,000	Stock	25,400
Reserve Fund	27,000	Debtors	33,600
Creditors	48,500	Cash	15,000
Bank Loan	11,500	Ashwin's Capital	15,000
	2,07,000		**2,07,000**

The firm was dissolved due to insolvency of Ashwin and the following was the result.

(i) The realisation of Assets were as follows:

a) The stock was completely damaged and could realise worth Rs 16,500 only.

b) Building was sold for Rs 49,800.

c) Furniture was realised by the firm at Rs 23,100 less than the book value.

d) A Customer who owes Rs 14,400 became insolvent and nothing could be recovered from his private estate.

(ii) Creditors were paid for Rs 36,900 in full settlement and Bank Loan was discharged fully.

(iii) The expenses of realisation Rs 4,100

(iv) Ashwin became insolvent and the firm could recover only Rs 4,000 from his private estate.

Prepare Realisation A/c, Partner's Capital A/c and cash A/c to close the books of the firm.

14. The following is the Balance Sheet of Gupta and Sharma as on December 31,2017:

Balance Sheet of Gupta and Sharma as on December 31, 2017

Liabilities		Amount Rs	Assets	Amount Rs
Sundry Creditors		38,000	Cash at Bank	12,500
Mrs.Gupta's loan		20,000	Sundry Debtors	55,000
Mrs.Sharma's loan		30,000	Stock	44,000
Reserve fund		6,000	Bills Receivable	19,000
Provision of doubtful debts		4,000	Machinery	52,000
Capital			Investment	38,500
Gupta	90,000		Fixtures	27,000
Sharma	60,000	1,50,000		
		2,48,000		2,48,000

The firm was dissolved on December 31, 2017 and asset realised and settlements of liabilities as follows:

(a) The Realisation of the assets were as follows:

	Rs
Sundry Debtors	52,000
Stock	42,000
Bills receivable	16,000
Machinery	49,000

(b) Investment was taken over by Gupta at agreed value of Rs 36,000 and agreed to pay of Mrs. Gupta's loan.

(c) The Sundry Creditors were paid off *less* 3% discount.

(d) The Realisation expenses incurred amounted to Rs 1,200.

Journalise the entries to be made on the dissolution and prepare Realisation Account, Bank Account and Partners Capital Accounts.

15. Ashok, Babu and Chetan are in partnership sharing profit in the proportion of 1/2, 1/3, 1/6 respectively. They dissolve the partnership of the December 31, 2017, when the balance sheet of the firm as under:

Balance Sheet of Ashok, Babu and Chetan as on December 31, 2017

Liabilities		**Amount Rs**	**Assets**	**Amount Rs**
Sundry Creditors		20,000	Bank	7,500
Bills payable		25,500	Sundry Debtors	58,000
Babu's loan		30,000	Stock	39,500
Capital's:			Machinery	48,000
Ashok	70,000		Investment	42,000
Babu	55,000		Freehold Property	50,500
Chetan	27,000	1,52,000		
Current Accounts :				
Ashok	10,000			
Babu	5,000			
Chetan	3,000	18,000		
		2,45,500		2,45,500

The Machinery was taken over by Babu for Rs 45,000, Ashok took over the Investment for Rs 40,000 and Freehold property was taken over by Chetan at Rs 55,000. The remaining Assets realised as follows: Sundry Debtors Rs 56,500 and Stock Rs 36,500. Sundry Creditors were settled at discount of 7%. A Office computer, not shown in the books of accounts realised Rs 9,000. Realisation expenses amounted to Rs 3,000. Prepare Realisation Account, Partners Capital Account, Bank Account.

16. The following is the Balance sheet of Tanu and Manu, who shares profit and losses in the ratio of 5:3, On December 31,2017:

Balance Sheet of Tanu and Manu as on December 31, 2017

Liabilities		Amount Rs	Assets	Amount Rs
Sundry Creditors		62,000	Cash at Bank	16,000
Bills Payable		32,000	Sundry Debtors	55,000
Bank Loan		50,000	Stock	75,000
Reserve fund		16,000	Motor car	90,000
Capital:			Machinery	45,000
Tanu	1,10,000		Investment	70,000
Manu	90,000	2,00,000	Fixtures	9,000
		3,60,000		3,60,000

On the above date the firm is dissolved and the following agreement was made: Tanu agree to pay the bank loan and took away the sundry debtors. Sundry creditors accepts stock and paid Rs 10,000 to the firm. Machinery is taken over by Manu for Rs 40,000 and agreed to pay of bills payable at a discount of 5%.. Motor car was taken over by Tanu for Rs 60,000. Investment realised Rs 76,000 and fixtures Rs 4,000. The expenses of dissolution amounted to Rs 2,200. Prepare Realisation Account, Bank Account and Partners Capital Accounts.

9.7 Summary

A partnership is a voluntary association of two or more legally competent persons to carry on as co-owners a business for profit. It is best if they have a written partnership agreement, but their contract may be a verbal one. Partnerships are characterized by limited life, which means that the partnership cannot exist separate from the individual partners, thus it may end when one partner becomes unable, through death, bankruptcy or lack of legal capacity, to contract. Partners, through mutual agency, have the legal ability to enter into contracts within the scope of the partnership. Such contracts are binding on the other partners. Unlimited liability, which also characterizes partnerships, refers to the fact that each partner is personally liable for the debts of the business. Though there are many advantages to forming a partnership, limited life, unlimited liability, and mutual agency are disadvantages that should be considered before forming a new partnership.

Partnership accounting is the same as proprietorship accounting, except that each partner has his or her own drawing account. Partners are owners of the business and do not receive salaries; rather, their drawing accounts are debited when cash is taken for personal use and income taxes are based on their share of the net income of the business. Partners will decide upon a profit-loss ratio which will be used to determine how profits and losses are to be allocated. Profits and losses may be distributed: (1) equally; (2) on a fractional basis; (3) based on amounts invested; or (4) using a fixed ratio. Should there be a loss, it will be distributed to the partners' capital accounts the same way as a net income unless there is an agreement to the contrary. A new partnership may be created when a new individual buys the interest of one of the existing partners, or if an additional person is admitted as a partner. In such a case, the old partnership is dissolved. In addition to adding a new partner, an existing partner may wish to withdraw from the partnership. In such a case, the value of all assets and liabilities of the partnership must be determined by an audit.

According to the chapter accounting for partnership, a partnership is defined as a relationship between two or more people who come together to establish a business and share its profits and losses. According to the Indian Partnership Act, a partnership is defined as a relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. There are certain features shared by all partnerships:

Two or More Persons: A firm to be called a partnership must have two or more partners. According to Section 464, Companies Act 2013, the Central Government has the power to set a maximum number of partners in any partnership. The maximum number is 50.

Agreement: Any partnership requires an agreement that forms the relationship between two or more people. The agreement can be oral or written even though the latter is preferable to avoid conflict in the future.

Business: The intent of business is crucial to any partnership.

Mutual Agency: A crucial aspect of a partnership, it implies that all partners have the right to participate in the business affairs of the firm.

Sharing Profits: All firms/partnerships have an agreement to share all profits and losses.

Liability of Partners: All partners are liable for the actions of the partnership, this means that any or every partner's personal assets can be used to pay off debts accrued by the partnership.

Partnership Deed

A partnership deed refers to the written agreement signed and verified by all the partners of a firm as per the chapter accounting for partnership. The partnership agreement can be in oral or written format and it is a partnership deed when:

The document is written with the consent of all partners.

It contains the terms of the agreement and all the relevant details like names of the partners, objective & nature of the business, profit and loss sharing ratio, capital given by every partner, accounting period, date of commencement, etc.

It is a partnership deed when it is drafted according to the Stamp Act and registered with the Registrar of Firms.

Provisions of the Indian Partnership Act

Here are some provisions of the Indian Partnership Act as mentioned in the chapter accounting for partnership that apply to the partnership deeds. They are:

Profit-Sharing Ratio: The profit and losses are equally divided amongst all partners if the partnership deed does not state otherwise.

Interest on Capital: Partners cannot claim interests on the capital contributed by them if the partnership deed does not specify it.

Interest on Drawings: There can be no interest in drawings made by partners.

Interest on Loans: If any partner has given a loan to the partnership firm, then she/he can claim interest on the same at a 6% rate per annum.

Remuneration of Firm's Work: Partners are not entitled to get a salary unless it is otherwise stated in the partnership deed.

Special Aspects of Partnership Accounts

According to accounting for partnership, there are certain aspects of partnership accounts that set them apart from other businesses:

Maintenance of Capital Accounts of Partners

The transactions in the capital accounts of all the partners must be maintained and recorded by the firm. The accounts contain a record of capital contribution and withdrawal, the share of profits, interest on capital, interest on drawings, etc.

There are two ways to maintain capital accounts; fixed capital method and fluctuating capital method.

Under the fixed capital method, two accounts are maintained for each partner. The two accounts are a capital account and a current account. The former shows partners' capital contribution while other items like profit, interest, and salary are recorded under the current account. The initial capital is fixed unless there is some addition or withdrawal.

Under the fluctuating capital method, only one account is maintained, i.e. capital account, and the amount keeps on fluctuating because it records all items.

Distribution of Profit among Partners

We already know that the profit and loss are equally divided amongst all partners according to the Partnership Act of India unless the partnership deed provides a specific ratio. Hence, to distribute the profit and loss, firms prepare the Profit and Loss Appropriation Account.
A profit and loss appropriation account is similar to a profit and loss account. The objective of the account is to appropriate profits after making adjustments with respect to other items like the partner's salary, commission, interest on drawings etc.

Interest on Capital

Generally, partners do not receive any interest in the capital contribution made to the firm according to accounting for partnership. If the deed states that interest must be credited, it is given at an agreed rate. There are two circumstances under which interest is given. When the contribution to capital is more and the profits are divided equally, and two, when the contribution is equal, and profit-sharing is unequal.

Interest on Drawing

Just as there is no interest charged on the capital, there is no interest charged on drawing the capital unless the deed explicitly says so. Interest is often charged on drawings to discourage partners from withdrawing their capital for personal use.

There are different ways to calculate interest for different time periods under which capital is withdrawn:

When the amount is withdrawn at the beginning of each month:
Average Period = No. of months of 1 drawings + No. of months of last drawings/ 2
When the amount is withdrawn at the end of each month
Average Period = No. of months of 1 drawings + No. of months of last drawings/ 2
When money is withdrawn in the middle of the month
Average Period = No. of months of 1 drawing + No. of months of last drawings
Similarly, when the amount is withdrawn on a quarterly basis, then the interest is calculated based on whether the money was withdrawn at the beginning or at the end of the quarter.

Guarantee of Profit to a Partner

Sometimes, all partners or old partners guarantee a minimum account of profit to a new partner when their share of profit is less than the profit-sharing ratio as per the chapter on accounting for partnership. The difference is either borne by all partners or the ones who gave the guarantee.

Past Adjustments

In the last part of the chapter on accounting for partnership, there is mention of past adjustments. Often, certain discrepancies are revealed after the final accounts have been prepared and profits appropriated. Discrepancies can be adjusted through a profit and loss adjustment account or by making changes in the capital accounts of the partners.

9.8 Key words

Partnership – An association of two or more persons to carry on as co-owners of a business for profit.

Partnership agreement – A written contract expressing the voluntary agreement of two or more individuals in a partnership.

Limited partnership – A partnership in which one or more general partners have unlimited liability and one or more partners have limited liability for the obligations of the firm.

Limited liability company – A form of business organization, usually classified as a partnership for tax purposes and usually with limited life, in which partners, who are called members, have limited liability.

Limited liability partnership – A partnership of professionals in which partners are given limited liability and the public is protected from malpractice by insurance carried by the partnership.

Limited partner – Apartner whose liability for the debts of the firm is limited to that partner's investment in the firm.

General partner – A partner who has unlimited liability for the debts of the firm.

Partners' capital statement – The owners' equity statement for a partnership which shows the changes in each partner's capital account and in total partnership capital during the year.

Partnership dissolution – A change in partners due to withdrawal or admission, which does not necessarily terminate the business.

Partnership liquidation – An event that ends both the legal and economic life of a partnership.

Capital deficiency – A debit balance in a partner's capital account after allocation of gain or loss.

Income ratio – The basis for dividing net income and net loss in a partnership.

No capital deficiency – All partners have credit balances after allocation of gain or loss.

Schedule of cash payments – A schedule showing the distribution of cash to the partners in a partnership liquidation.

Admission by investment – Admission of a partner by investing assets in the partnership, causing both partnership net assets and total capital to increase.

Admission by purchase of an interest – Admission of a partner in a personal transaction between one or more existing partners and the new partner; does not change total partnership assets or total capital.

Withdrawal by payment from partners' personal assets – Withdrawal of a partner in a personal transaction between partners; does not change total partnership assets or total capital.

Withdrawal by payment from partnership assets – Withdrawal of a partner in a transaction involving the partnership, causing both partnership net assets and total capital to decrease.

9.10 References/suggested readings

1. Accounting Made Simple: Accounting Explained in 100 Pages or Less
2. A Brief History of Economic Genius Paperback
3. Accounting All-in-One For Dummies
4. Accounting Handbook (Barron's Accounting Handbook)
5. The Tax and Legal Playbook: Game-Changing Solutions to Your Small
6. Warren Buffett Accounting Book: Reading Financial Statements for Value Investing Buffett Book Edition
7. A Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing
8. Financial Shenanigans: How to Detect Accounting Gimmicks & Fraud in Financial Reports
9. Freakonomics: A Rogue Economist Explores the Hidden Side of Everything Paperback
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UNIT-IV

ACCOUNTING FOR DEPRECIATION

STRUCTURE

4.0 OBJECTIVES

After going through this lesson, you should be able to-

- Know the meaning, need and causes of depreciation.
- Know the different methods of charging depreciation.
- Understand the accounting treatment of charging depreciation.

4.1 INTRODUCTION

The term depreciation refers to the reduction in or loss of quality or value of a fixed asset through wear or tear in or tear, in use, effusion of time, obsolescence through technology and market changes or from any other cause. Depreciation take place in case of all fixed assets with certain possible exceptions e.g. land and antiques etc, although the process may be invisible or gradual. Depreciation does take place irrespective of regular repairs and proper maintenance of assets. The word 'depreciation' is closely related to the concept of business income.

Unless it is charged against revenues, we cannot say that the business income has been ascertained properly. This is because of the fact that the use of long term assets tend to consume their economic value and at some point of time these assets become useless. The economic value so consumed must be recovered from the revenue of the firm to have a proper measure of its income. Hence, the reader's must understand that the process of charging depreciation is the technique used by accountants for recovering the cost of fixed assets over a period.

The concept of depreciation is closely linked to the concept of business income. In the revenue generating process, the use of long term assets tends to consume their economic potential. At some point of time these assets become useless and are disposed of and possibly replaced.
The economic potential so consumed represents the expired cost of these assets and must be recovered from the revenue of the business in order to determine the income earned by the business. Depreciation may, therefore, be defined as that portion of the cost of the assets that is deducted from revenue for assets services' used in the operation of a business.

Definition: In order to have a clear understanding about the concept of depreciation, it will be useful to quote definitions given by some prominent writers.

According to Pickles, "Depreciation is the permanent and continuing diminution in the quality, quantity or value of an asset".

The Institute of Chartered Accountants of England and Wales defines depreciation as "that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit earned."

According to Spicer and Pegler, "depreciation may be defined as the measure of the exhaustion of the effective life of an asset from any cause during a given period."
From the above definitions, it can be concluded that depreciation is a gradual decrease in the value of an asset from any cause.
Basic features of depreciation
1. The term depreciation is used only in respect of fixed assets. Of course, the current assets may also lose their value. Loss on account of fall in their value is taken care of by valuing them for Balance Sheet purpose at cost or market price whichever is less.
2. Depreciation is a charge against profits. This means that true profit of the business cannot be ascertained without charging depreciation.

3. Depreciation is different from maintenance. Maintenance expenses are incurred for keeping the machine in a state of efficiency. However, any degree of maintenance cannot assure that the asset will never reach a state of scrap. Of course, good maintenance delays this stage but it cannot absolutely prevent it.

4. All fixed assets, with certain possible exceptions e.g. land, and antiques, etc., suffer depreciation although the process may be invisible or gradual.

The following definition will make the understanding of the concept of depreciation more convenient to the learner's. According to IAS-4, "Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life,"

According to AS-6, "depreciation is a measure of wearing out, consumption or other of value of a depreciable asset arising from use, effusion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the assets. Depreciation includes amortisation of assets whose useful life is pre-determined."

The American Institute of Certified Public Accountants (AICPA) employed the definition as given below

"Depreciation Accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any) over the estimated useful life of unit (which may be a group of assets) in a systematic and retional manner. It a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year."

From the above definitions it is clear that each accounting period must be charged with a fair proportion of the depreciable amount of the asset, during the expected useful life of the asset. Depreciable amount of an asset is its historical cost less the estimated residual value. Finally, it could be concluded that depreciation is a gradual reduction in the economic value of an asset from any cause.

Depreciation, Depletion and Amortisation: The terms depreciation, depletion and amortisation are used often interchangeably. However, these different terms have been developed in accounting usage for describing this process for different types of assets. These terms have been described as follows:

Depreciation: Depreciation is concerned with charging the cost of man-made fixed assets to operation (and not with determination of asset value for the balance sheet). In other words, the term ‘depreciation’ is used when expired utility of physical asset (building, machinery, or equipment) is to be recorded.

Depletion: This term is applied to the process of removing an available but irreplaceable resource such as extracting coal from a coal miner or oil out of an oil well. Depletion differs from depreciation in that the former implies removal of a natural resource, while the latter implies a reduction in the service capacity of an asset.

Amortisation: The process of writing off intangible assets is termed as amortisation. The intangible assets like patents, copyrights, leaseholds and goodwill are recorded at cost in the books of account. Many of these assets have a limited useful life and are, therefore, written off.
Obsolescence: It refers to the decline in the useful life of an asset because of factors like (i) technological advancements, (ii) changes in the market demand of the product, (iii) legal or other restrictions, or (iv) improvement in production process.

The depreciation occurs because of the following:

1. Constant use: The constant use of assets results into their wear and tear, which in turn reduces their working capacity. Hence, a decrease in the value of assets may be seen due to reduced capacity. The value of assets like, machinery, furniture, etc., declines with the constant use of them.
2. Passage of Time: Many fixed assets lose their value with the passage of time. This holds true in case of intangible fixed assets such as patents, copy rights, lease hold properties, etc. The term “amortisation” is generally used to indicate the reduction in the value of such assets.
3. Depletion: Depletion also causes decline in the value of certain assets. This is true in case of wasting assets such as mines, oil wells and forest-stands. On account of continuous extraction of minerals or oils, these assets go on declining in their value and finally they gets completely exhausted.
4. Obsolescence: There may not be any physical deterioration in the asset itself. Despite of this there may be reduction in the utility of an asset that results from the development of a better method, machine or process. For example, an old machine which is still in good working condition may have to be replaced by a new machine because of the later being more economical as well as efficient. In fact, new inventions, developments in production processes, changes in demand for product or services, etc. make the asset out of date.
5. Accidents: An asset may get reduction in its value if it meets an accident.
6. Permanent fall in the Market Value: Certain assets may get permanent fall in their value and this decline in their value is treated as depreciation. For example, a permanent decline in the market value of securities and investment may be assumed as depreciation

4.2 CAUSES OF DEPRECIATION

The causes of depreciation are as follows:

1. Wear and tear: Assets get worn or torn out on account of constant use as is the case with plant and machinery, furniture, and fixtures used in a factory.

2. Exhaustion / Depletion An asset may get exhausted through working. This is the case with mineral mines, oil wells, etc. On account of continuous extraction of minerals or oil, a stage comes, when the mine or well gets completely exhausted and nothing is left.

3. Obsolescence: Some assets are discarded before they are worn out because of changed conditions. For example, an old machine which is still workable may have to be replaced by a new machine because of the latter being more efficient and economical. Such a loss on account of new inventions or changed fashions is termed as loss on account of obsolescence.

4. Efflux of time: Certain assets get decreased in their value with the passage of time. This is true in the case of assets like leasehold properties, patents or copy rights.

5. Accidents: An asset may meet with an accident and, therefore, it may get depreciation in its value.

On the basis of the above causes, it can be said that depreciation, is the decrease or depletion in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accidents,

4.3 NEED FOR PROVIDING DEPRECIATION

The need for providing depreciation arises on account of the following points:

1. To Ascertain the Profits or Losses: The true profits or losses could be ascertained when all costs of earning revenues have been properly charged against them. Fixed assets like building, plant and machinery, furniture, motor vehicles etc are important tool in earning business income. But the cost of the fixed asset is not charged to profit and loss of the accounting period in which the asset is purchased. Therefore, the cost of the fixed asset less its salvage value must be allocated rationally to the periods that receive benefit from the use of the asset. Thus, depreciation is an item of business expense and must be provided for a proper matching of costs with the revenue.
2. To show the Asset as its Reasonable Value: The assets get decrease in their value over a period of time on account of various such as passage of time, constant use, accidents, etc. Therefore, if the depreciation is not charged then the asset will appear in the balance sheet at the over stated value. This practice is unfair as the balance sheet fail to present the true financial position.

3. Replacement of assets: Business assets become useless at the expiry of their life and, therefore, need replacement. The cash resources of the concern are saved from being distributed by way of dividend by providing for depreciation. The resources so saved, if set aside in each year, may be adequate to replace it at the end of life of the asset.
4. To Reduce Income Tax: If tax is paid on the business income without providing for depreciation then it will be in excess to the actual income tax. This is a loss to the business man. Thus, for calculating tax, depreciation should be deducted be from income similar to the other expenses.

4.4 BASIC ELEMENTS OF DEPRECIATION

In order to assess depreciation amount to be charged in respect of an asset in an accounting period the following three important factors should be considered:

1. **Cost of the asset:** The knowledge about the cost of the asset is very essential for determining the amount of depreciation to be charged to the profit and loss account. The cost of the asset includes the invoice price of the asset less any trade discount plus all costs essential to make the asset usable. Cost of transportation and transit insurance are included in acquisition cost. However, the financial charges such as interest on money borrowed for the purchase for the purchase of the asset should not be included in the cost of the asset.
2. **Estimated life of the asset:** Estimated life generally means that for how many years or hours an asset could be used in business with ordinary repairs for generating revenues. For estimating useful life of an asset one must begin with the consideration of its physical life and the modifications, if any, made, factors of obsolescence and experience with similar assets. In fact, the economic life of an asset is shorter than its physical life. The physical life is based mostly on internal policies such as intensity of use, repairs, maintenance and replacements. The economic life, on the other hand, is based mostly on external factors such as obsolescence from technological changes.
3. **Scrap Value of the Asset:** The salvage value of the asset is that value which is estimated to be realised on account of the sale of the asset at the end of its useful life. This value should be calculated after deducting the disposal costs from the sale value of the asset. If the scrap value is considered as insignificant, it is normally regarded as nil

4.5 METHODS OF RECORDING DEPRECIATION

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

4.5.1 When a provision for depreciation account is maintained

The following journal entries are passed in case method is followed:

i) Depreciation account Dr.

To provision for Depreciation Account

(for providing depreciation)

ii) Profit and loss Account Dr.

To Depreciation account

(for closing depreciation account)

iii) Provision for Depreciation account Dr.

To Asset Account

(entry on sale of an asset)

iv) Any amount realised on account of sale of the asset is credited to the Asset Account. The balance, if any, in the Asset Account is transferred to the profit and loss Account.

4.5.2 When a provision for depreciation account is not maintained

The following journal entries are passed in this method:

i) Depreciation account Dr.

To Asset Account

(Entry for providing depreciation)

ii) Profit and loss Account Dr.

To Depreciation Account

(Entry for closing Depreciation Account)

iii) In case the asset is sold, the amount realised is credited to the Asset Amount. Any profit or loss on sale of the asset is transferred to the Profit and loss account.

DEPRECIATION ACCOUNTING

Depreciation Accounting is mainly concerned with a rational and systematic distribution of cost over the estimated useful life of the asset. According to the **American Institute of Certified Public Accountants,** Depreciation Accounting is "a system of accounting which aims to distribute the cost or other basic values of tangible capital assets less salvage (if any) over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is the process of allocation and not of valuation."

The objective of Depreciation Accounting is to absorb the cost of using the assets in different accounting periods in a way so as to give the true figures of profit or loss made by the business.

Objectives of providing Depreciation

The following are the objectives of providing depreciation:

1. Ascertainment of true profits: When an asset is purchased, it is nothing more than a payment in advance for an expense. For example, if a building is purchased for Rs.10,000 for business purposes, the effect of such a purchase will be saving in the cost of rent in the future. But, after a certain number of years, the building will become useless. The cost of the building is, therefore, nothing except paying rent in advance for

a period of years. If the rent had been paid, it would have been charged as an expense for determination of thetrue profits, made by the business during a particular period. The amount paid for the purchase of building should, therefore, be charged over a period of time for which the asset would be serviceable.

2. Presentation of true financial position: The assets get depreciated in their value over a period of time on account of various factors as explained before. In order to present a true state of affairs of the business, the assets should be shown in the Balance Sheet, at their proper values.
3. Replacement of assets: Assets used in the business need replacement after the expiry of their service life. By providing depreciation a part of the profits of the business is kept in the business which can be used for purchase of new assets on the old fixed assets becoming useless.

Factors Affecting the Account of Depreciation

Following are the three important factors which should be considered for determining the amount of depreciation to be charged to the Profit and Loss Account in respect of a particular asset.

1. Cost of the asset: The cost of the asset includes the invoice price of the asset less any trade discount plus all costs essential to bring the asset to a usable condition. It should be noted that financial charges, such as interest on money borrowed for the purchase of the asset, should not be included in the cost of the asset.
2. Estimated scrap value: The term scrap value means the residual or the salvage value which is estimated to be realised on account of the sale of the asset at the end of its useful life. In determining the scrap value, the cost to be incurred in the disposal or removing of the asset should be deducted out of the total realisable value.
3. Estimated useful life: This is also termed as economic life of the asset. This may be calculated in terms of years, months, hours, units of output or other operating measures such as kilometers in case of a taxi or a truck.

4.6 METHODS OF PROVIDING DEPRECIATION:

The following are the various methods of providing depreciation:

i) Fixed instalment or Straight Line Method

ii) Diminishing Balance or Written down Value Method

iii) Sum of the years [or Digits] Method

iv) Annuity Method

v) Sinking Fund or Depreciation Fund Method

vi) Insurance Policy Method

vii) Revaluation Method

viii) Depletion Method

ix) Machine Hour Rate Method

We will now discuss in detail each of the above Methods.

4.6.1 Fixed Instalment or Straight Line Method:

In this method, a suitable percentage of original cost is written off the asset every year throughout the effective life of the asset. Thus if an asset costs Rs. 50,000 and 10 percent depreciation is thought proper (over its useful life of 10 years), Rs. 5000 would be written off every year. In this method, the amount of depreciation is arrived at as under:

$$\text{Depreciation} = \frac{\text{Cost – Scrap Value}}{\text{Estimated Life in Years}}$$

This is also known as fixed instalment method. Under this method the depreciation is charged on the uniform basis year after year. When the amount of depreciation charged yearly under this method is plotted on a graph paper, we shall get a straight line. Thus, the straight line method assumes that depreciations is a function, of time rather than use in the sense that each accounting period received the same benefit from using the asset as every other period. The formula for calculating depreciation charge for each accounting period is:

Depreciation = Original cost of the fixed assets – Residual value / Estimated Life in years

For example, if an asset cost Rs. 50,000 and it will have a residual value of Rs. 2000 at the end of its useful life of 10 years, the amount of annual depreciation will be Rs. 4800 and it will be calculated as follow:

Depreciation = Rs.50,000 – 2000/10 years = Rs. 4800 pa

This method has many shortcomings. First, it does not take into consideration the reasonal fluctuations, booms and depression. The amount of depreciation is the same in that year in which the machine is used day and night to that in the another year in which it is used for some months. Second, it ignores the interest on the money spent on the acquisition of that asset. Third, the total charge for use of asset (i.e., depreciation and repairs) goes on increasing form year to year though the assets might have been use uniformly from year to year. For example, repairs cost together with depreciation charge in the beginning years is much less than what it is in the later year. Thus, each subsequent year is burdened with grater charge for the use of asset on account of increasing cost on repairs.

Illustration-1: H. Ltd. purchased machinery on 1st January 1990 for Rs. 29000 and spent Rs. 2000 on its carriage and Rs. 1,000 on its erection. Machinery is estimated to have a scrap value of Rs. 5000 at the end of its useful life of 5 year. The accounts are closed every year on 31st December. Prepare the machinery account for five years charging depreciation according to straight line method.

Machinery Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1990	To Bank	22000	Dec. 31	By Depreciation	4000
Jan. 1	To Bank	2000	"	By Balance C/d	21000
	To Bank	1000			
		25000			25000
1991	To Balance b/d	21000	1991	By Depreciation	4000
Jan.1			Dec.31	Balance c/d	17000
		21000			21000
1992	To Balance/b/c	17000	1992	By Depreciation	4000
Jan.1			Dec. 31	By Balance c/d	13000
		17000			17000
1993	To Balance b/c	13000	1993	By Depreciation	4000
Jan.1			Dec.31	By Balance	9000
		13000			13000
1994	To Balance b/d	9000	1994	By Depreciation	4000
Jan.1			Dec.31	By Balance c/d	5000
		9000			9000

This method is very suitable particularly in case of those assets which get depreciated more on account of expire of period e.g. lease hold properties, patents, etc.

Merits:

i) This method is very simple to understand and easy to apply.

ii) The value of the asset can be reduced to zero or to its scrap value under this method.

iii) This method is very suitable particularly in case of those assets which get depreciated more on account of expiry of period e.g., Lease-hold properties, patent Rights, etc.

Demerits:

i) This method does not take into account the effective utilization of the asset. The amount of depreciation charged in this method is same every year irrespective of the use of the asset.

ii) This method tends to report an increasing rate of return on investment in the asset on account of the fact that net balance of the asset account is taken. This is not justifiable.

Illustration 2

ABC Ltd. purchases a machinery for a sum of Rs.48,000 on 1st January 1990. Installation charges are Rs.3,000. The machinery is estimated to have a scrap value of Rs. 1,000 at the end of its useful life of five years. You are required to prepare the Machinery account for five years charging depreciation according to Straight Line Method.

Solution

Annual Depreciation to be charged = $\frac{C - S}{N} = \frac{51{,}000 - 1{,}000}{5}$

Dr. **Machinery Account** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
1990 Jan 1	To Bank To Bank (installation charges)	48,000 3,000	1990 Dec. 31	By Depreciation " Balance c/d	10,000 41,000
		51,000			**51,000**
1991 Jan 1	To Balance b/d	41,000	1991 Dec. 31	By Depreciation " Balance c/d	10,000 31,000
		41,000			**41,000**
1992 Jan. 1	To Balance b/d	31,000	1991 Dec. 31	By Depreciation " Balance c/d	10,000 21,000
		31,000			31,000
1993 Jan. 1	To Balance b/d	21,000	1993 Dec. 31	By Depreciation " Balance c/d	10,000 11,000
		21,000			21,000
1994 Jan. 1	To Balance b/d	11,000	1994 Dec. 31	By Depreciation " Balance c/d (Scrap value)	10,000 1,000
		11,000			11,000

Journal entries

Journal entries in the books of the firm				
Date	Particulars	L/F No	Dr.Amt.Rs	Cr.Amt.Rs
I Year				
1	Fixed Asset A/c Dr To Cash/Bank A/c (Being Fixed asset purchased)		XXX	 XXX
2	Fixed Asset A/c Dr To Vendor A/c (Being Fixed asset purchased on credit)		XXX	 XXX
3	Depreciation A/c Dr To Fixed Asset A/c (Being depreciation charged on Fixed asset)		XXX	 XXX
4	Profit& Loss a/c A/c Dr To Depreciation A/c (Being depreciation transferred to P/L a/c)		XXX	 XXX

5	Bank A/c Dr To Fixed Asset A/c (Being Fixed asset is sold out at book value)		XXX	 XXX
6	Bank A/c Dr To Fixed Asset A/c To Profit %& Loss A/c (Being Fixed asset is sold out at above the book value and profit on sale is received)		XXX	 XXX XXX
7	Bank A/c Dr Profit & Loss A/c Dr To Fixed Asset A/c (Being Fixed asset is sold out at less than the book value and loss is incurred		XXX XX	 XXX
8	The above entries 2 and 3 are to be passed every year.			

Illustration

On 1st January, 2003 a Company purchased a plant for ` 20,000. On 1st July in the same year, it purchased additional plant worth ` 8,000 and spent ` 2,000 on its erection. On 1st July, 2004, the plant purchased on 1st jan., 2003 having become obsolete, was sold off for ` 12,500. On 1st October, 2005, fresh plant was purchased for ` 28,000 and on the same date, the plant purchased on 1st July, 2003 was sold at ` 6,000. Depreciation is provided at 10% per annum on original cost on 31st December every year. Show the plant account for 2003 to 2005

Solution

Dr. **Plant Account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2003				**2003**			
Jan. 01	To Cash A/c		20,000	Dec. 31	By Depreciation A/c		
July 01	To Cash A/c		8,000		(i) for a year 2,000		
	To Cash A/c				(ii) for six months 500		2,500
	(expenses)		2,000		By Balance c/d		
					(i) 18,000		
					(ii) 500		27,500
			30,000				30,000
2004				**2004**			
Jan. 1	To Balanc b/d			July 1	By Cash A/c (sale)		12,500
	(i) 18,000			Dec. 31	By Depreciation A/c (i)		1,000[1]
	(ii) 9,500		27,500		By Profit & Loss A/c		4,500[1]
				July 1	By Depreciation A/c (ii)		1,000
				Dec. 31	By Balance c/d (₹9,500-₹1,000)		8,500
			27,500				27,500
2005				**2005**			
Jan. 1	To Balance b/d (ii)		8,500	Oct. 1	By Cash A/c (sale)		6,000
Oct. 1	To Cash A/c (iii)		28,000	Oct. 1	By Depreciation A/c (ii)		750[2]
				Oct. 1	By Profit & Loss A/c (loss)		1,750
				Dec. 31	By Depreciation A/c (iii) (28,000x10/100x3/12)		700
				Dec. 31	By Balance c/d (₹28,000-₹700)		27,300
			36,500				36,500

Note : Calculation of loss on sale of plant :

		₹
(i)	On 1-1-2004 book value of the plant sold [Plant (i)]	18,000
	Less : Depreciation for 6 months *i.e.* 20,000 x 10/100 x 6/12	1,000
	On 1-7-2004 book value of plant sold	17,000
	Less : Sale price of plant	12,500
	Loss on sale of plant	4,500
(ii)	On 1-1-2005 book value of plant sold [Plant (ii)]	8,500
	Less : Depreciation for 9 months is 10,000 x 10/100 x 9/12	750
	On 1-10-2005 book value of plant sold	7,750
	Less : Sale Price	6,000
	Loss on Sale of Plant	1,750

4.6.2. Diminishing Balance or Written Down Value Method

In this method, the rate or percentage of depreciation is fixed and depreciation is charged on the book value of the asset standing at the beginning of each year. Thus, the amount of depreciation goes on decreasing every year. For example, if the cost of an asset is Rs. 10,000 and the rate of depreciation is 10%, then the amount of depreciation to be charged in the first year will be Rs.1000 [10% on Rs.10,000]. In the second year, depreciation will be charged at 10% on the book value of the asset i.e., on Rs.9000 [i.e., 10000-1000] and so on.

This is also known as Written down value method [WDV]. Under the diminishing balance method depreciation is charged at fixed rate on the reducing balance (i.e., cost less depreciation) every year. Thus, the amount of depreciation goes on decreasing every year. Under this method also the amount of depreciation is transferred to profit and loss account in each of the year and in the balance sheet the asset is shown at book value after reducing depreciation from it. For example, if an asset is purchased for Rs. 10,000 and depreciation is to be charged at 20% p.a. on reducing balance system then the depreciation for the first year will be Rs. 2000. In the second year, it will Rs. 1600 (i.e. 20% of 8000), in the third year Rs. 1280 (i.e. 20% of 6400) and so on. The rate of depreciation under this method can be computed by using the following formula:

$$\text{Depreciation rate} = -1\sqrt{\frac{\text{Net scrap value}}{\text{Acquisition cost}}}$$

For example, if the cost of an asset is 27000, scrap value Rs. 3375, economic life 3 year, the rate of depreciation would be:

$$\text{Depreciation Rate} = 1 - 3\sqrt{\frac{3375}{27000}}$$

$$= 1 - \frac{15}{30} = 50\%$$

Merits of Diminishing Balance Method

(i) It is very easy to understand and calculate the amount of depreciation despite the early variation in the book value after depreciation

(ii) This method put an equal burden for use of the asset on each subsequent year since the amount of depreciation goes on decreasing for each subsequent year while the charge for repairs goes on increasing for each subsequent year.

(iii) This method has also been approved by the income tax act applicable in India

(iv) Asset is never reduced to zero because if the rate of depreciation is (say) 20%. Then even when asset is reduced to very small value, there must remain the 80% of that small value as on written off balance.

(v) This method is simple to understand and easy to follow.

(vi) This method puts an equal burden for the use of the asset on each subsequent year.

(vii) The amount of depreciation goes on decreasing for each subsequent year while the charge for repairs goes on increasing for each subsequent year. Thus, the increase in the cost of repairs for each subsequent year is compensated by decrease in the amount of depreciation for each subsequent year.

Demerits:

(i) It ignores the interest on the capital committed to purchase that asset. (ii) It does not provide adequately for replacing the asset at the end of its life. (iii) The calculation of rate of depreciation is not so simple. (iv) The formula for calculating the rate of depreciation can be applied only when there is some residual of the asset.

(ii) The value of the asset cannot be brought down to zero under this method.

(iii) The determination of a suitable rate of depreciation is also difficult under this method as compared to the Fixed Installment Method.

Suitability

This method is suitable in those cases where the receipts are expected to decline as the asset gets older and, it is believed that the allocation of depreciation of depreciation ought to be related to the pattern of assets expected receipts.

Illustration 3: A company purchases Machinery on 1st April 1990 for Rs. 20,000. Prepare the machinery account for three years charging depreciation @ 25% p.a. according to the written Down value Method.

MACHINERY ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1990 Apr. 1	To Bank	20000	1991 Mar. 31	By Depreciation By Balance C/d	5000 15000
		20000			20000
1991 Apr.1	To Balance b/d	15000	1992 Mar.31	By Depreciation By Balance c/d	3750 11250
		15000			15000
1992 Apr 1	To Balance b/d	11250	1993 Mar.31	By Depreciation By Balance c/d	2812.5 8437.5
		11250			11250

Illustration 4

Cosmos Enterprises Ltd. acquired a machine on 1st January 1992 at a cost of Rs. 18,000 and spent Rs.2,000 on its installation. The firm writes off depreciation at 10% of the original cost every year. Show the Machinery Account for three years.

Solution

Dr. **Machinery Account** **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
1992 Jan 1	To Bank To Bank (installation charges)	18,000 2,000	1992 Dec. 31	By Depreciation (10% on Rs.20,000) " Balance c/d	2,000 18,000
		20,000			**20,000**
1993 Jan 1	To Balance b/d	18,000	1993 Dec. 31	By Depreciation (10% on Rs.18,000) " Balance c/d	1,800 16,200
		18,000			**18,000**
1994 Jan.1	To Balance b/d	16,200	1991 Dec. 31	By Depreciation (10% on Rs.16,200) " Balance c/d	1,620 14,580
		16,200			**16,200**
1995	To Balance b/d	14,580			

Illustration

On April 1, 2009 Ganga Bros. purchased two machines for ₹ 75,000 each. Depreciation at the rate of 10% on diminishing balance method was provided. On March 31, 2011, one machine was sold for ₹ 55,000. An improved model with a cost of ₹ 80,000 was purchased on the same day. You are required to show the Machinery Account for 2009-10 to 2010-11.

Solution

Dr. **Machinery Account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2009				**2010**			
Oct. 01	To Bank		1,50,000	Mar. 31	By Depreciation A/c		15,000
				Mar. 31	By Balance c/d		1,35,000
			1,50,000				1,50,000
2010				**2011**			
Apr. 01	To Balance b/d		1,35,000	Mar. 31	By Depreciation A/c		13,500
Mar. 31	To Bank A/c		80,000	Mar. 31	By Bank A/c		55,000
					By P & L A/c		5,750
					By Balance c/d		1,40,750
			2,15,000				2,15,000
2011							
Apr. 01	To Balance b/d		1,40,750				

Note : Calculation of loss on sale of machine :

Initial Cost	75,000
Dep. in 2010	- 7,500
	67,500
	- 6,750
	60,750
	- 55,000
Loss on Sale	5,750

Illustration

On October 1, 2008, the Akash Transport Company purchased a Truck for ` 8,00,000. On April 1, 2010, this Truck was involved in an accident and was completely destroyed and ` 6,00,000 were received from Insurance Company in full settlement. On the same date another Truck was purchased by the company for ` 10,00,000. The company writes off 20% depreciation p. a. on written down value method. Give the Truck Account from 2008 to 2010.

Solution

Dr. **Truck Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2008				**2008**			
Oct. 01	To Bank A/c		8,00,000	Dec. 31	By Depreciation A/c $8,00,000\times\frac{20}{100}\times\frac{3}{12}$		40,000
				Dec. 31	By Balance c/d		7,60,000
			8,00,000				8,00,000
2009				**2009**			
Jan. 01	To Balance b/d		7,60,000	Dec. 31	By Depreciation A/c $7,60,000\times\frac{20}{100}$		1,52,000
				Dec. 31	By Balance c/d		6,08,000
			7,60,000				7,60,000
2010				**2010**			
Jan. 01	Balance b/d		6,08,000	Apr. 01	By Bank A/c		6,00,000
Apr. 01	To P & L A/c		22,400	Apr. 01	By Depreciation A/c $6,08,000\times\frac{20}{100}\times\frac{3}{12}$		30,400
Apr. 01	To Bank A/c		10,00,000	Dec. 31	By Depreciation A/c $1,00,000\times\frac{20}{100}\times\frac{9}{12}$		1,50,000
				Dec. 31	By Balance c/d		8,50,000
			16,30,400				16,30,400

4.6.3 Annuity Method:

The three methods discussed above ignore interest factor. The Annuity Method takes care of this factor. Under this method, the depreciation is charged on the basis that besides losing the original cost of the asset, the business also loses interest on the amount used for buying the asset. The 'interest' here means the interest which the business could have earned otherwise if the money used in purchasing the asset would have been invested in some other form of investment. Thus, according to this method, such an amount is charged by way of depreciation which takes into account not only the cost of the asset but also interest thereon at an accepted rate. The amount of interest is calculated on the book value of the asset in the beginning of the year. The amount of depreciation is uniform and is determined on the basis of the Annuity

Table. An extract of the Annuity Table is shown in the Appendix. The following journal entries are passed in case depreciation is charged according to this method.

i) On purchase of an asset :

Asset A/C Dr. xxx

To Bank xxx

ii) For Charging interest

Asset A/C Dr. xxx

To Interest A/C xxx

iii) For charging Depreciation:

Depreciation A/C Dr. xxx

To Asset A/C xxx

So far we have described such methods of charging depreciation which ignore the interest factor. Also, some times it becomes inconvenient for a company to follow any of the methods discussed earlier. Under such circumstances the company may use some special depreciation systems. Annuity method is one of these special systems of depreciation. Under this system, the depreciation is charged on the basis that besides losing the acquisition cost of the asset the business also loses interest on the amount used for purchasing the asset. Here, interest refers to that income which the business would have earned otherwise if the money used in buying the asset would have been committed in some other profitable investment. Therefore, under the annuity method the amount of total depreciation is determined by adding the cost and interest thereon at an expected rate. The annuity table is used to help in the determination of the amount of depreciation. A specimen of Annuity Table is as follows:

ANNUITY TABLE

Year	3%	4%	5%	6%
4	0.269027	0.275490	0.282012	0.288591
5	0.218335	0.224627	0.230975	0.237376
6	0.184598	0.190762	0.197012	0.203363
7.	0.160506	0.166610	0.172820	0.179135
8.	0.142456	0.148528	0.154722	0.161036
9.	0.128434	0.134493	0.140690	0.147022
10.	0.117231	0.12391	0.129505	0.135868

In case depreciation is charged according to this method, the following accounting entries are passed:

(i) Purchase of an asset

Asset Account Dr.

To Bank

(ii) For Charging interest

Asset Account Dr.

To Interest Account

(iii) For Charging depreciation:

Depreciation Account Dr.

To Asset Account

Evaluation of Annuity Method

Merits: (i) This method keep into account interest on money spent on the purchase of the asset. And (ii) The value of the asset become zero at the end of life.

Demerits

(i) This method is comparatively more difficult than the methods discussed so far.

(ii) It makes no arrangement of money to replace the old asset with the new one at the expiry of its life.

(iii) Under this method the burden on the profit and loss account is no similar in each year because the depreciation remains constant year after year but the interest goes on decreasing.

Illustration-5: On 1st January, 1990 a firm purchased a leasehold property for 4 year at a cost of Rs. 24000. It decides to depreciate the lease by Annuity Method by charging interest at 5% per annum. The Annuity Table shows that the annual necessary to write off Rs. 1 at 5% Rs. 0.282012. You are required to prepare the lease Hold Property Account for four years and show the net amount to be charged to the profit and loss account for these four years.

LEASE HOLD PROPERTY ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1990 Jan. 1	To Bank	24000.00	1990 Dec. 31	By Depreciation	6768.29
	To interest	1200.00	Dec.31	By balance c/d	18431.71
		25200.00			25200.00
1991 Jan.1	To balance b/d	18431.71	1991 Dec.31	By Depreciation	6768.29
Dec.31	To Interest	921.59	Dec.31	By Balance c/d	12585.01
		19353.30			19353.30
1992 Jan.1	To balance b/d	12585.01	1992 Dec.31	By Depreciation	6768.29
Dec. 31	To Interest	629.25	Dec.31	By Balance c/d	6445.97
		13214.26			13214.26
1993 Jan.1	To balance b/d	6445.97	1993 Dec.31	By Depreciation	6768.29
			Dec.31	By Balance c/d	9000
Dec.31	To Interest	322.30			13000
		6768.27			6768.27

NET AMOUNT CHARGEABLE TO THE PROFIT AND LOSS ACCOUNT

Year	Depreciation debited	Interest Credited	Net Charge against Profit
1990	6768.29	1200.00	5568.29
1991	6768.29	921.59	5846.70
1992	6768.29	629.25	6139.04
1993	6768.29	322.30	6445.99
Rs.	27073.16	3073.14	24000.02

Illustration 6

A lease is purchased on 1st January 1990 for four years at a cost of Rs. 20,000. It is proposed to depreciate the lease by the annuity method charging 5% interest. Show the Lease Account for four years and also the relevant entries in the P & L A/C.

Solution:

Annuity Table shows that to depreciate Re.1 by annuity method over 4 years, charging 5% interest, one must write off a sum of Re.0.282012. To write off Rs.20,000 one requires to write off every year Rs.5.640.24 [i.e.. 0.282012 x 20,000].

Dr. **Lease Account** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
1990 Jan. 1 Dec.31	To Bank "Interest (5% on 20,000)	20,000 1,000	1990 Dec.31	By Depreciation "Balance c/d	5,640.24 15,359.76
		21,000			**21,000**
1991 Jan. 1 Dec.31	To Balance b/d "Interest (5% on 15359.76)	15,359.76 767.99	1991 Dec.31	By Depreciation "Balance c/d	5,640.24 10,487.51
		16,127.75			**16,127.75**
1992 Jan. 1 Dec. 31	To Balance b/d "Interest (5% on 10487.51)	10,487.51 524.38	1992 Dec.31	By Depreciation "Balance c/d	5,640.24 5,371.65
		11,011.89			**11,011.89**
1993 Jan. 1 Dec. 31	To Balance b/d "Interest (5% on 5371.65)	5,371.65 268.59	1993 Dec.31	By Depreciation	5,640.24
		5,640.24			**5,640.24**

Dr. **Profit and Loss Account** **Cr.**

Date	**Particulars**	**Rs.**	**Date**	**Particulars**	**Rs.**
1990 Dec.31	To Depreciation a/c	5640.24	1990 Dec.31	By Interest a/c	1,000.00
1991 Dec.31	To Depreciation a/c	5640.24	1991 Dec.31	By Interest a/c	769.99
1992 Dec.31	To Depreciation a/c	5640.24	1992 Dec.31	By Interest a/c	524.00
1993 Dec.31	To Depreciation a/c	5640.24	1993 Dec.31	By Interest a/c	268.59

4.6.4 Sinking Fund or Depreciation Fund Method:

One of the objectives of providing for depreciation is to provide for replacement of the asset at the end of its useful life. In case of the four methods discussed earlier, the amount of depreciation charged from the Profit and loss Account continues to remain in the business. However, this amount may get invested in all sorts of assets in course of running the business thus making it difficult to buy a new asset in place of the old one. Depreciation Fund method takes care of such a contingency. According to this method, the amount charged by way of depreciation is invested in readily saleable securities carrying a certain rate of interest. The amount received on account of interest from these securities is also invested from time to time together with the annual amount charged, by way of depreciation. At the end of the useful life of the asset, when replacement is required, the securities are sold away and the money realized on account of the sale of the securities is used for purchase of a new asset. How much amount is to be invested every year so that a given sum is available at the end of a given period depends on the rate of interest. The Sinking Fund table shows how much is to be invested every year together with the interest earned so that at the end of the period one gets Re. 1.

Business assets become useless at the expiry of their life and therefore, need replacement. However, all the methods of depreciation discussed above do not help in accumulating the amount which can be readily available for the replacement of the asset its useful life comes to an end Depreciation fund method takes care of such a contingency as it incorporates the benefits of depreciating the asset as well as accumulating the necessary amount for its replacement. Under this method, the amount of depreciation charged from the profit and loss account is invested in certain securities carrying a particular rate of interest. The interest received on the investment in such securities is also invested every year together with the amount of annual depreciation. In the last of the life of asset the depreciation amount is set aside interest is received as usual. But the amount is not invested because the amount is immediately needed for the purchase of new asset. Rather all the investments so far accumulated are sold away. Cash realised on the sale of investments is utilised for the purchase of new asset. The following accounting entries are generally made in order to work out this system of depreciation.

1. at the end of the first year

(i) for setting aside the amount of depreciation: The amount to be charge by way of depreciation is determined on the basis of sinking Fund Table given as an Appendix at the end of every book of accountancy.

Depreciation Account Dr.

To Depreciation Fund Account (or Sinking Fund A/c)

(ii) For investing the amount charged by way of depreciation:

Depreciation Fund Investment A/c Dr.

To Bank A/c

2. In the second and subsequent years

(i) For receiving interest. The interest on the balance of Depreciation Fund Investment outstanding in the beginning of each year will be received by the end of the year. This entry is:

Bank Account Dr.

To Depreciation Fund Account

(ii) For setting aside the amount of depreciation

Profit and Loss A/c Dr.

To Depreciation Fund A/c

(iii) For investing the amount

Depreciation Fund Investment A/c Dr.

To Bank A/c

(Annual instalment of depreciation and interest received invested)

3. In the last year

(i) For receiving interest:

Bank A/c Dr.

To Depreciation Fund A/c

(ii) For setting aside the amount of depreciation

Profit and loss A/c Dr.

To depreciation Fund A/c

Note: In the last year no investment will be made, because the amount is immediately required for the purchase of new asset.

(iii) For the sale of investment:

Bank A/c Dr.

To Depreciation Fund Investment A/c

(iv) For the transfer of profit or loss on sale on investments: The profit or loss on the sale of these investments is transferred to the Depreciation Fund Account.

The entry for loss:

Depreciation Fund A/c Dr.

To Depreciation Fund Investment A/c

The entry for profit

Depreciation Fund Investment A/c

To Depreciation Fund A/c

(v) For the sale of old asset:

Bank A/c Dr.

To asset A/c

(vi) The depreciation fund is transferred to asset account and any balance left in the asset account is transferred to profit and loss account. The entry is:

Depreciation Fund A/c. Dr.

To asset A/c

(vii) The balance in Asset Account represents profit or loss. Therefore it will be transferred to the profit and loss account.

(viii) The cash realised on the sale of investments and the old asset is utilised for the purchase of new asset.

Merits

(i) Periodic depreciation together with realized interest is invested outside the business in liquid securities which readily provides ready money for replacing the old asset.

(ii) Overall as also periodic depreciation is smaller than the asset's actual depreciable cost due to deduction of interest.

Demerits

(i) Sinking fund method assumes a constant rate of return on every periodic investment in identical securities. This is hardly true in this dynamic world where rates do vary now and then. This upsets the earlier periodic allocation for depreciation.

(ii) This method puts an increasing burden on the profit and loss of each year on Account of a fixed charge for depreciation but increasing charging for repairs.

4.6.5 Insurance Policy Method

This method is similar to the Depreciation Fund method. Instead of making investment, arrangements are made with the insurance company which will receive premium annually and pay at the end of the fixed period, the required amount with which the old asset can be replaced premium have to be paid at the beginning of each year. The annual premium is treated as the annual depreciation.

The following entries are passed:

A. First and subsequent years:

On payment of insurance premium at the beginning of each year

(i) Depreciation Insurance Policy A/C Dr.

To Bank

At the end of the year for providing depreciation:

(ii) Profit and Loss A/C Dr.

To Depreciation Fund A/C

B. At the end of the last year:

On realization of money from the Insurance Co.,

(iii) Bank A/C Dr.

To Depreciation Insurance Policy A/C

(iv) For transfer of profit on insurance policy

Depreciation Insurance Policy A/C Dr.

To Depreciation Fund A/C

(v) For transfer of accumulated depreciation to the Asset A/C

Depreciation Fund A/C Dr.

To Asset A/C

Under this method, instead of investing the money in securities an insurance policy for the required amount is taken. The amount of the policy is such that it is adequate to replace the asset when it is worn out. A fixed sum equal to the amount do depreciation is paid as premium every year. Company receiving premium allows a small rate of interest on compound basis. At the maturity of the policy, the insurance company pays the agreed amount with which the new asset can be purchased. Accounting entries will be made as follows.

1. First and every subsequent years

(a) Depreciation Insurance policy A/c Dr.

To Bank

(Entry in the beginning of the year for payment of insurance premium)

(b) Profit and loss Account Dr.

To Depreciation fund A/c

(Entry at the end of the year for providing depreciation)

2. Last year

(a) Bank A/c Dr.

To Depreciation Policy A/c

(Entry for the amount of policy received)

(b) For transfer of profit on insurance policy:

Depreciation Insurance Policy A/c Dr.

To Depreciation Fund A/c

(c) For transfer of accumulated depreciation to the asset account:

Depreciation Fund A/c Dr.

To Asset A/c

(d) On purchase of new asset:

New Asset A/c Dr.

To Bank

4.6.6 Machine Hour Rate Method

In case of this method, the running time of the asset is taken into account for the purpose of calculating the amount of depreciation. It is suitable for charging depreciation on plant and machinery, air-crafts, gliders, etc.

The amount of depreciation is calculated as follows:

Depreciation= Acquisition cost of the assets – Scrap value/ Life of the Asset in hours

For example, if machinery has been purchased for Rs. 20000 and it will have a scrap value of Rs. 1000 at the end of its useful life of 1900 hours, the amount of depreciation per hour will be computed as follows:

Depreciation = Acquisition cost of the assets – Scrap value / Life of the Asset in hours

Depreciation= Rs. 20,000 – 1,000/1900=Rs.10 per hour

If in a particular year, the machine runs for 490 hours, the amount of depreciation will be Rs. 4900 (i.e., Rs. 10x490). It is obvious from this example that under machine hour rate method the amount of depreciation is closely related with the frequency of use of an asset. The simplicity in calculations and under standing is the main advantage of this methods. However, it can be used only in case of those assets whose life can be measured in terms of working time.

4.7 SALE OF AN ASSET

An enterprise may sell an asset either because of obsolescence or inadequacy or even for other reasons. In case an asset is sold during the course of the year, the amount realised should be credited to the Asset Account. The amount of depreciation for the period of which the asset has been used should be written off in the usual manner. Any balance in the Asset Account will represent profit or loss on disposal of the asset. This balance in the Asset Account should be transferred to the profit and loss account.

Illustration: A company purchased a machinery costing Rs. 60,000 on 1.4.1990. The accounting year of the company ends on 31st December every year. The company further purchased machinery on 1st October, 1990 costing Rs. 40,000. On 1st January 1992, one-third of the machinery which was installed on 1.4.1990, became obsolete and was sold for Rs. 5000. Show how the machinery account would appear in the books of the company. The depreciation is to be charged at 10% p.a. on written down value method.

MACHINERY ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1.4.90	To Bank	60000	31.12.90	By Depreciation	45000
Oct. 1	To Bank	40000		on Rs. 60000 for 9 month	1000
				on Rs. 40000 for 3 month	
			Dec.31	By Balance c/d	94500
		100000			100000
1.191	To Balance b/d	94500	31.12.91	By Depreciation on Rs. 94500 for 1 year	9450
			Dec. 31	By Balance c/d	85050
		94500			94500
1.192	To Balance b/d	85050	31.12.91	By Bank (sale pro)	5000
			Jan. 1	By Profit Loss account loss on sale (16650-5000)	11650
			Dec. 31	By Depreciation	6840
			Dec. 31	By Balance c/d	61560
		85050			85050

*Total written down value as on Jan. 1, 1992	85050
Less written down value of 1/3 of Machinery sold (2000-(1500+1850)	16650
	68400
Depreciation at 10% on Rs. 68400	6840

Illustration 8

Alfa Co. Ltd., purchased a machine on 1st January 1992 for Rs.11.000. It decided to provide for its replacement by Insurance policy method. The company took an insurance policy for 3 years for Rs.10,000 in consideration of the yearly premium of Rs.3150. Show the Insurance Policy A/c, Depreciation Fund A/C and the Machinery A/c assuming that the retired machine realizes Rs.900 as scrap.

Solution

Dr. **Insurance Policy Account** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
1992 Jan. 1	To Bank (Premium)	3,150	1992 Dec. 31	By Balance c/d	3,150
		3,150			**3,150**
1993 Jan 1	To Balance b/d To Bank (Premium)	3,150 3,150	1993 Dec. 31	By Balance c/d	6,300
		6,300			**6,300**
1994 Jan 1	To Balance b/d To Bank (Premium) To Depreciation A/c (Profit Transferred)	6,300 3,150 550	1994 Dec. 31	By Bank	10,000
		10,000			**10,000**

Dr. **Depreciation Fund Account** **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
1992 Dec. 31	To Balance c/d	3,150	1992 Dec. 31	By P & L A/c	3,150
		3,150			**3,150**
1993 Jan 1	To Balance c/d To Bank (Premium)	6,300 3,150	1993 Jan 1	By Balance b/d By P & L A/c	3,150 3,150
		6,300			**6,300**
1994 Dec. 31	To Machinery A/c Transfer	10,000	1994 Dec. 31	By Balance b/d By P & L A/c By Insurance Policy A/c	6,300 3,150 550
		10,000			**10,000**

Dr. **Machinery Account** **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
1992 Jan. 1	To Bank	11,000	1992 Dec. 31	By Balance c/d	11,000
1993 Jan 1	To Balance b/d	11,000	1993 Dec. 31	By Balance c/d	11,000
1994 Dec. 31	To Balance b/d	11,000	1994 Dec. 31	By Depreciation Fund A/c By Bank By P & L A/c Loss (transferred)	10,000 900 100
		11,000			**11,000**

4.8 Comprehensive Problems and solutions

Illustration-9. A company whose accounting year is the calendar year, purchased on 1st April, 1982 Machinery costing Rs.30,000. It purchased further Machinery on 1st October, 1982 costing Rs.20,000 and on 1st July, 1983 costing Rs.10,000. On 1st January, 1984, one-third of the Machinery installed on 1st April,1982 became obsolete and was sold for Rs.3,000. Show how Machinery Account would appear in the books of the company, it being given that Machinery was depreciated by Fixed Installment Method at 10 % per annum.

Solution

Dr **MACHINERY ACCOUNT** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
1982			1982	By Depreciation A/c	2,750
Apr. 1	To Bank A/c	30,000	Dec.31	(on Rs.30,000 for nine months and on Rs.20,000 for 3 months)	
Oct. 1	To Bank A/c	20,000			
		50,000			**50,000**
1983			1983	By Depreciation A/c	5,500
Jan.1	To Balance b/d	47,250	Dec.31	(on Rs.50,000 for one year and on Rs. for 10,000 for 6 months)	
Jul. 1	To Bank A/c	10,000		By Balance c/d	51,750
		57,250			**57,250**
1984	To Balance b/d	51,750	1984	By Bank A/c	3,000
Jan. 1			Jan 1	By P&L a/c (Loss on sale)	5,250
			Dec. 31	By Dep. (on Rs.50,000 for one year)	5,000
			Dec. 31	By Balance c/d	38,500
		51,750			**51,750**

Illustration-10: On 1st January, 1982, a limited company purchased machinery for Rs.12,000 and on 30th June, 1983 it acquired additional machinery at a cost of Rs.2,000. On 31st March, 1984 one of the original machines which had cost of Rs.500 was found to have become obsolete and was sold as scrap for Rs.50. It was replaced on that date by a new machine costing Rs.800. Depreciation to be provided at the rate of 15 per cent per annum on the written down value. Show ledger accounts for the first three years.

Solution

MACHINERY ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1982	To Cash	12,000	Dec.31	By Dep. (15% on Rs.12,000)	1,800
				" Balance c/d	10,200
		12,000			**12,000**
1983			1983	By Dep. (15% on Rs.10,200 for 1	1,680
Jan.1	To Balance b/d	10,200	Dec.31	year and on Rs.2,000 for 1/2 year)	
Jun.30	" Cash	2,000		" Balance c/d	10,520
		12,200			**12,200**
1984	To Balance b/d	10,520	1984	By Cash	50
Jan.1			Mar.31	" P & L A/c (Loss on sale)*	297
		800		" Dep. (15% on Rs.10,159 for 1 year	
Mar.31	" Cash			and on Rs.800 for a 3/4 year)	1,628
				" Balance c/d	9,345
		11,320			11,320

Illustration-11. A company has acquired a lease of a cinema theatre for a term of 5 years by payment of Rs.4,00,000. It is proposed to depreciate the lease by the Annuity Method, charging 5 percent per annum. Show the Ledger Account of asset during the period of the lease. Reference to the Annuity Table shows that the amount for Re.1 for 5 years at 5 percent is Re.0.230975. Calculations are to be made to the nearest rupee.

Solution

Annual depreciation is calculated as follows:

0.230975 x 4,00,000 = Rs. 92,390

LEASE ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
Year 1 Jan 1 Dec. 31	 To Bank A/c To Interest A/c	 4,00,000 20,000	Year 1 Dec. 31 Dec. 31	 By Depreciation A/c Balance c/d	 92,390 3,27,610
		4,20,000			**4,20,000**
Year II Jan 1 Dec. 31	 To Balance b/d To Interest A/c	 3,27,610 16,386	Year II Dec. 31 Dec. 31	 By Depreciation A/c By Balance c/d	 92,390 2,51,606
		3,43,996			**3,43,996**
Year III Jan 1 Dec. 31	 To Balance b/d To Interest A/c	 2,51,606 12,580	Year III Dec. 31 Dec. 31	 By Depreciation A/c By Balance c/d	 92,390 1,71,196
		2,64,186			**2,64,186**
Year IV Jan 1 Dec. 31	 To Balance b/d To Interest A/c	 1,71,796 8,590	Year IV Dec. 31 Dec. 31	 By Depreciation A/c By Balance c/d	 92,390 87,996
		1,80,386			**1,80,386**
Year V Jan 1 Dec. 31	 To Balance b/d To Interest (Balancing figure)	 87,996 4,394	Year V Dec. 31	 By Depreciation	 92,390
		92,390			**92,390**

4.9 SUMMARY

The term depreciation refers to the reduction or loss of quality or value of a fixed asset through wear or tear, in use, effusion of time, obsolescence through technology and market changes or from any other cause. The term depreciation, depletion and amortization are used often interchangeably. However, these different terms have been developed in accounting usage for describing this process for different type of assets.

The term 'depreciation' is concerned with charging the cost of man-made fixed assets, depletion applied to the process of removing an available but irreplaceable resource such as coal mines or oil well, amortisation refers to the process of writing off intangible assets. The main objectives of charging depreciation are to ascertain the true profits or losses and to show the assets at its reasonable value. The amount of depreciation to be charged depends upon cost of the asset, estimated life of the asset and scrap value of the asset. There are different methods of charging depreciation, i.e., fixed instalment method, machine hour rate method, diminishing balance method, sum of years digits method, annuity method, depreciation fund method, insurance policy method and depletion method.

4.10 KEYWORDS

Fixed Assets: Assets which have been purchased for continuous use in the business.

Depreciation Rate: A percentage applied to the historical cost or the substituted amount of a depreciable asset.

Balance Sheet: A statement of the financial position of an enterprise as at a given time.

Depletion: A measure of exhaustation of a wasting asset represented by periodic write-off of cost.

Obsolescence: Dimunition in the value of an asset by the reason of its becoming out-of-date due to technological changes.

Provision: An amount retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy.

4.11 SELF ASSESSMENT QUESTIONS

1. Why is it necessary to calculate depreciation? Discuss various factors which are considered for calculating depreciation
2. Distinguish between the following:
(a) Straight line method and diminishing balance method.
(b) Annuity method and depreciation Fund method.
(c) Depreciation and depletion
3. Explain the circumstances under which different methods of depreciation can be employed.
4. Discuss the advantages and disadvantage of Insurance Policy Method and Straight Line Method.
5. What is sum of the year-digits method do depreciation? In what way does it differ from sinking fund method or depreciation?

6. A firm purchases a plant for a sum of Rs. 10,000 on 1st January 1990. Installation charges are Rs. 2,000. Plant is estimated to have a scrap value of Rs. 1,000 at the end of its useful life of five years. You are required to prepare the plant account for five years charging depreciation according to Straight Line Method

7. A plant is purchased for Rs. 20,000. It is depreciated at 5% per annum on reducing balance for five years when it becomes obsolete due to new method of production and is scrapped. The scrap produces Rs. 5,385. Show the plant account in the ledger.

8. The machinery account of a factory showed a balance of Rs. 1,90,000 on 1st January 1998. 1st accounts were made up on 31st December each year and depreciation is written off at 10% p.a. under the Diminishing Balance Method.

On 1st June 1998, New Machinery is acquired at a cost of Rs. 28,000 and installation charges incurred in erecting the machines works out to Rs. 892 on the same date. On 1st June 1998 a machine which had cost Rs. 6,000 on 1st January 1993 was sold for Rs. 750, another machine which had cost Rs. 600 on 1st January 1994, was scrapped on the same date and it realised nothing. Write up plant and Machinery Account for the year 1998, allowing the same rate of Depreciation as in the past calculating Depreciation to the nearest multiple of a Rupee.
(Ans. Loss on Sale Rs. 2,645, Loss on scrapping Rs. 377, Closing Balance Rs. 1,94,665).

9. A company purchased a four years lease on January, 1, 1985 for Rs. 20,150. It is decided to provide for the replacement of the lease at the end of four years by setting up a Depreciation Fund. It is expected that investments will fetch interest at 4per cent. Sinking Fund tables show that to provide the requisite sum at 4percent at the end of four years, an investment of Rs. 4,745.02 is required. Investments are made to the nearest rupee. On December 31, 1988, the investments are sold for Rs. 14,830 On 1st January, 1989, the same lease is renewed for a further period of 4 years by payment of Rs. 22,000. Show journal entries and give the important ledger account to record the above.

10. Chillies Ltd, acquired a long-term lease of property on payment of Rs. 60,000. A leasehold Redemption Policy was taken out on which an annual premium of Rs. 1,440 was payable. The surender value of the policy on 31st March, 1997 was Rs. 12,896 to which amount the policy account stood adjusted. Next premium was paid on 20th December, 1997 and the surrender value on 31st March, 1978 was Rs. 14,444.
(i) Show the Redemption fund account and the policy account for the year ended 31st March, 1998 (ii) Assuming that of maturity, a sum of Rs. 60,100 was received and the balance in policy account then stood at Rs. 59,920 give the ledger accounts showing the entries necessary to close the accounts concerned.
(Ans. (i) Balance at the end of 1998 Fund A/c & Policy A/c Rs. 14,444 (ii) Transfer to P & L a/c profit on maturity Rs. 100).

11. Machinery account of CSI Ltd. showed debit balance of Rs. 32,400 on 1st January, 1998. Depreciation was provided at 10% per annum. On 1st July 1998, a part of the machinery purchased for Rs. 10,000 on 1st January 1996 was sold for Rs. 7,000 and on the same date a new machinery which cost Rs. 20,000 was purchased. On 31st Dec. 1998 the company decided to change the method of depreciation from Diministing Balance Method to Fixed Instalment Method with effect from 1st January, 1996, depreciation remaining at 10% per annum. Show Machinery account.

Essay type Questions

1. Define depreciation. Explain the need and significance of depreciation.
2. Enumerate the various causes of depreciation and spell out the objectives of providing for depreciation.
3. Discuss the various factors which are to be considered for calculating depreciation.
4. Discuss in detail various methods of providing depreciation. Bring out the pros and cons of each method.
5. Distinguish between straight line method and diminishing balance method of providing depreciation.
6. A newly established concern has acquired the following assets:

(i) Lease-hold property (ii) Loose Tools (iii) Coal mine
(iv) Power Plant (v) Motor Truck

You are required to suggest the suitable method of depreciation for each of the assets, giving reasons in support of your suggestion.

7. Write short notes on:

(i) Provisions and Reserves
(ii) Secret Reserves
(iii) Depreciation policy.

Comprehensive Problems

1. M/s. Sekar & Co purchased a Machinery on 1.1.2002 for Rs.10,00,000. The firm writes off depreciation at 10 % on the original cost every year. The Books are closed on 31st March every year. Pass the necessary Journal entries, prepare Machinery Account and Depreciation Account for the first three years.

(Answer: Balance at the end of the third year Rs. 7,00,000)

2. A & Co. purchased a Plant for Rs.80,000 on 1.4.2001. it is depreciated at 10 % p.a on reducing balancing method for three years. Accounts are closed on 31st March every year. Pass the necessary Journal entries, prepare Machinery Account and Depreciation Account for the first three years.

(Answer: Balance at the end of the third year Rs. 58,320)

3. A company purchased a Plant for Rs. 4,00,000 on 1st April 2000, an additional machinery was purchased for Rs.40,000 on 1st April 2001. Prepare the Plant account for three years. Depreciation is provided at 10% p.a using Straight line method. The firm closes its books on 31st March of every year.

(Answer: Balance at the end of the third year Rs. 3,12,000)

4. A Plant is purchased for Rs.90,000. It is depreciated at 10 p.a on reducing balance for Three years. When it becomes obsolete due to new method of production and is scrapped. The scrap produces Rs. 66,000 at the end of the third year. Prepare plant and depreciation account for three years.
(Answer: Profit on sale of plant is Rs. 390)

5. Depreciation in a factory is provided by the "straight line" method at the rate of 10 percent per annum. The balance standing on the Plant and Machinery December 1991 after writing off depreciation for the year was Rs.19,515 (Total cost price of the plant was (Total cost price of the plant was Rs.35,800 including plant purchased in 1981 for Rs.8,900) During January 1992 new plant was purchased at a cost of Rs.2,950 and one machine which had cost of Rs.550 in 1978 was sold as scarp for Rs.35. During January 1993, there were additions costing Rs.1,800 and a machine which had cost Rs.700 in 1989 was sold for Rs.350. You are required to write up Machinery Account for 1992 and 1993. All calculations are to be shown.
(Ans: Machinery Account Balance 1992 Rs.19,480 and 1993 Rs.17,765)
(Hints: (i) Do not provide depreciation in 1992 on Rs.8,900 because it must have been completely written off by 1992
(ii) Profit on sale of plant during 1992 Rs.35; (iii) Loss on sale of plant during 1993
(Rs.420-Rs.350) = Rs.70).

6. The book value of Plant and Machinery on 1st January 1988 was Rs.2,00,000. New Machinery for Rs.10,000 was purchased on 1st October 1988 and for Rs.2,00,000 on 1st July, 1989. On 1st Apri1,1990 a machinery whose book value had been Rs.30,000 on 1st January,1988 was sold for Rs.16,000 and the entire amount was credited to plant and machinery Account. Depreciation had been charged at 10% per annum on the book value on 1st January,1968 on straight line method. It was decided on 31st December,1990 that depreciation at the rate of 20 percent per annum on diminishing balance method should be charged with retrospective effect since 1st January,1988. Show the Plant and Machinery Account from 1st January 1988 to 31st December, 1990.
(Ans: Depreciation in 1988,1989 and 1990 Rs. 40,500, 35,900 and 27,840 (including Rs.960 on sold Machine). Book value of sold machine on 1st April 1990 Rs. 18,240 ; Loss on sold machine Rs.2,240; Balance in Machinery A/c Rs.1,07,520)

7. Kiwi Enterprises Ltd., which depreciates its machinery at 10% on diminishing balance method held on 1st January,1991 Rs.9,72,000 to the debit of machinery account.
During the year 1991, part of the machinery purchased on 1st January 1989 for Rs.80,000 was sold for Rs.45,000 on 1st July 1991 and a new machinery at a cost of Rs.1,50,000 was purchased and installed on the same date, installation charges being Rs.8,000.

The company wanted to change its method of depreciation from diminishing balance method to straight line method with effect from 1st January 1989 and adjust the difference in the account of 1991. The rate of depreciation remains the same as before.

Show the machinery Account and ascertain the amount chargeable to profit & loss A/c for depreciation including obsolescence loss in the year 1991.

(Ans; Rs.1,50,900 chargeable to P & L A/c for depreciation (including Rs.15,000 for obsolescence in 1991; Balance in machinery A/c Rs.9,34,100.)

8. On 1st April, 1988 a new plant was purchased for Rs.40,000 and a further sum of Rs.2,000 was spent on its installation. On 1st October,1990 another plant was the acquired for Rs.25,000. Due to an accident on 3rd January 1991 the first plant was totally destroyed and the remnants were sold for Rs.1,000 only.

On 1st January 1992 a second hand plant was purchased for Rs.30,000 and a further sum of Rs.5,000 was spent for bringing the same to use on and from 15th March 1992. Depreciation has been provided at 10 percent on straight line basis. It was the practice to provide depreciation for full year on all acquisitions made at any time during any year and to ignore depreciation on any item sold or disposed of during any year. None of the assets were insured. The accounts are closed annually to 31st March. It is now decided to follow the rate of 15 percent on diminishing balance method with retrospective effect in respect of the existing items of plant and to make the necessary adjustment entry on 1st April 1992.

Show the journal entries to be passed for the purpose and the Plant Account and the Accumulated Depreciation Account for all the years.

(Ans: Balance in Plant A/c Rs.60,000 and Accumulated Depreciation A/c Rs.12,187 including additional depreciation of Rs.3687)

9. A company purchased 3 years lease on January 1st 1992 for Rs.25,000. It is decided to provide for the replacement of the lease at the end of 3 years by setting up a depreciation fund. It is expected that investments will fetch interest at 5%. Sinking fund tables show that to provide the requisite sum at 5% at the end of 3 years, an investment of Rs. 7,930.22 is required every year. Investments are made to the nearest rupee. On 31st December 1994 the investments are sold for Rs.15,250. Show the journal entries and give the Lease account, Depreciation Fund account and Depreciation Fund Investment account.

(Ans: Interest at the end of 1993 and 1994 Rs.397 and Rs.813 respectively; Loss on sale of investments Rs.1007; debit to P & L A/c for 1994 Rs.8937.)

10. The Machinery Account of a factory showed a balance of Rs.3,80,000 on January, 1991. Its accounts were made up on 31st December each year and depreciation written off at 10 percent on written down value. On 1st June 1991 new machinery was acquired at a cost of Rs.57,783 and on the same date a machine, which had cost Rs.12,000 on 1st January 1987 was

scrapped without realising anything. Write up the Plant and Machinery Account for the year 1991 allowing the same rate of depreciation as in the past, and showing clearly- how you arrive at the amounts of obsolescence and depreciation to be charged to the profit and loss account. (Ans: Balance of Machinery Rs.3,89,326).

11.On 1st July, 2008 a company purchased a machine for Rs 3,90,000 and spent Rs 10,000 on its installation. It decided to provide depreciation @ 15% per annum, using written down value method. On 30th November, 2011 the machine was dismantled at a cost of Rs 5,000 and then sold for Rs 1,00,000.

On 1st December, 2011 the company acquired and put into operation a new machine at a total cost of Rs 7,60,000. Depreciation was provided on the new machine on the same basis as had been used in the case of the earlier machine. The company closes its books of account every year on 31st March.

Prepare machine account and depreciation account.

12. The cost of machinery in use with a firm on 1st April, 2011 was Rs 2,50,000 against which the depreciation provision stood at Rs 1,05,000 on that date; the firm provided depreciation at 10% of the diminishing value. On 31st December, 2011 two machines costing Rs 15,000 and Rs 12,000 respectively, both purchased on 1st October, 2008, had to be discarded because of damage and had to be replaced by two new machines costing Rs 20,000 and Rs 15,000 respectively. One of the discarded machines was sold for Rs 8,000; against the other it was expected that Rs 3,000 would be realisable. Show the relevant accounts in the ledger on the firm for the year ended 31st March, 2012.

13. Metropol Ltd. acquired a machine for Rs 5,40,000 on 1st April 2009. Depreciation was to be charged at 20% per annum on straight line method.

On 1st October, 2011 a modification was made to improve its technical efficiency at a cost of Rs 50,000 which it was considered would also extend the useful life of the machine by two years. At the same time, an important component of the machine was replaced at a cost of Rs 10,000 because of excessive wear and tear. Routine maintenance during the accounting year ending 31st, March, 2012 cost Rs 7,500. Prepare machine account.

14. X Co. Ltd. purchased a machine on 1st April, 2008 for Rs 1,60,000. On October 1, 2009 another machine was purchased for Rs 1,40,000. On October 1, 2010 the first machine was sold for Rs 1,20,000. On the same date, another machine was purchased for Rs 1,00,000. On October 1, 2011 the second machine was sold for Rs 92,000. Rate of depreciation was 10% on original cost annually on 31st March. On 31st March, 2011 the method of charging depreciation was changed to diminishing balance method, the rate being 15%. Prepare Machine Account for the years ending 31st March, 2009, 2010, 2011, and 2012.

15. A lease is purchased on 1st April, 2007 for 5 years at a cost of Rs 1,00,000. It is proposed to depreciate the lease by annuity method charging 12 per cent interest. Show the Lease Account for five years and also the relevant entries in the Profit and Loss Account.

16. A company purchased a four years' lease on April 1, 2008 for Rs 10,00,000. It is decided to provide for the replacement of the lease at the end of four years by setting up a Depreciation Fund. It is expected that investments will fetch interest at 12 per cent. Sinking fund tables show that Re. 0.209234 invested each year will produce Re. 1 at the end of four years at 12% per annum. Investments were made in 12% Bonds of Rs 100 each available at face value. Interest was receivable yearly on 31st March. On March 31, 2012, the investments were sold for Rs 6,98,940. On 1st April, 2012 the same lease was renewed for a further period of 4 years by payment of Rs 12,00,000. Show journal entries and give the important ledger accounts to record the above.

17. A company purchased a lease for 3 years for Rs 3,00,000 on 1st April. 2009 and decided to provide for its replacement by means of an insurance policy for Rs 3,00,000. The annual premium is Rs 89,500. On 1st April, 2012 the lease is renewed for a further period of 3 years for Rs 3,30,000. Show the necessary ledger accounts.

4.12 REFERENCES/SUGGESTED READINGS

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UNIT-IV

ACCOUNTING FOR DEPRECIATION

STRUCTURE

4.0 OBJECTIVES

After going through this lesson, you should be able to-

- Know the meaning, need and causes of depreciation.
- Know the different methods of charging depreciation.
- Understand the accounting treatment of charging depreciation.

4.1 INTRODUCTION

The term depreciation refers to the reduction in or loss of quality or value of a fixed asset through wear or tear in or tear, in use, effusion of time, obsolescence through technology and market changes or from any other cause. Depreciation take place in case of all fixed assets with certain possible exceptions e.g. land and antiques etc, although the process may be invisible or gradual. Depreciation does take place irrespective of regular repairs and proper maintenance of assets. The word 'depreciation' is closely related to the concept of business income.

Unless it is charged against revenues, we cannot say that the business income has been ascertained properly. This is because of the fact that the use of long term assets tend to consume their economic value and at some point of time these assets become useless. The economic value so consumed must be recovered from the revenue of the firm to have a proper measure of its income. Hence, the reader's must understand that the process of charging depreciation is the technique used by accountants for recovering the cost of fixed assets over a period.

The concept of depreciation is closely linked to the concept of business income. In the revenue generating process, the use of long term assets tends to consume their economic potential. At some point of time these assets become useless and are disposed of and possibly replaced.
The economic potential so consumed represents the expired cost of these assets and must be recovered from the revenue of the business in order to determine the income earned by the business. Depreciation may, therefore, be defined as that portion of the cost of the assets that is deducted from revenue for assets services' used in the operation of a business.

Definition: In order to have a clear understanding about the concept of depreciation, it will be useful to quote definitions given by some prominent writers.

According to Pickles, "Depreciation is the permanent and continuing diminution in the quality, quantity or value of an asset".

The Institute of Chartered Accountants of England and Wales defines depreciation as "that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit earned."

According to Spicer and Pegler, "depreciation may be defined as the measure of the exhaustion of the effective life of an asset from any cause during a given period."
From the above definitions, it can be concluded that depreciation is a gradual decrease in the value of an asset from any cause.
Basic features of depreciation
1. The term depreciation is used only in respect of fixed assets. Of course, the current assets may also lose their value. Loss on account of fall in their value is taken care of by valuing them for Balance Sheet purpose at cost or market price whichever is less.
2. Depreciation is a charge against profits. This means that true profit of the business cannot be ascertained without charging depreciation.

3. Depreciation is different from maintenance. Maintenance expenses are incurred for keeping the machine in a state of efficiency. However, any degree of maintenance cannot assure that the asset will never reach a state of scrap. Of course, good maintenance delays this stage but it cannot absolutely prevent it.

4. All fixed assets, with certain possible exceptions e.g. land, and antiques, etc., suffer depreciation although the process may be invisible or gradual.

The following definition will make the understanding of the concept of depreciation more convenient to the learner's. According to IAS-4, "Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life,"

According to AS-6, "depreciation is a measure of wearing out, consumption or other of value of a depreciable asset arising from use, effusion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the assets. Depreciation includes amortisation of assets whose useful life is pre-determined."

The American Institute of Certified Public Accountants (AICPA) employed the definition as given below

"Depreciation Accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any) over the estimated useful life of unit (which may be a group of assets) in a systematic and retional manner. It a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year."

From the above definitions it is clear that each accounting period must be charged with a fair proportion of the depreciable amount of the asset, during the expected useful life of the asset. Depreciable amount of an asset is its historical cost less the estimated residual value. Finally, it could be concluded that depreciation is a gradual reduction in the economic value of an asset from any cause.

Depreciation, Depletion and Amortisation: The terms depreciation, depletion and amortisation are used often interchangeably. However, these different terms have been developed in accounting usage for describing this process for different types of assets. These terms have been described as follows:

Depreciation: Depreciation is concerned with charging the cost of man-made fixed assets to operation (and not with determination of asset value for the balance sheet). In other words, the term ‘depreciation’ is used when expired utility of physical asset (building, machinery, or equipment) is to be recorded.

Depletion: This term is applied to the process of removing an available but irreplaceable resource such as extracting coal from a coal miner or oil out of an oil well. Depletion differs from depreciation in that the former implies removal of a natural resource, while the latter implies a reduction in the service capacity of an asset.

Amortisation: The process of writing off intangible assets is termed as amortisation. The intangible assets like patents, copyrights, leaseholds and goodwill are recorded at cost in the books of account. Many of these assets have a limited useful life and are, therefore, written off.
Obsolescence: It refers to the decline in the useful life of an asset because of factors like (i) technological advancements, (ii) changes in the market demand of the product, (iii) legal or other restrictions, or (iv) improvement in production process.

The depreciation occurs because of the following:

1. Constant use: The constant use of assets results into their wear and tear, which in turn reduces their working capacity. Hence, a decrease in the value of assets may be seen due to reduced capacity. The value of assets like, machinery, furniture, etc., declines with the constant use of them.
2. Passage of Time: Many fixed assets lose their value with the passage of time. This holds true in case of intangible fixed assets such as patents, copy rights, lease hold properties, etc. The term “amortisation” is generally used to indicate the reduction in the value of such assets.
3. Depletion: Depletion also causes decline in the value of certain assets. This is true in case of wasting assets such as mines, oil wells and forest-stands. On account of continuous extraction of minerals or oils, these assets go on declining in their value and finally they gets completely exhausted.
4. Obsolescence: There may not be any physical deterioration in the asset itself. Despite of this there may be reduction in the utility of an asset that results from the development of a better method, machine or process. For example, an old machine which is still in good working condition may have to be replaced by a new machine because of the later being more economical as well as efficient. In fact, new inventions, developments in production processes, changes in demand for product or services, etc. make the asset out of date.
5. Accidents: An asset may get reduction in its value if it meets an accident.
6. Permanent fall in the Market Value: Certain assets may get permanent fall in their value and this decline in their value is treated as depreciation. For example, a permanent decline in the market value of securities and investment may be assumed as depreciation

4.2 CAUSES OF DEPRECIATION

The causes of depreciation are as follows:

1. Wear and tear: Assets get worn or torn out on account of constant use as is the case with plant and machinery, furniture, and fixtures used in a factory.

2. Exhaustion / Depletion An asset may get exhausted through working. This is the case with mineral mines, oil wells, etc. On account of continuous extraction of minerals or oil, a stage comes, when the mine or well gets completely exhausted and nothing is left.

3. Obsolescence: Some assets are discarded before they are worn out because of changed conditions. For example, an old machine which is still workable may have to be replaced by a new machine because of the latter being more efficient and economical. Such a loss on account of new inventions or changed fashions is termed as loss on account of obsolescence.

4. Efflux of time: Certain assets get decreased in their value with the passage of time. This is true in the case of assets like leasehold properties, patents or copy rights.

5. Accidents: An asset may meet with an accident and, therefore, it may get depreciation in its value.

On the basis of the above causes, it can be said that depreciation, is the decrease or depletion in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accidents,

4.3 NEED FOR PROVIDING DEPRECIATION

The need for providing depreciation arises on account of the following points:

1. To Ascertain the Profits or Losses: The true profits or losses could be ascertained when all costs of earning revenues have been properly charged against them. Fixed assets like building, plant and machinery, furniture, motor vehicles etc are important tool in earning business income. But the cost of the fixed asset is not charged to profit and loss of the accounting period in which the asset is purchased. Therefore, the cost of the fixed asset less its salvage value must be allocated rationally to the periods that receive benefit from the use of the asset. Thus, depreciation is an item of business expense and must be provided for a proper matching of costs with the revenue.
2. To show the Asset as its Reasonable Value: The assets get decrease in their value over a period of time on account of various such as passage of time, constant use, accidents, etc. Therefore, if the depreciation is not charged then the asset will appear in the balance sheet at the over stated value. This practice is unfair as the balance sheet fail to present the true financial position.

3. Replacement of assets: Business assets become useless at the expiry of their life and, therefore, need replacement. The cash resources of the concern are saved from being distributed by way of dividend by providing for depreciation. The resources so saved, if set aside in each year, may be adequate to replace it at the end of life of the asset.
4. To Reduce Income Tax: If tax is paid on the business income without providing for depreciation then it will be in excess to the actual income tax. This is a loss to the business man. Thus, for calculating tax, depreciation should be deducted be from income similar to the other expenses.

4.4 BASIC ELEMENTS OF DEPRECIATION

In order to assess depreciation amount to be charged in respect of an asset in an accounting period the following three important factors should be considered:

1. **Cost of the asset:** The knowledge about the cost of the asset is very essential for determining the amount of depreciation to be charged to the profit and loss account. The cost of the asset includes the invoice price of the asset less any trade discount plus all costs essential to make the asset usable. Cost of transportation and transit insurance are included in acquisition cost. However, the financial charges such as interest on money borrowed for the purchase for the purchase of the asset should not be included in the cost of the asset.
2. **Estimated life of the asset:** Estimated life generally means that for how many years or hours an asset could be used in business with ordinary repairs for generating revenues. For estimating useful life of an asset one must begin with the consideration of its physical life and the modifications, if any, made, factors of obsolescence and experience with similar assets. In fact, the economic life of an asset is shorter than its physical life. The physical life is based mostly on internal policies such as intensity of use, repairs, maintenance and replacements. The economic life, on the other hand, is based mostly on external factors such as obsolescence from technological changes.
3. **Scrap Value of the Asset:** The salvage value of the asset is that value which is estimated to be realised on account of the sale of the asset at the end of its useful life. This value should be calculated after deducting the disposal costs from the sale value of the asset. If the scrap value is considered as insignificant, it is normally regarded as nil

4.5 METHODS OF RECORDING DEPRECIATION

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

4.5.1 When a provision for depreciation account is maintained

The following journal entries are passed in case method is followed:

i) Depreciation account Dr.

To provision for Depreciation Account

(for providing depreciation)

ii) Profit and loss Account Dr.

To Depreciation account

(for closing depreciation account)

iii) Provision for Depreciation account Dr.

To Asset Account

(entry on sale of an asset)

iv) Any amount realised on account of sale of the asset is credited to the Asset Account. The balance, if any, in the Asset Account is transferred to the profit and loss Account.

4.5.2 When a provision for depreciation account is not maintained

The following journal entries are passed in this method:

i) Depreciation account Dr.

To Asset Account

(Entry for providing depreciation)

ii) Profit and loss Account Dr.

To Depreciation Account

(Entry for closing Depreciation Account)

iii) In case the asset is sold, the amount realised is credited to the Asset Amount. Any profit or loss on sale of the asset is transferred to the Profit and loss account.

DEPRECIATION ACCOUNTING

Depreciation Accounting is mainly concerned with a rational and systematic distribution of cost over the estimated useful life of the asset. According to the **American Institute of Certified Public Accountants,** Depreciation Accounting is "a system of accounting which aims to distribute the cost or other basic values of tangible capital assets less salvage (if any) over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is the process of allocation and not of valuation."

The objective of Depreciation Accounting is to absorb the cost of using the assets in different accounting periods in a way so as to give the true figures of profit or loss made by the business.

Objectives of providing Depreciation

The following are the objectives of providing depreciation:

1. Ascertainment of true profits: When an asset is purchased, it is nothing more than a payment in advance for an expense. For example, if a building is purchased for Rs.10,000 for business purposes, the effect of such a purchase will be saving in the cost of rent in the future. But, after a certain number of years, the building will become useless. The cost of the building is, therefore, nothing except paying rent in advance for

a period of years. If the rent had been paid, it would have been charged as an expense for determination of thetrue profits, made by the business during a particular period. The amount paid for the purchase of building should, therefore, be charged over a period of time for which the asset would be serviceable.

2. Presentation of true financial position: The assets get depreciated in their value over a period of time on account of various factors as explained before. In order to present a true state of affairs of the business, the assets should be shown in the Balance Sheet, at their proper values.
3. Replacement of assets: Assets used in the business need replacement after the expiry of their service life. By providing depreciation a part of the profits of the business is kept in the business which can be used for purchase of new assets on the old fixed assets becoming useless.

Factors Affecting the Account of Depreciation

Following are the three important factors which should be considered for determining the amount of depreciation to be charged to the Profit and Loss Account in respect of a particular asset.

1. Cost of the asset: The cost of the asset includes the invoice price of the asset less any trade discount plus all costs essential to bring the asset to a usable condition. It should be noted that financial charges, such as interest on money borrowed for the purchase of the asset, should not be included in the cost of the asset.
2. Estimated scrap value: The term scrap value means the residual or the salvage value which is estimated to be realised on account of the sale of the asset at the end of its useful life. In determining the scrap value, the cost to be incurred in the disposal or removing of the asset should be deducted out of the total realisable value.
3. Estimated useful life: This is also termed as economic life of the asset. This may be calculated in terms of years, months, hours, units of output or other operating measures such as kilometers in case of a taxi or a truck.

4.6 METHODS OF PROVIDING DEPRECIATION:

The following are the various methods of providing depreciation:

i) Fixed instalment or Straight Line Method

ii) Diminishing Balance or Written down Value Method

iii) Sum of the years [or Digits] Method

iv) Annuity Method

v) Sinking Fund or Depreciation Fund Method

vi) Insurance Policy Method

vii) Revaluation Method

viii) Depletion Method

ix) Machine Hour Rate Method

We will now discuss in detail each of the above Methods.

4.6.1 Fixed Instalment or Straight Line Method:

In this method, a suitable percentage of original cost is written off the asset every year throughout the effective life of the asset. Thus if an asset costs Rs. 50,000 and 10 percent depreciation is thought proper (over its useful life of 10 years), Rs. 5000 would be written off every year. In this method, the amount of depreciation is arrived at as under:

$$\text{Depreciation} = \frac{\text{Cost} - \text{Scrap Value}}{\text{Estimated Life in Years}}$$

This is also known as fixed instalment method. Under this method the depreciation is charged on the uniform basis year after year. When the amount of depreciation charged yearly under this method is plotted on a graph paper, we shall get a straight line. Thus, the straight line method assumes that depreciations is a function, of time rather than use in the sense that each accounting period received the same benefit from using the asset as every other period. The formula for calculating depreciation charge for each accounting period is:

Depreciation = Original cost of the fixed assets – Residual value / Estimated Life in years

For example, if an asset cost Rs. 50,000 and it will have a residual value of Rs. 2000 at the end of its useful life of 10 years, the amount of annual depreciation will be Rs. 4800 and it will be calculated as follow:

Depreciation = Rs.50,000 – 2000/10 years = Rs. 4800 pa

This method has many shortcomings. First, it does not take into consideration the reasonal fluctuations, booms and depression. The amount of depreciation is the same in that year in which the machine is used day and night to that in the another year in which it is used for some months. Second, it ignores the interest on the money spent on the acquisition of that asset. Third, the total charge for use of asset (i.e., depreciation and repairs) goes on increasing form year to year though the assets might have been use uniformly from year to year. For example, repairs cost together with depreciation charge in the beginning years is much less than what it is in the later year. Thus, each subsequent year is burdened with grater charge for the use of asset on account of increasing cost on repairs.

Illustration-1: H. Ltd. purchased machinery on 1st January 1990 for Rs. 29000 and spent Rs. 2000 on its carriage and Rs. 1,000 on its erection. Machinery is estimated to have a scrap value of Rs. 5000 at the end of its useful life of 5 year. The accounts are closed every year on 31st December. Prepare the machinery account for five years charging depreciation according to straight line method.

Machinery Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1990	To Bank	22000	Dec. 31	By Depreciation	4000
Jan. 1	To Bank	2000	"	By Balance C/d	21000
	To Bank	1000			
		25000			25000
1991	To Balance b/d	21000	1991	By Depreciation	4000
Jan.1			Dec.31	Balance c/d	17000
		21000			21000
1992	To Balance/b/c	17000	1992	By Depreciation	4000
Jan.1			Dec. 31	By Balance c/d	13000
		17000			17000
1993	To Balance b/c	13000	1993	By Depreciation	4000
Jan.1			Dec.31	By Balance	9000
		13000			13000
1994	To Balance b/d	9000	1994	By Depreciation	4000
Jan.1			Dec.31	By Balance c/d	5000
		9000			9000

This method is very suitable particularly in case of those assets which get depreciated more on account of expire of period e.g. lease hold properties, patents, etc.

Merits:

i) This method is very simple to understand and easy to apply.

ii) The value of the asset can be reduced to zero or to its scrap value under this method.

iii) This method is very suitable particularly in case of those assets which get depreciated more on account of expiry of period e.g., Lease-hold properties, patent Rights, etc.

Demerits:

i) This method does not take into account the effective utilization of the asset. The amount of depreciation charged in this method is same every year irrespective of the use of the asset.

ii) This method tends to report an increasing rate of return on investment in the asset on account of the fact that net balance of the asset account is taken. This is not justifiable.

Illustration 2

ABC Ltd. purchases a machinery for a sum of Rs.48,000 on 1st January 1990. Installation charges are Rs.3,000. The machinery is estimated to have a scrap value of Rs. 1,000 at the end of its useful life of five years. You are required to prepare the Machinery account for five years charging depreciation according to Straight Line Method.

Solution

Annual Depreciation to be charged = $\frac{C - S}{N} = \frac{51{,}000 - 1{,}000}{5}$

Dr. **Machinery Account** **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
1990 Jan 1	To Bank To Bank (installation charges)	48,000 3,000	1990 Dec. 31	By Depreciation " Balance c/d	10,000 41,000
		51,000			**51,000**
1991 Jan 1	To Balance b/d	41,000	1991 Dec. 31	By Depreciation " Balance c/d	10,000 31,000
		41,000			**41,000**
1992 Jan. 1	To Balance b/d	31,000	1991 Dec. 31	By Depreciation " Balance c/d	10,000 21,000
		31,000			31,000
1993 Jan. 1	To Balance b/d	21,000	1993 Dec. 31	By Depreciation " Balance c/d	10,000 11,000
		21,000			21,000
1994 Jan. 1	To Balance b/d	11,000	1994 Dec. 31	By Depreciation " Balance c/d (Scrap value)	10,000 1,000
		11,000			11,000

Journal entries

Journal entries in the books of the firm				
Date	Particulars	L/F No	Dr.Amt.Rs	Cr.Amt.Rs
I Year				
1	Fixed Asset A/c Dr To Cash/Bank A/c (Being Fixed asset purchased)		XXX	 XXX
2	Fixed Asset A/c Dr To Vendor A/c (Being Fixed asset purchased on credit)		XXX	 XXX
3	Depreciation A/c Dr To Fixed Asset A/c (Being depreciation charged on Fixed asset)		XXX	 XXX
4	Profit& Loss a/c A/c Dr To Depreciation A/c (Being depreciation transferred to P/L a/c)		XXX	 XXX

5	Bank A/c Dr To Fixed Asset A/c (Being Fixed asset is sold out at book value)		XXX	 XXX
6	Bank A/c Dr To Fixed Asset A/c To Profit %& Loss A/c (Being Fixed asset is sold out at above the book value and profit on sale is received)		XXX	 XXX XXX
7	Bank A/c Dr Profit & Loss A/c Dr To Fixed Asset A/c (Being Fixed asset is sold out at less than the book value and loss is incurred		XXX XX	 XXX
8	The above entries 2 and 3 are to be passed every year.			

Illustration

On 1st January, 2003 a Company purchased a plant for ` 20,000. On 1st July in the same year, it purchased additional plant worth ` 8,000 and spent ` 2,000 on its erection. On 1st July, 2004, the plant purchased on 1st jan., 2003 having become obsolete, was sold off for ` 12,500. On 1st October, 2005, fresh plant was purchased for ` 28,000 and on the same date, the plant purchased on 1st July, 2003 was sold at ` 6,000. Depreciation is provided at 10% per annum on original cost on 31st December every year. Show the plant account for 2003 to 2005

Solution

Dr. **Plant Account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2003				**2003**			
Jan. 01	To Cash A/c		20,000	Dec. 31	By Depreciation A/c		
July 01	To Cash A/c		8,000		(i) for a year 2,000		
	To Cash A/c				(ii) for six months 500		2,500
	(expenses)		2,000		By Balance c/d		
					(i) 18,000		
					(ii) 500		27,500
			30,000				30,000
2004				**2004**			
Jan. 1	To Balanc b/d			July 1	By Cash A/c (sale)		12,500
	(i) 18,000			Dec. 31	By Depreciation A/c (i)		1,000[1]
	(ii) 9,500		27,500		By Profit & Loss A/c		4,500[1]
				July 1	By Depreciation A/c (ii)		1,000
				Dec. 31	By Balance c/d (₹9,500-₹1,000)		8,500
			27,500				27,500
2005				**2005**			
Jan. 1	To Balance b/d (ii)		8,500	Oct. 1	By Cash A/c (sale)		6,000
Oct. 1	To Cash A/c (iii)		28,000	Oct. 1	By Depreciation A/c (ii)		750[2]
				Oct. 1	By Profit & Loss A/c (loss)		1,750
				Dec. 31	By Depreciation A/c (iii) (28,000x10/100x3/12)		700
				Dec. 31	By Balance c/d (₹28,000-₹700)		27,300
			36,500				36,500

Note : Calculation of loss on sale of plant :

		₹
(i)	On 1-1-2004 book value of the plant sold [Plant (i)]	18,000
	Less : Depreciation for 6 months *i.e.* 20,000 x 10/100 x 6/12	1,000
	On 1-7-2004 book value of plant sold	17,000
	Less : Sale price of plant	12,500
	Loss on sale of plant	4,500
(ii)	On 1-1-2005 book value of plant sold [Plant (ii)]	8,500
	Less : Depreciation for 9 months is 10,000 x 10/100 x 9/12	750
	On 1-10-2005 book value of plant sold	7,750
	Less : Sale Price	6,000
	Loss on Sale of Plant	1,750

4.6.2. Diminishing Balance or Written Down Value Method

In this method, the rate or percentage of depreciation is fixed and depreciation is charged on the book value of the asset standing at the beginning of each year. Thus, the amount of depreciation goes on decreasing every year. For example, if the cost of an asset is Rs. 10,000 and the rate of depreciation is 10%, then the amount of depreciation to be charged in the first year will be Rs.1000 [10% on Rs.10,000]. In the second year, depreciation will be charged at 10% on the book value of the asset i.e., on Rs.9000 [i.e., 10000-1000] and so on.

This is also known as Written down value method [WDV]. Under the diminishing balance method depreciation is charged at fixed rate on the reducing balance (i.e., cost less depreciation) every year. Thus, the amount of depreciation goes on decreasing every year. Under this method also the amount of depreciation is transferred to profit and loss account in each of the year and in the balance sheet the asset is shown at book value after reducing depreciation from it. For example, if an asset is purchased for Rs. 10,000 and depreciation is to be charged at 20% p.a. on reducing balance system then the depreciation for the first year will be Rs. 2000. In the second year, it will Rs. 1600 (i.e. 20% of 8000), in the third year Rs. 1280 (i.e. 20% of 6400) and so on. The rate of depreciation under this method can be computed by using the following formula:

$$\text{Depreciation rate} = -1\sqrt{\frac{\text{Net scrap value}}{\text{Acquisition cost}}}$$

For example, if the cost of an asset is 27000, scrap value Rs. 3375, economic life 3 year, the rate of depreciation would be:

$$\text{Depreciation Rate} = 1 - 3\sqrt{\frac{3375}{27000}}$$

$$= 1 - \frac{15}{30} = 50\%$$

Merits of Diminishing Balance Method

(i) It is very easy to understand and calculate the amount of depreciation despite the early variation in the book value after depreciation

(ii) This method put an equal burden for use of the asset on each subsequent year since the amount of depreciation goes on decreasing for each subsequent year while the charge for repairs goes on increasing for each subsequent year.

(iii) This method has also been approved by the income tax act applicable in India

(iv) Asset is never reduced to zero because if the rate of depreciation is (say) 20%. Then even when asset is reduced to very small value, there must remain the 80% of that small value as on written off balance.

(v) This method is simple to understand and easy to follow.

(vi) This method puts an equal burden for the use of the asset on each subsequent year.

(vii) The amount of depreciation goes on decreasing for each subsequent year while the charge for repairs goes on increasing for each subsequent year. Thus, the increase in the cost of repairs for each subsequent year is compensated by decrease in the amount of depreciation for each subsequent year.

Demerits:

(i) It ignores the interest on the capital committed to purchase that asset. (ii) It does not provide adequately for replacing the asset at the end of its life. (iii) The calculation of rate of depreciation is not so simple. (iv) The formula for calculating the rate of depreciation can be applied only when there is some residual of the asset.

(ii) The value of the asset cannot be brought down to zero under this method.

(iii) The determination of a suitable rate of depreciation is also difficult under this method as compared to the Fixed Installment Method.

Suitability

This method is suitable in those cases where the receipts are expected to decline as the asset gets older and, it is believed that the allocation of depreciation of depreciation ought to be related to the pattern of assets expected receipts.

Illustration 3: A company purchases Machinery on 1st April 1990 for Rs. 20,000. Prepare the machinery account for three years charging depreciation @ 25% p.a. according to the written Down value Method.

MACHINERY ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1990	To Bank	20000	1991	By Depreciation	5000
Apr. 1			Mar. 31	By Balance C/d	15000
		20000			20000
1991	To Balance b/d	15000	1992	By Depreciation	3750
Apr.1			Mar.31	By Balance c/d	11250
		15000			15000
1992	To Balance b/d	11250	1993	By Depreciation	2812.5
Apr 1			Mar.31	By Balance c/d	8437.5
		11250			11250

Illustration 4

Cosmos Enterprises Ltd. acquired a machine on 1st January 1992 at a cost of Rs. 18,000 and spent Rs.2,000 on its installation. The firm writes off depreciation at 10% of the original cost every year. Show the Machinery Account for three years.

Solution

Dr. **Machinery Account** **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
1992 Jan 1	To Bank To Bank (installation charges)	18,000 2,000	1992 Dec. 31	By Depreciation (10% on Rs.20,000) " Balance c/d	2,000 18,000
		20,000			**20,000**
1993 Jan 1	To Balance b/d	18,000	1993 Dec. 31	By Depreciation (10% on Rs.18,000) " Balance c/d	1,800 16,200
		18,000			**18,000**
1994 Jan.1	To Balance b/d	16,200	1991 Dec. 31	By Depreciation (10% on Rs.16,200) " Balance c/d	1,620 14,580
		16,200			**16,200**
1995	To Balance b/d	14,580			

Illustration

On April 1, 2009 Ganga Bros. purchased two machines for ₹ 75,000 each. Depreciation at the rate of 10% on diminishing balance method was provided. On March 31, 2011, one machine was sold for ₹ 55,000. An improved model with a cost of ₹ 80,000 was purchased on the same day. You are required to show the Machinery Account for 2009-10 to 2010-11.

Solution

Dr. **Machinery Account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2009				**2010**			
Oct. 01	To Bank		1,50,000	Mar. 31	By Depreciation A/c		15,000
				Mar. 31	By Balance c/d		1,35,000
			1,50,000				1,50,000
2010				**2011**			
Apr. 01	To Balance b/d		1,35,000	Mar. 31	By Depreciation A/c		13,500
Mar. 31	To Bank A/c		80,000	Mar. 31	By Bank A/c		55,000
					By P & L A/c		5,750
					By Balance c/d		1,40,750
			2,15,000				2,15,000
2011							
Apr. 01	To Balance b/d		1,40,750				

Note : Calculation of loss on sale of machine :

Initial Cost	75,000
Dep. in 2010	- 7,500
	67,500
	- 6,750
	60,750
	- 55,000
Loss on Sale	5,750

Illustration

On October 1, 2008, the Akash Transport Company purchased a Truck for ` 8,00,000. On April 1, 2010, this Truck was involved in an accident and was completely destroyed and ` 6,00,000 were received from Insurance Company in full settlement. On the same date another Truck was purchased by the company for ` 10,00,000. The company writes off 20% depreciation p. a. on written down value method. Give the Truck Account from 2008 to 2010.

Solution

Dr. **Truck Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2008				**2008**			
Oct. 01	To Bank A/c		8,00,000	Dec. 31	By Depreciation A/c $8,00,000 \times \frac{20}{100} \times \frac{3}{12}$		40,000
				Dec. 31	By Balance c/d		7,60,000
			8,00,000				8,00,000
2009				**2009**			
Jan. 01	To Balance b/d		7,60,000	Dec. 31	By Depreciation A/c $7,60,000 \times \frac{20}{100}$		1,52,000
				Dec. 31	By Balance c/d		6,08,000
			7,60,000				7,60,000
2010				**2010**			
Jan. 01	Balance b/d		6,08,000	Apr. 01	By Bank A/c		6,00,000
Apr. 01	To P & L A/c		22,400	Apr. 01	By Depreciation A/c $6,08,000 \times \frac{20}{100} \times \frac{3}{12}$		30,400
Apr. 01	To Bank A/c		10,00,000	Dec. 31	By Depreciation A/c $1,00,000 \times \frac{20}{100} \times \frac{9}{12}$		1,50,000
				Dec. 31	By Balance c/d		8,50,000
			16,30,400				16,30,400

4.6.3 Annuity Method:

The three methods discussed above ignore interest factor. The Annuity Method takes care of this factor. Under this method, the depreciation is charged on the basis that besides losing the original cost of the asset, the business also loses interest on the amount used for buying the asset. The 'interest' here means the interest which the business could have earned otherwise if the money used in purchasing the asset would have been invested in some other form of investment. Thus, according to this method, such an amount is charged by way of depreciation which takes into account not only the cost of the asset but also interest thereon at an accepted rate. The amount of interest is calculated on the book value of the asset in the beginning of the year. The amount of depreciation is uniform and is determined on the basis of the Annuity

Table. An extract of the Annuity Table is shown in the Appendix. The following journal entries are passed in case depreciation is charged according to this method.

i) On purchase of an asset :

Asset A/C Dr. xxx

To Bank xxx

ii) For Charging interest

Asset A/C Dr. xxx

To Interest A/C xxx

iii) For charging Depreciation:

Depreciation A/C Dr. xxx

To Asset A/C xxx

So far we have described such methods of charging depreciation which ignore the interest factor. Also, some times it becomes inconvenient for a company to follow any of the methods discussed earlier. Under such circumstances the company may use some special depreciation systems. Annuity method is one of these special systems of depreciation. Under this system, the depreciation is charged on the basis that besides losing the acquisition cost of the asset the business also loses interest on the amount used for purchasing the asset. Here, interest refers to that income which the business would have earned otherwise if the money used in buying the asset would have been committed in some other profitable investment. Therefore, under the annuity method the amount of total depreciation is determined by adding the cost and interest thereon at an expected rate. The annuity table is used to help in the determination of the amount of depreciation. A specimen of Annuity Table is as follows:

ANNUITY TABLE

Year	3%	4%	5%	6%
4	0.269027	0.275490	0.282012	0.288591
5	0.218335	0.224627	0.230975	0.237376
6	0.184598	0.190762	0.197012	0.203363
7.	0.160506	0.166610	0.172820	0.179135
8.	0.142456	0.148528	0.154722	0.161036
9.	0.128434	0.134493	0.140690	0.147022
10.	0.117231	0.12391	0.129505	0.135868

In case depreciation is charged according to this method, the following accounting entries are passed:

(i) Purchase of an asset

Asset Account Dr.

To Bank

(ii) For Charging interest

Asset Account Dr.

To Interest Account

(iii) For Charging depreciation:

Depreciation Account Dr.

To Asset Account

Evaluation of Annuity Method

Merits: (i) This method keep into account interest on money spent on the purchase of the asset. And (ii) The value of the asset become zero at the end of life.

Demerits

(i) This method is comparatively more difficult than the methods discussed so far.

(ii) It makes no arrangement of money to replace the old asset with the new one at the expiry of its life.

(iii) Under this method the burden on the profit and loss account is no similar in each year because the depreciation remains constant year after year but the interest goes on decreasing.

Illustration-5: On 1st January, 1990 a firm purchased a leasehold property for 4 year at a cost of Rs. 24000. It decides to depreciate the lease by Annuity Method by charging interest at 5% per annum. The Annuity Table shows that the annual necessary to write off Rs. 1 at 5% Rs. 0.282012. You are required to prepare the lease Hold Property Account for four years and show the net amount to be charged to the profit and loss account for these four years.

LEASE HOLD PROPERTY ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1990 Jan. 1	To Bank	24000.00	1990 Dec. 31	By Depreciation	6768.29
	To interest	1200.00	Dec.31	By balance c/d	18431.71
		25200.00			25200.00
1991 Jan.1	To balance b/d	18431.71	1991 Dec.31	By Depreciation	6768.29
Dec.31	To Interest	921.59	Dec.31	By Balance c/d	12585.01
		19353.30			19353.30
1992 Jan.1	To balance b/d	12585.01	1992 Dec.31	By Depreciation	6768.29
Dec. 31	To Interest	629.25	Dec.31	By Balance c/d	6445.97
		13214.26			13214.26
1993 Jan.1	To balance b/d	6445.97	1993 Dec.31	By Depreciation	6768.29
				By Balance c/d	9000
Dec.31	To Interest	322.30			13000
		6768.27			6768.27

NET AMOUNT CHARGEABLE TO THE PROFIT AND LOSS ACCOUNT

Year	Depreciation debited	Interest Credited	Net Charge against Profit
1990	6768.29	1200.00	5568.29
1991	6768.29	921.59	5846.70
1992	6768.29	629.25	6139.04
1993	6768.29	322.30	6445.99
Rs.	27073.16	3073.14	24000.02

Illustration 6

A lease is purchased on 1st January 1990 for four years at a cost of Rs. 20,000. It is proposed to depreciate the lease by the annuity method charging 5% interest. Show the Lease Account for four years and also the relevant entries in the P & L A/C.

Solution:

Annuity Table shows that to depreciate Re.1 by annuity method over 4 years, charging 5% interest, one must write off a sum of Re.0.282012. To write off Rs.20,000 one requires to write off every year Rs.5.640.24 [i.e.. 0.282012 x 20,000].

Dr. **Lease Account** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
1990 Jan. 1 Dec.31	To Bank "Interest (5% on 20,000)	20,000 1,000	1990 Dec.31	By Depreciation "Balance c/d	5,640.24 15,359.76
		21,000			**21,000**
1991 Jan. 1 Dec.31	To Balance b/d "Interest (5% on 15359.76)	15,359.76 767.99	1991 Dec.31	By Depreciation "Balance c/d	5,640.24 10,487.51
		16,127.75			**16,127.75**
1992 Jan. 1 Dec. 31	To Balance b/d "Interest (5% on 10487.51)	10,487.51 524.38	1992 Dec.31	By Depreciation "Balance c/d	5,640.24 5,371.65
		11,011.89			**11,011.89**
1993 Jan. 1 Dec. 31	To Balance b/d "Interest (5% on 5371.65)	5,371.65 268.59	1993 Dec.31	By Depreciation	5,640.24
		5,640.24			**5,640.24**

Dr. **Profit and Loss Account** **Cr.**

Date	**Particulars**	**Rs.**	**Date**	**Particulars**	**Rs.**
1990 Dec.31	To Depreciation a/c	5640.24	1990 Dec.31	By Interest a/c	1,000.00
1991 Dec.31	To Depreciation a/c	5640.24	1991 Dec.31	By Interest a/c	769.99
1992 Dec.31	To Depreciation a/c	5640.24	1992 Dec.31	By Interest a/c	524.00
1993 Dec.31	To Depreciation a/c	5640.24	1993 Dec.31	By Interest a/c	268.59

4.6.4 Sinking Fund or Depreciation Fund Method:

One of the objectives of providing for depreciation is to provide for replacement of the asset at the end of its useful life. In case of the four methods discussed earlier, the amount of depreciation charged from the Profit and loss Account continues to remain in the business. However, this amount may get invested in all sorts of assets in course of running the business thus making it difficult to buy a new asset in place of the old one. Depreciation Fund method takes care of such a contingency. According to this method, the amount charged by way of depreciation is invested in readily saleable securities carrying a certain rate of interest. The amount received on account of interest from these securities is also invested from time to time together with the annual amount charged, by way of depreciation. At the end of the useful life of the asset, when replacement is required, the securities are sold away and the money realized on account of the sale of the securities is used for purchase of a new asset. How much amount is to be invested every year so that a given sum is available at the end of a given period depends on the rate of interest. The Sinking Fund table shows how much is to be invested every year together with the interest earned so that at the end of the period one gets Re. 1.

Business assets become useless at the expiry of their life and therefore, need replacement. However, all the methods of depreciation discussed above do not help in accumulating the amount which can be readily available for the replacement of the asset its useful life comes to an end Depreciation fund method takes care of such a contingency as it incorporates the benefits of depreciating the asset as well as accumulating the necessary amount for its replacement. Under this method, the amount of depreciation charged from the profit and loss account is invested in certain securities carrying a particular rate of interest. The interest received on the investment in such securities is also invested every year together with the amount of annual depreciation. In the last of the life of asset the depreciation amount is set aside interest is received as usual. But the amount is not invested because the amount is immediately needed for the purchase of new asset. Rather all the investments so far accumulated are sold away. Cash realised on the sale of investments is utilised for the purchase of new asset. The following accounting entries are generally made in order to work out this system of depreciation.

1. at the end of the first year

(i) for setting aside the amount of depreciation: The amount to be charge by way of depreciation is determined on the basis of sinking Fund Table given as an Appendix at the end of every book of accountancy.

Depreciation Account Dr.

To Depreciation Fund Account (or Sinking Fund A/c)

(ii) For investing the amount charged by way of depreciation:

Depreciation Fund Investment A/c Dr.

To Bank A/c

2. In the second and subsequent years

(i) For receiving interest. The interest on the balance of Depreciation Fund Investment outstanding in the beginning of each year will be received by the end of the year. This entry is:

Bank Account Dr.

To Depreciation Fund Account

(ii) For setting aside the amount of depreciation

Profit and Loss A/c Dr.

To Depreciation Fund A/c

(iii) For investing the amount

Depreciation Fund Investment A/c Dr.

To Bank A/c

(Annual instalment of depreciation and interest received invested)

3. In the last year

(i) For receiving interest:

Bank A/c Dr.

To Depreciation Fund A/c

(ii) For setting aside the amount of depreciation

Profit and loss A/c Dr.

To depreciation Fund A/c

Note: In the last year no investment will be made, because the amount is immediately required for the purchase of new asset.

(iii) For the sale of investment:

Bank A/c Dr.

To Depreciation Fund Investment A/c

(iv) For the transfer of profit or loss on sale on investments: The profit or loss on the sale of these investments is transferred to the Depreciation Fund Account.

The entry for loss:

Depreciation Fund A/c Dr.

To Depreciation Fund Investment A/c

The entry for profit

Depreciation Fund Investment A/c

To Depreciation Fund A/c

(v) For the sale of old asset:

Bank A/c Dr.

To asset A/c

(vi) The depreciation fund is transferred to asset account and any balance left in the asset account is transferred to profit and loss account. The entry is:

Depreciation Fund A/c. Dr.

To asset A/c

(vii) The balance in Asset Account represents profit or loss. Therefore it will be transferred to the profit and loss account.

(viii) The cash realised on the sale of investments and the old asset is utilised for the purchase of new asset.

Merits

(i) Periodic depreciation together with realized interest is invested outside the business in liquid securities which readily provides ready money for replacing the old asset.

(ii) Overall as also periodic depreciation is smaller than the asset's actual depreciable cost due to deduction of interest.

Demerits

(i) Sinking fund method assumes a constant rate of return on every periodic investment in identical securities. This is hardly true in this dynamic world where rates do vary now and then. This upsets the earlier periodic allocation for depreciation.

(ii) This method puts an increasing burden on the profit and loss of each year on Account of a fixed charge for depreciation but increasing charging for repairs.

4.6.5 Insurance Policy Method

This method is similar to the Depreciation Fund method. Instead of making investment, arrangements are made with the insurance company which will receive premium annually and pay at the end of the fixed period, the required amount with which the old asset can be replaced premium have to be paid at the beginning of each year. The annual premium is treated as the annual depreciation.

The following entries are passed:

A. First and subsequent years:

On payment of insurance premium at the beginning of each year

(i) Depreciation Insurance Policy A/C Dr.

To Bank

At the end of the year for providing depreciation:

(ii) Profit and Loss A/C Dr.

To Depreciation Fund A/C

B. At the end of the last year:

On realization of money from the Insurance Co.,

(iii) Bank A/C Dr.

To Depreciation Insurance Policy A/C

(iv) For transfer of profit on insurance policy

Depreciation Insurance Policy A/C Dr.

To Depreciation Fund A/C

(v) For transfer of accumulated depreciation to the Asset A/C

Depreciation Fund A/C Dr.

To Asset A/C

Under this method, instead of investing the money in securities an insurance policy for the required amount is taken. The amount of the policy is such that it is adequate to replace the asset when it is worn out. A fixed sum equal to the amount do depreciation is paid as premium every year. Company receiving premium allows a small rate of interest on compound basis. At the maturity of the policy, the insurance company pays the agreed amount with which the new asset can be purchased. Accounting entries will be made as follows.

1. First and every subsequent years

(a) Depreciation Insurance policy A/c Dr.

To Bank

(Entry in the beginning of the year for payment of insurance premium)

(b) Profit and loss Account Dr.

To Depreciation fund A/c

(Entry at the end of the year for providing depreciation)

2. Last year

(a) Bank A/c Dr.

To Depreciation Policy A/c

(Entry for the amount of policy received)

(b) For transfer of profit on insurance policy:

Depreciation Insurance Policy A/c Dr.

To Depreciation Fund A/c

(c) For transfer of accumulated depreciation to the asset account:

Depreciation Fund A/c Dr.

To Asset A/c

(d) On purchase of new asset:

New Asset A/c Dr.

To Bank

4.6.6 Machine Hour Rate Method

In case of this method, the running time of the asset is taken into account for the purpose of calculating the amount of depreciation. It is suitable for charging depreciation on plant and machinery, air-crafts, gliders, etc.

The amount of depreciation is calculated as follows:

Depreciation= Acquisition cost of the assets – Scrap value/ Life of the Asset in hours

For example, if machinery has been purchased for Rs. 20000 and it will have a scrap value of Rs. 1000 at the end of its useful life of 1900 hours, the amount of depreciation per hour will be computed as follows:

Depreciation = Acquisition cost of the assets – Scrap value / Life of the Asset in hours

Depreciation= Rs. 20,000 – 1,000/1900=Rs.10 per hour

If in a particular year, the machine runs for 490 hours, the amount of depreciation will be Rs. 4900 (i.e., Rs. 10x490). It is obvious from this example that under machine hour rate method the amount of depreciation is closely related with the frequency of use of an asset. The simplicity in calculations and under standing is the main advantage of this methods. However, it can be used only in case of those assets whose life can be measured in terms of working time.

4.7 SALE OF AN ASSET

An enterprise may sell an asset either because of obsolescence or inadequacy or even for other reasons. In case an asset is sold during the course of the year, the amount realised should be credited to the Asset Account. The amount of depreciation for the period of which the asset has been used should be written off in the usual manner. Any balance in the Asset Account will represent profit or loss on disposal of the asset. This balance in the Asset Account should be transferred to the profit and loss account.

Illustration: A company purchased a machinery costing Rs. 60,000 on 1.4.1990. The accounting year of the company ends on 31st December every year. The company further purchased machinery on 1st October, 1990 costing Rs. 40,000. On 1st January 1992, one-third of the machinery which was installed on 1.4.1990, became obsolete and was sold for Rs. 5000. Show how the machinery account would appear in the books of the company. The depreciation is to be charged at 10% p.a. on written down value method.

MACHINERY ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1.4.90	To Bank	60000	31.12.90	By Depreciation	45000
Oct. 1	To Bank	40000		on Rs. 60000 for 9 month	1000
				on Rs. 40000 for 3 month	
			Dec.31	By Balance c/d	94500
		100000			100000
1.191	To Balance b/d	94500	31.12.91	By Depreciation on Rs. 94500 for 1 year	9450
			Dec. 31	By Balance c/d	85050
		94500			94500
1.192	To Balance b/d	85050	31.12.91	By Bank (sale pro)	5000
			Jan. 1	By Profit Loss account loss on sale (16650-5000)	11650
			Dec. 31	By Depreciation	6840
			Dec. 31	By Balance c/d	61560
		85050			85050

*Total written down value as on Jan. 1, 1992	85050
Less written down value of 1/3 of Machinery sold (2000-(1500+1850)	16650
	68400
Depreciation at 10% on Rs. 68400	6840

Illustration 8

Alfa Co. Ltd., purchased a machine on 1st January 1992 for Rs.11.000. It decided to provide for its replacement by Insurance policy method. The company took an insurance policy for 3 years for Rs.10,000 in consideration of the yearly premium of Rs.3150. Show the Insurance Policy A/c, Depreciation Fund A/C and the Machinery A/c assuming that the retired machine realizes Rs.900 as scrap.

Solution

Dr.		Insurance Policy Account			Cr.
Date	Particulars	Rs.	Date	Particulars	Rs.
1992 Jan. 1	To Bank (Premium)	3,150	1992 Dec. 31	By Balance c/d	3,150
		3,150			**3,150**
1993 Jan 1	To Balance b/d To Bank (Premium)	3,150 3,150	1993 Dec. 31	By Balance c/d	6,300
		6,300			**6,300**
1994 Jan 1	To Balance b/d To Bank (Premium) To Depreciation A/c (Profit Transferred)	6,300 3,150 550	1994 Dec. 31	By Bank	10,000
		10,000			**10,000**

Dr. **Depreciation Fund Account** **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
1992 Dec. 31	To Balance c/d	3,150	1992 Dec. 31	By P & L A/c	3,150
		3,150			**3,150**
1993 Jan 1	To Balance c/d To Bank (Premium)	6,300 3,150	1993 Jan 1	By Balance b/d By P & L A/c	3,150 3,150
		6,300			**6,300**
1994 Dec. 31	To Machinery A/c Transfer	10,000	1994 Dec. 31	By Balance b/d By P & L A/c By Insurance Policy A/c	6,300 3,150 550
		10,000			**10,000**

Dr. **Machinery Account** **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
1992 Jan. 1	To Bank	11,000	1992 Dec. 31	By Balance c/d	11,000
1993 Jan 1	To Balance b/d	11,000	1993 Dec. 31	By Balance c/d	11,000
1994 Dec. 31	To Balance b/d	11,000	1994 Dec. 31	By Depreciation Fund A/c By Bank By P & L A/c Loss (transferred)	10,000 900 100
		11,000			**11,000**

4.8 Comprehensive Problems and solutions

Illustration-9. A company whose accounting year is the calendar year, purchased on 1st April, 1982 Machinery costing Rs.30,000. It purchased further Machinery on 1st October, 1982 costing Rs.20,000 and on 1st July, 1983 costing Rs.10,000. On 1st January, 1984, one-third of the Machinery installed on 1st April,1982 became obsolete and was sold for Rs.3,000. Show how Machinery Account would appear in the books of the company, it being given that Machinery was depreciated by Fixed Installment Method at 10 % per annum.

Solution

Dr **MACHINERY ACCOUNT** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
1982			1982	By Depreciation A/c	2,750
Apr. 1	To Bank A/c	30,000	Dec.31	(on Rs.30,000 for nine months and on Rs.20,000 for 3 months)	
Oct. 1	To Bank A/c	20,000			
		50,000			**50,000**
1983			1983	By Depreciation A/c	5,500
Jan.1	To Balance b/d	47,250	Dec.31	(on Rs.50,000 for one year and on Rs. for 10,000 for 6 months)	
Jul. 1	To Bank A/c	10,000		By Balance c/d	51,750
		57,250			**57,250**
1984	To Balance b/d	51,750	1984	By Bank A/c	3,000
Jan. 1			Jan 1	By P&L a/c (Loss on sale)	5,250
			Dec. 31	By Dep. (on Rs.50,000 for one year)	5,000
			Dec. 31	By Balance c/d	38,500
		51,750			**51,750**

Illustration-10: On 1st January, 1982, a limited company purchased machinery for Rs.12,000 and on 30th June, 1983 it acquired additional machinery at a cost of Rs.2,000. On 31st March, 1984 one of the original machines which had cost of Rs.500 was found to have become obsolete and was sold as scrap for Rs.50. It was replaced on that date by a new machine costing Rs.800. Depreciation to be provided at the rate of 15 per cent per annum on the written down value. Show ledger accounts for the first three years.

Solution

MACHINERY ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1982	To Cash	12,000	Dec.3I	By Dep. (15% on Rs.12,000) " Balance c/d	1,800 10,200
		12,000			**12,000**
1983 Jan.1 Jun.30	 To Balance b/d " Cash	 10,200 2,000	1983 Dec.31	By Dep. (15% on Rs.10,200 for 1 year and on Rs.2,000 for 1/2 year) " Balance c/d	1,680 10,520
		12,200			**12,200**
1984 Jan.1 Mar.31	To Balance b/d " Cash	10,520 800	1984 Mar.31	By Cash " P & L A/c (Loss on sale)* " Dep. (15% on Rs.10,159 for 1 year and on Rs.800 for a 3/4 year) " Balance c/d	50 297 1,628 9,345
		11,320			11,320

Illustration-11. A company has acquired a lease of a cinema theatre for a term of 5 years by payment of Rs.4,00,000. It is proposed to depreciate the lease by the Annuity Method, charging 5 percent per annum. Show the Ledger Account of asset during the period of the lease. Reference to the Annuity Table shows that the amount for Re.1 for 5 years at 5 percent is Re.0.230975. Calculations are to be made to the nearest rupee.

Solution

Annual depreciation is calculated as follows:

$$0.230975 \times 4,00,000 = \text{Rs. } 92,390$$

LEASE ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
Year 1			Year 1		
Jan 1	To Bank A/c	4,00,000	Dec. 31	By Depreciation A/c	92,390
Dec. 31	To Interest A/c	20,000	Dec. 31	Balance c/d	3,27,610
		4,20,000			**4,20,000**
Year II			Year II		
Jan 1	To Balance b/d	3,27,610	Dec. 31	By Depreciation A/c	92,390
Dec. 31	To Interest A/c	16,386	Dec. 31	By Balance c/d	2,51,606
		3,43,996			**3,43,996**
Year III			Year III		
Jan 1	To Balance b/d	2,51,606	Dec. 31	By Depreciation A/c	92,390
Dec. 31	To Interest A/c	12,580	Dec. 31	By Balance c/d	1,71,196
		2,64,186			**2,64,186**
Year IV			Year IV		
Jan 1	To Balance b/d	1,71,796	Dec. 31	By Depreciation A/c	92,390
Dec. 31	To Interest A/c	8,590	Dec. 31	By Balance c/d	87,996
		1,80,386			**1,80,386**
Year V			Year V		
Jan 1	To Balance b/d	87,996	Dec. 31	By Depreciation	92,390
Dec. 31	To Interest (Balancing figure)	4,394			
		92,390			**92,390**

4.9 SUMMARY

The term depreciation refers to the reduction or loss of quality or value of a fixed asset through wear or tear, in use, effusion of time, obsolescence through technology and market changes or from any other cause. The term depreciation, depletion and amortization are used often interchangeably. However, these different terms have been developed in accounting usage for describing this process for different type of assets.

The term 'depreciation' is concerned with charging the cost of man-made fixed assets, depletion applied to the process of removing an available but irreplaceable resource such as coal mines or oil well, amortisation refers to the process of writing off intangible assets. The main objectives of charging depreciation are to ascertain the true profits or losses and to show the assets at its reasonable value. The amount of depreciation to be charged depends upon cost of the asset, estimated life of the asset and scrap value of the asset. There are different methods of charging depreciation, i.e., fixed instalment method, machine hour rate method, diminishing balance method, sum of years digits method, annuity method, depreciation fund method, insurance policy method and depletion method.

4.10 KEYWORDS

Fixed Assets: Assets which have been purchased for continuous use in the business.
Depreciation Rate: A percentage applied to the historical cost or the substituted amount of a depreciable asset.

Balance Sheet: A statement of the financial position of an enterprise as at a given time.
Depletion: A measure of exhaustation of a wasting asset represented by periodic write-off of cost.
Obsolescence: Dimunition in the value of an asset by the reason of its becoming out-of-date due to technological changes.
Provision: An amount retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy.

4.11 SELF ASSESSMENT QUESTIONS

1. Why is it necessary to calculate depreciation? Discuss various factors which are considered for calculating depreciation
2. Distinguish between the following:
(a) Straight line method and diminishing balance method.
(b) Annuity method and depreciation Fund method.
(c) Depreciation and depletion
3. Explain the circumstances under which different methods of depreciation can be employed.
4. Discuss the advantages and disadvantage of Insurance Policy Method and Straight Line Method.
5. What is sum of the year-digits method do depreciation? In what way does it differ from sinking fund method or depreciation?

6. A firm purchases a plant for a sum of Rs. 10,000 on 1st January 1990. Installation charges are Rs. 2,000. Plant is estimated to have a scrap value of Rs. 1,000 at the end of its useful life of five years. You are required to prepare the plant account for five years charging depreciation according to Straight Line Method

7. A plant is purchased for Rs. 20,000. It is depreciated at 5% per annum on reducing balance for five years when it becomes obsolete due to new method of production and is scrapped. The scrap produces Rs. 5,385. Show the plant account in the ledger.

8. The machinery account of a factory showed a balance of Rs. 1,90,000 on 1st January 1998. 1st accounts were made up on 31st December each year and depreciation is written off at 10% p.a. under the Diminishing Balance Method.

On 1st June 1998, New Machinery is acquired at a cost of Rs. 28,000 and installation charges incurred in erecting the machines works out to Rs. 892 on the same date. On 1st June 1998 a machine which had cost Rs. 6,000 on 1st January 1993 was sold for Rs. 750, another machine which had cost Rs. 600 on 1st January 1994, was scrapped on the same date and it realised nothing. Write up plant and Machinery Account for the year 1998, allowing the same rate of Depreciation as in the past calculating Depreciation to the nearest multiple of a Rupee.
(Ans. Loss on Sale Rs. 2,645, Loss on scrapping Rs. 377, Closing Balance Rs. 1,94,665).

9. A company purchased a four years lease on January, 1, 1985 for Rs. 20,150. It is decided to provide for the replacement of the lease at the end of four years by setting up a Depreciation Fund. It is expected that investments will fetch interest at 4per cent. Sinking Fund tables show that to provide the requisite sum at 4percent at the end of four years, an investment of Rs. 4,745.02 is required. Investments are made to the nearest rupee. On December 31, 1988, the investments are sold for Rs. 14,830 On 1st January, 1989, the same lease is renewed for a further period of 4 years by payment of Rs. 22,000. Show journal entries and give the important ledger account to record the above.

10. Chillies Ltd, acquired a long-term lease of property on payment of Rs. 60,000. A leasehold Redemption Policy was taken out on which an annual premium of Rs. 1,440 was payable. The surender value of the policy on 31st March, 1997 was Rs. 12,896 to which amount the policy account stood adjusted. Next premium was paid on 20th December, 1997 and the surrender value on 31st March, 1978 was Rs. 14,444.
(i) Show the Redemption fund account and the policy account for the year ended 31st March, 1998 (ii) Assuming that of maturity, a sum of Rs. 60,100 was received and the balance in policy account then stood at Rs. 59,920 give the ledger accounts showing the entries necessary to close the accounts concerned.
(Ans. (i) Balance at the end of 1998 Fund A/c & Policy A/c Rs. 14,444 (ii) Transfer to P & L a/c profit on maturity Rs. 100).

11. Machinery account of CSI Ltd. showed debit balance of Rs. 32,400 on 1st January, 1998. Depreciation was provided at 10% per annum. On 1st July 1998, a part of the machinery purchased for Rs. 10,000 on 1st January 1996 was sold for Rs. 7,000 and on the same date a new machinery which cost Rs. 20,000 was purchased. On 31st Dec. 1998 the company decided to change the method of depreciation from Diministing Balance Method to Fixed Instalment Method with effect from 1st January, 1996, depreciation remaining at 10% per annum. Show Machinery account.

Essay type Questions

1. Define depreciation. Explain the need and significance of depreciation.
2. Enumerate the various causes of depreciation and spell out the objectives of providing for depreciation.
3. Discuss the various factors which are to be considered for calculating depreciation.
4. Discuss in detail various methods of providing depreciation. Bring out the pros and cons of each method.
5. Distinguish between straight line method and diminishing balance method of providing depreciation.
6. A newly established concern has acquired the following assets:

(i) Lease-hold property (ii) Loose Tools (iii) Coal mine

(iv) Power Plant (v) Motor Truck

You are required to suggest the suitable method of depreciation for each of the assets, giving reasons in support of your suggestion.

7. Write short notes on:

(i) Provisions and Reserves

(ii) Secret Reserves

(iii) Depreciation policy.

Comprehensive Problems

1. M/s. Sekar & Co purchased a Machinery on 1.1.2002 for Rs.10,00,000. The firm writes off depreciation at 10 % on the original cost every year. The Books are closed on 31st March every year. Pass the necessary Journal entries, prepare Machinery Account and Depreciation Account for the first three years.

(Answer: Balance at the end of the third year Rs. 7,00,000)

2. A & Co. purchased a Plant for Rs.80,000 on 1.4.2001. it is depreciated at 10 % p.a on reducing balancing method for three years. Accounts are closed on 31st March every year. Pass the necessary Journal entries, prepare Machinery Account and Depreciation Account for the first three years.

(Answer: Balance at the end of the third year Rs. 58,320)

3. A company purchased a Plant for Rs. 4,00,000 on 1st April 2000, an additional machinery was purchased for Rs.40,000 on 1st April 2001. Prepare the Plant account for three years. Depreciation is provided at 10% p.a using Straight line method. The firm closes its books on 31st March of every year.

(Answer: Balance at the end of the third year Rs. 3,12,000)

4. A Plant is purchased for Rs.90,000. It is depreciated at 10 p.a on reducing balance for Three years. When it becomes obsolete due to new method of production and is scrapped. The scrap produces Rs. 66,000 at the end of the third year. Prepare plant and depreciation account for three years.
(Answer: Profit on sale of plant is Rs. 390)

5. Depreciation in a factory is provided by the "straight line" method at the rate of 10 percent per annum. The balance standing on the Plant and Machinery December 1991 after writing off depreciation for the year was Rs.19,515 (Total cost price of the plant was (Total cost price of the plant was Rs.35,800 including plant purchased in 1981 for Rs.8,900) During January 1992 new plant was purchased at a cost of Rs.2,950 and one machine which had cost of Rs.550 in 1978 was sold as scarp for Rs.35. During January 1993, there were additions costing Rs.1,800 and a machine which had cost Rs.700 in 1989 was sold for Rs.350. You are required to write up Machinery Account for 1992 and 1993. All calculations are to be shown.
(Ans: Machinery Account Balance 1992 Rs.19,480 and 1993 Rs.17,765)
(Hints: (i) Do not provide depreciation in 1992 on Rs.8,900 because it must have been completely written off by 1992
(ii) Profit on sale of plant during 1992 Rs.35; (iii) Loss on sale of plant during 1993
(Rs.420-Rs.350) = Rs.70).

6. The book value of Plant and Machinery on 1st January 1988 was Rs.2,00,000. New Machinery for Rs.10,000 was purchased on 1st October 1988 and for Rs.2,00,000 on 1st July, 1989. On 1st Apri1,1990 a machinery whose book value had been Rs.30,000 on 1st January,1988 was sold for Rs.16,000 and the entire amount was credited to plant and machinery Account. Depreciation had been charged at 10% per annum on the book value on 1st January,1968 on straight line method. It was decided on 31st December,1990 that depreciation at the rate of 20 percent per annum on diminishing balance method should be charged with retrospective effect since 1st January,1988. Show the Plant and Machinery Account from 1st January 1988 to 31st December, 1990.
(Ans: Depreciation in 1988,1989 and 1990 Rs. 40,500, 35,900 and 27,840 (including Rs.960 on sold Machine). Book value of sold machine on 1st April 1990 Rs. 18,240 ; Loss on sold machine Rs.2,240; Balance in Machinery A/c Rs.1,07,520)

7. Kiwi Enterprises Ltd., which depreciates its machinery at 10% on diminishing balance method held on 1st January,1991 Rs.9,72,000 to the debit of machinery account.
During the year 1991, part of the machinery purchased on 1st January 1989 for Rs.80,000 was sold for Rs.45,000 on 1st July 1991 and a new machinery at a cost of Rs.1,50,000 was purchased and installed on the same date, installation charges being Rs.8,000.

The company wanted to change its method of depreciation from diminishing balance method to straight line method with effect from 1st January 1989 and adjust the difference in the account of 1991. The rate of depreciation remains the same as before.

Show the machinery Account and ascertain the amount chargeable to profit & loss A/c for depreciation including obsolescence loss in the year 1991.

(Ans; Rs.1,50,900 chargeable to P & L A/c for depreciation (including Rs.15,000 for obsolescence in 1991; Balance in machinery A/c Rs.9,34,100.)

8. On 1st April, 1988 a new plant was purchased for Rs.40,000 and a further sum of Rs.2,000 was spent on its installation. On 1st October,1990 another plant was the acquired for Rs.25,000. Due to an accident on 3rd January 1991 the first plant was totally destroyed and the remnants were sold for Rs.1,000 only.

On 1st January 1992 a second hand plant was purchased for Rs.30,000 and a further sum of Rs.5,000 was spent for bringing the same to use on and from 15th March 1992. Depreciation has been provided at 10 percent on straight line basis. It was the practice to provide depreciation for full year on all acquisitions made at any time during any year and to ignore depreciation on any item sold or disposed of during any year. None of the assets were insured. The accounts are closed annually to 31st March. It is now decided to follow the rate of 15 percent on diminishing balance method with retrospective effect in respect of the existing items of plant and to make the necessary adjustment entry on 1st April 1992.

Show the journal entries to be passed for the purpose and the Plant Account and the Accumulated Depreciation Account for all the years.

(Ans: Balance in Plant A/c Rs.60,000 and Accumulated Depreciation A/c Rs.12,187 including additional depreciation of Rs.3687)

9. A company purchased 3 years lease on January 1st 1992 for Rs.25,000. It is decided to provide for the replacement of the lease at the end of 3 years by setting up a depreciation fund. It is expected that investments will fetch interest at 5%. Sinking fund tables show that to provide the requisite sum at 5% at the end of 3 years, an investment of Rs. 7,930.22 is required every year. Investments are made to the nearest rupee. On 31st December 1994 the investments are sold for Rs.15,250. Show the journal entries and give the Lease account, Depreciation Fund account and Depreciation Fund Investment account.

(Ans: Interest at the end of 1993 and 1994 Rs.397 and Rs.813 respectively; Loss on sale of investments Rs.1007; debit to P & L A/c for 1994 Rs.8937.)

10. The Machinery Account of a factory showed a balance of Rs.3,80,000 on January, 1991. Its accounts were made up on 31st December each year and depreciation written off at 10 percent on written down value. On 1st June 1991 new machinery was acquired at a cost of Rs.57,783 and on the same date a machine, which had cost Rs.12,000 on 1st January 1987 was

scrapped without realising anything. Write up the Plant and Machinery Account for the year 1991 allowing the same rate of depreciation as in the past, and showing clearly- how you arrive at the amounts of obsolescence and depreciation to be charged to the profit and loss account.
(Ans: Balance of Machinery Rs.3,89,326).

11.On 1st July, 2008 a company purchased a machine for Rs 3,90,000 and spent Rs 10,000 on its installation. It decided to provide depreciation @ 15% per annum, using written down value method. On 30th November, 2011 the machine was dismantled at a cost of Rs 5,000 and then sold for Rs 1,00,000.
On 1st December, 2011 the company acquired and put into operation a new machine at a total cost of Rs 7,60,000. Depreciation was provided on the new machine on the same basis as had been used in the case of the earlier machine. The company closes its books of account every year on 31st March.
Prepare machine account and depreciation account.

12. The cost of machinery in use with a firm on 1st April, 2011 was Rs 2,50,000 against which the depreciation provision stood at Rs 1,05,000 on that date; the firm provided depreciation at 10% of the diminishing value. On 31st December, 2011 two machines costing Rs 15,000 and Rs 12,000 respectively, both purchased on 1st October, 2008, had to be discarded because of damage and had to be replaced by two new machines costing Rs 20,000 and Rs 15,000 respectively. One of the discarded machines was sold for Rs 8,000; against the other it was expected that Rs 3,000 would be realisable. Show the relevant accounts in the ledger on the firm for the year ended 31st March, 2012.

13. Metropol Ltd. acquired a machine for Rs 5,40,000 on 1st April 2009. Depreciation was to be charged at 20% per annum on straight line method.
On 1st October, 2011 a modification was made to improve its technical efficiency at a cost of Rs 50,000 which it was considered would also extend the useful life of the machine by two years. At the same time, an important component of the machine was replaced at a cost of Rs 10,000 because of excessive wear and tear. Routine maintenance during the accounting year ending 31st, March, 2012 cost Rs 7,500. Prepare machine account.

14. X Co. Ltd. purchased a machine on 1st April, 2008 for Rs 1,60,000. On October 1, 2009 another machine was purchased for Rs 1,40,000. On October 1, 2010 the first machine was sold for Rs 1,20,000. On the same date, another machine was purchased for Rs 1,00,000. On October 1, 2011 the second machine was sold for Rs 92,000. Rate of depreciation was 10% on original cost annually on 31st March. On 31st March, 2011 the method of charging depreciation was changed to diminishing balance method, the rate being 15%. Prepare Machine Account for the years ending 31st March, 2009, 2010, 2011, and 2012.

15. A lease is purchased on 1st April, 2007 for 5 years at a cost of Rs 1,00,000. It is proposed to depreciate the lease by annuity method charging 12 per cent interest. Show the Lease Account for five years and also the relevant entries in the Profit and Loss Account.

16. A company purchased a four years' lease on April 1, 2008 for Rs 10,00,000. It is decided to provide for the replacement of the lease at the end of four years by setting up a Depreciation Fund. It is expected that investments will fetch interest at 12 per cent. Sinking fund tables show that Re. 0.209234 invested each year will produce Re. 1 at the end of four years at 12% per annum. Investments were made in 12% Bonds of Rs 100 each available at face value. Interest was receivable yearly on 31st March. On March 31, 2012, the investments were sold for Rs 6,98,940. On 1st April, 2012 the same lease was renewed for a further period of 4 years by payment of Rs 12,00,000. Show journal entries and give the important ledger accounts to record the above.

17. A company purchased a lease for 3 years for Rs 3,00,000 on 1st April. 2009 and decided to provide for its replacement by means of an insurance policy for Rs 3,00,000. The annual premium is Rs 89,500. On 1st April, 2012 the lease is renewed for a further period of 3 years for Rs 3,30,000. Show the necessary ledger accounts.

4.12 REFERENCES/SUGGESTED READINGS

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Unit-V

SINGLE ENTRY SYSTEM

STRUCTURE

5.0 OBJECTIVES

After going through this lesson, you should be able to-

- Know the meaning, advantages and disadvantages of single entry system.
- Differentiate single entry system and double entry system.
- Compute profit or loss under single entry system.
- Differentiate between statement of affairs and balance sheet.

5.1 INTRODUCTION

Single Entry System is an incomplete 'double entry system'. In case of double entry system of book- keeping both the aspects of every transaction are recorded. In this system, the first entry is made to the debit of an account, and the second entry to the credit of second account. However, in case of single entry system, the business houses for their convenience and more practical approach ignore the strict rules of double entry system. The users of this system maintain only the essential records. In other words, it is a system which may not keep some books of subsidiary records and some ledger accounts which otherwise are kept in case of double entry system. In fact, single entry system may consist of double entry in respect of certain transactions such as cash paid to creditors, cash received from debtors, etc, and single entry in regard to certain events and transactions such as cash sales and purchases and expenses incurred on purchase of fixed assets. Further, the users of this system may pass no entry in respect of certain transactions, for instance, depreciation, bad debts, etc.

According to a Dictionary of Accountancy by Kohler, "A system of book-keeping in which as a rule only records of cash and of personal accounts are maintained, it is always incomplete double entry varying with the circumstances." Thus, under the so-called single entry system both the aspects of business transactions and events are not recorded and, therefore, this may be defined, "as any system which is not exactly the Double Entry System". Under the single entry system usually a cash book and personal accounts are maintained.

5.2 SALIENT FEATURES

From the foregoing discussion, the following salient features have emerged about the single entry system:

a) Under this system usually a cash book and personal accounts are maintained.
b) Usually real and nominal accounts are not kept in this system.
c) The cash book maintained, under this system usually mixes up both the personal and the business transactions.
d) In this system, it is seen quite oftenly that in order to collect the necessary information one has to depend on original vouchers. For example, the amount of credit purchases may have to be found out on the basis of original invoices received from the suppliers in case the figures are not readily available.
e) This system can be applied only in case of sole trader or partnership concerns. Limited companies, because of legal provisions, cannot keep books on single entry system.
f) It is adopted as per individual requirements and convenience by the business houses. Therefore, the system may differ from firm to firm, which brings lack of uniformity in accounting books.

Differences between single entry and double entry system

The differences between single entry and double entry system are listed below:

Single Entry System	Double Entry System
A single Entry System is a bookkeeping system in which only one part of a transaction is recorded, such as debit or credit.	A double entry system is a method of recording transactions in which both sides of a transaction are recorded.
This sort of bookkeeping is not for tax purposes. To put it another way, it is not accepted by the tax authorities.	This method of bookkeeping is acceptable for tax purposes. To put it another way, this method is accepted by the tax authorities.
If you use a single-entry bookkeeping system, you won't be able to prepare a trial balance.	In the case of a double-entry bookkeeping system, a trial balance can be prepared.
We can't accurately determine the company's financial status using the Single Entry System of Bookkeeping.	We accurately determine the company's financial status using the Double Entry System of Bookkeeping.
The single entry bookkeeping system is	The double entry bookkeeping system is a full

an inadequate accounting system since it does not record all financial transactions. Instead, it only tracks personal accounts such as debtors, creditors, and cash.	accounting system since it records all financial activities and categorize them into personal, real, and nominal accounts.
While keeping books of account under it, there is a considerable chance of workers committing frauds and errors.	While keeping books of account under it, there is a reduced danger of workers making frauds and errors.
Because it is not maintained to a specific standard, only the business owner can utilize it.	Because all books are kept in standard formats, this system can be used by any involved parties.
This system is only appropriate for small businesses.	It's appropriate for any business.

5.3 DISADVANTAGES AND ADVANTAGES OF SINGLE ENTRY SYSTEM

5.3.1 Disadvantages

a) It is an incomplete system of accounting since this system does not record both the aspects of business transactions and events. Because of this limitation, one cannot prepare trial balance and, thus, the arithmetical accuracy cannot be easily checked in the absence of a trial balance. This increases the chances of misappropriations and frauds as compared to the Double Entry System of book-keeping.

b) This system lacks uniformity since the businessmen apply it as per their individual requirements and conveniences.

c) It becomes difficult to valuate assets in case a businessman wanted to sell his business.

d) In the absence of complete information for sales, purchases and other expenses, the trading and profit and loss account cannot be prepared. Hence, rate of gross profit on sales and the true profit or loss position cannot be known.

e) As there are no real accounts, the balance sheet cannot be drawn up to give a correct picture of the financial position of the business on a particular date.

f) This system hampers comparison, planning, and sound decision-making because the system does not provide accurate figures about the performance of the business and its financial position.

5.3.2 Advantages

a) This system is more economical than double entry system and hence, suitable for small business firms.

b) This system is also suitable to those firms which have more cash transaction and a large number of personal accounts.

c) This system does not require specialised knowledge of accounting since only selected books of accounts are kept under it.

5.4 CALCULATION OF PROFIT OR LOSS

In case of a business maintaining accounts according to single entry system, profit (or loss) made during the year are calculated by any of the following two methods:

i) Increase in net worth method.

ii) Conversion method.

5.4.1 Increase in Net worth Method

Under this method, profit can be calculated by comparing the net worth in the beginning of the year and at the end of the year. Any decrease in net worth is taken as loss, but any increase in net worth is taken as profit. However, this is true only in the absence of any other information. Thus, under a pure single entry system profit cannot be calculated by preparing trading and profit and loss account. For this purpose, we need to calculate and compare capital (net worth) in the beginning and at the end of the year. For example, if net worth of the business on 1.4.1997 is Rs. 50,50,000 and it is Rs. 52,50,000 on 31stMarch, 1998, it can be said that the business has made profit of Rs. 2,00,000 during the period.

Single entry system is an imperfect way of keeping accounting records. Under this system cash book and personal accounts are maintained and, nominal and real accounts are not maintained. Of course, this system is suitable for small businesses as it saves time and cost of recording and maintaining accounting records but suffers from the following defects:

1. Trial balance can't be prepared and as such arithmetical accuracy of the accounting entries cannot be established.
2. It is difficult to finalize the accounts. So true profits and financial position cannot be known.
3. Assets accounts are not maintained under this system and as such control over assets can't be exercised.

Ascertained of Profit

Profit can be ascertained under this system, using either of the following methods:

1. Statement of Affairs method
2. Conversion method

Statement of Affairs Method

Profit, as a rule, is the difference between closing and opening balances of capital, after adjusting for drawings and additional capital introduced. Capital balance can be ascertained by preparing "Statement of Affairs", which is nothing but a summarized statement of assets and liabilities. Statement of affairs is like a balance sheet for all practical purposes, but is not prepared from trial balance. It is prepared from existing cash book, personal accounts and previous statement of affairs. Capital balance in a `statement of affairs' is a balancing figure (i.e.) net of assets over liabilities (Capital = Total assets - Total liabilities).

In order to determine the capital in the beginning of the period and at the end, we prepare 'statement of affairs'. A statement of affairs is a statement of all assets and liabilities. The excess of assets over liabilities is taken as net worth. For calculating profit by net worth method the following adjustments are required:

(i) Adjustment for drawings: The drawings made by proprietor from the business for his personal use are added to the capital at the end because drawings made during the year will reduce the capital at the end but not the profit for the year. In other words, accurate amount of profit (or loss) can be known only by making adjustments, in the capital at the end, for the drawings made.

(ii) Adjustment for capital introduced: The proprietor may introduce fresh capital in the business during the course of the financial year. This fresh capital is deducted from the capital at the end because the fresh capital will increase the capital of the proprietor at the end of the financial year, but not the profit. Thus the increase in the capital at the end due to introduction of capital during the year should not be misunderstood for increase in capital because of profits made during the year.

Steps for Preparing Statement of Affairs

The procedure for preparing the Statement of Affairs can be understood with the following steps: a) Firstly, we are to prepare statement of affairs at the beginning for ascertaining net worth in the beginning. b) Secondly, we shall prepare statement of affairs at the end for calculating net worth at the end. c) Thirdly, make adjustments for drawings, and capital introduced during the year. d) In the end, deduct net worth in the beginning from the net worth at the end. The excess of capital at the end over capital in the beginning will denote the profit.

Format of statement of profit or loss

Statement of Profit or Loss for the year ended ....

	Particulars	*Amount* ₹
	Capital as at the end of year (computed from statement of affairs as at the end of year)	.....
Add	Drawings during the year	.....
Less	Additional capital introduced during the year	(.....)
	Adjusted capital at the end of year	.....
Less	Capital as at the beginning of year (computed from statement of affairs as at the beginning of year)	(.....)
	Profit or Loss made during the year	.....

Format of statement of affairs

Statement of Affairs as at —

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
Bills payable	....	Land and Building	....
Creditors	....	Machinery	....
Outstanding expenses	....	Furniture	....
Capital (balancing figure)*	....	Stock	....
		Debtors	....
		Cash and Bank	....
		Prepaid expenses	....
		Capital (balancing figure)*	....
	XXX X		XXXX

*Note: * where the total of liabilities side is more than total of assets side, capital would be shown in assets side and it represents debit balance of capital.*

Illustrations:

1. **Find out the profit from the following for the year 2021**

Opening capital- Rs.25000

Additional capital- Rs.10000

Closing capital- Rs.58000

Drawings-Rs.2000

Sol:

Computation of profit for the year 2021

Particulars	Amount .Rs
Closing capital	58000
Add: Drawings	2000
Adjusted capital	**60000**

Less: (additional capital+ opening capital)=10000+25000	(35000)
Profit	**25000**

2. Find out profit from the following

Particulars	Amount .Rs
Capital on 1.1.2021	20000
Additional capital introduced on 1.6.2021	10000
Drawings per month	2500
Capital on 31.12.2021	85000
Profit	**???**

Sol: Computation of profit for the year 2021

Particulars	Amount .Rs
Closing capital	85000
Add: Drawings(2500X12)	30000
Adjusted capital	**115000**
Less: (additional capital+ opening capital)=(10000+20000)	30000
Profit	**85000**

Illustration-3: Find out profit of M/S.Swarna &Co for the year 2019

Particulars	1-1-2019	31.12.2019
Cash	200	150
Bank	2250	-
Stock	15000	22250
Furniture	1750	2100
Debtors	9500	18250
Plant	23800	32200
Creditors	31000	30700
Bank OD	-	10250

Sol:

Statement of the affairs as on 1-1-2019

Liabilities	Amt.Rs	Assets	Amt.Rs.

Creditors	31000	Cash	200
		Bank	2250
Opening capital (Balancing figure)	**21500**	Stock	15000
		Furniture	1750
		Debtors	9500
		Plant	23800
Total	52500	Total	52500

Statement of the affairs as on 31-12-2019

Liabilities	Amt.Rs	Assets	Amt.Rs.
Creditors	30700	Cash	150
Bank OD	10250	Bank	-
Closing capital (Balancing figure)	**34000**	Stock	22250
		Furniture	2100
		Debtors	18250
		Plant	32200
Total	74950	Total	74950

Statement showing Profit or loss of M/s Swarna &Co for the year ending 31-12-2019

Particulars	Amount .Rs
Closing capital	34000
Add: Drawings(2500X12)	30000
Adjusted capital	**64000**
Less: opening capital	21500
Profit	**42500**

Illustration-4: Swarna, Manu and Chinnu are partners doing business and maintaining accounts on single entry basis. the balance sheet on 1-1-2018 is as follows

Liabilities	Amt.Rs	Assets	Amt.Rs.
Creditors	22000	Cash	15000
Capitals :		Bank	4000
Swarna	60000	Stock	43000
Manu	45000	Furniture	15000
Chinnu	30000	Debtors	50000
		Plant	30000
Total	157000	Total	157000

On 31-12-2018 the balances are as follows: cash-Rs.5000; Debtors-Rs.72000; Stock-Rs.39000; Plant-Rs.43000; furniture-Rs.15000, Creditors-Rs.36000.

Drawings are : Swarna- Rs.3000 per month; Manu-Rs.2500 per month and Chinnu-Rs.1500 per month. Depreciate furniture @10% and allow interest on capital @6%. Find out profit for the year.

Sol:

Balance sheet of Swarna, Manu and Chinnu on 31-12-2018

Liabilities	Amt.Rs	Assets	Amt.Rs.
Creditors	36000	Cash	5000
Capitals combined Balancing figure	**136500**	Bank	-
		Stock	39000
		Furniture(15000-1500)	13500
		Debtors	72000
		Plant	43000
Total	172500	Total	172500

Statement showing Profit or loss of M/s Swarna &Co for the year ending 31-12-2019

Particulars		Amount .Rs
Closing capital		136500
Add: Drawings: Swarna-3000X12= 36000 Manu-2500X12=30000 Chinnu-1500X12=18000		84000
Adjusted capital		**220500**
Less: opening capital- Interest on capitals@6%(135000X6%=	135000 8100	143100
Profit		**77400**

Illustration 1: J. Sikidar keeps her books on single entry system. From the following particulars, prepare a statement showing profit or loss made by her for the year ended March 31, 2006.

	March 31, 2005 (Rs.)	March 31, 2006 (Rs.)
Debtors	16,000	19,000
Stock	12,000	15,000
Furniture	2,000	4,000
Cash in hand	1,000	1,500
Creditors	1, 200	1,800
Bank overdraft	—	2,000

During the year Sikidar introduced Rs. 10,000 as further capital in the business and withdrew Rs. 6000

Solution

Sikidar's Statement of Affairs as on 31st March, 2005

Liabilities	Rs.	Assets	Rs.
Creditors	1,200	Debtors	16,000
Capital	29,800	Stock	12,000
(Balancing Figure)		Furniture	2,000
		Cash in hand	1,000
	31,000		31,000

Sikidar's Statement of Affairs as on 31st March, 2006

Liabilities	Rs.	Assets	Rs.
Creditors	1,800	Debtors	19,000
Bank Overdraft	2,000	Stock	15,000
Capital	35,700	Furniture	4,000
(Balancing Figure)		Cash in hand	1,500
	39,500		39,500

STATEMENT OF PROFIT

FOR THE YEAR ENDING 31.3.2006

	Rs.
Capital as on 31.3.2006	35,700
Add Drawings made during the year	6,000
	41,700
Less further capital introduced	10,000
	31,700
Less capital in the beginning (31.3.2005)	29,800
Profit made during the year ending as on 31.3.2006	**1,900**

Illustration

Mrs. Vandana runs a small printing firm. She was maintaining only some records, which she thought, were sufficient to run the business. On April 01, 2016, available information from her records indicated that she had the following assets and liabilities: Printing Press ` 5,00,000, Buildings ` 2,00,000, Stock ` 50,000, Cash at bank ` 65,600, Cash in hand ` 7,980, Dues from customers ` 20,350, Dues to creditors ` 75,340 and Outstanding wages ` 5,000. She withdrew ` 8,000 every month for meeting her personal expenses. She had also introduced ` 15,000 during the year as additional capital. On March 31, 2017 her position was as follows : Press ` 5, 25,000, Buildings ` 2,00,000, Stock ` 55,000, Cash at bank ` 40,380, Cash in hand ` 15,340, Dues from customers ` 17,210, Dues to creditors ` 65,680.

Calculate the profit made by Mrs. Vandana during the year using statement of affairs method.

Solution

Books of Mrs. Vandana
Statement of Affairs as on April 1, 2016
and as on March 31, 2017

Liabilities	*Apr. 01, 16* ₹	*Mar. 31, 17* ₹	*Assets*	*Apr. 01, 16* ₹	*Mar.31,17* ₹
Creditors	75,340	65,680	Printing press	5,00,000	5,25,000
Wages outstanding	5,000	–	Buildings	2,00,000	2,00,000
Capital	7,63,590	7,87,250	Debtors	20,350	17,210
(balancing figure)			Stock	50,000	55,000
			Cash at bank	65,600	40,380
			Cash in hand	7,980	15,340
	8,43,930	8,52,930		8,43,930	8,52,930

Statement of Profit or Loss for the year ended on March 31, 2017

	Particulars	*Amount* ₹
	Capital as on March 31, 2017	7,87,250
Add	Drawings during the year	96,000
		8,83,250
Less	Additional capital introduced during the year	(15,000)
	Adjusted capital at the end of the year (31. 3. 2017)	8,68,250
Less	Capital as on April 01, 2016	(7,63,590)
	Profit made during the year	1,04,660

Illustration 3: Anil and Sunil are partners in a firm sharing profits and losses in the ratio of 3:2. Their capital on 1st January, 2005are in the proportion of ¾ and ¼. They do not keep their books under double entry system. Their position on 31st December, 2004 and 31st December 2005 are given as under:

	31st Dec., 2004 Rs.	31st Dec., 2005 Rs.
Machinery	1,60,000	3,00,000
Creditors	1,60,000	1,20,000
Debtors	1,40,000	1,90,000
Stock	1,20,000	1,60,000
Furniture	80,000	1,00,000
Cash at bank	40,000	50,000

You are required to ascertain the profit or loss made by the partners during the year 2005 and prepare Balance Sheet as on 31st December, 2005 after taking into consideration the following adjustments:

i) Depreciation on Machinery @ 10% and on Furniture @ 15%

ii) A provision for Bad and Doubtful Debts is to be created at 2½ % on debtors.

iii) Provide interest on capital @ 5% p.a.

Conversion Method

We have seen under the net worth method in the preceding explanation that the method does not give details of the gross profit and net profit. Also, it does not provide a clear picture of the operational results of a business. Resultantly, it becomes just impossible to make a objective analysis of the financial statements. But the effective steps needed to strengthen the financial position of the business cannot be devised without making a meaningful analysis of financial position.

Hence, it is quite essential to ascertain the missing information from the books of accounts, and other sources. The missing information can be ascertained by preparing Total Debtors Account, Receipts and Payments Account, Total Creditors Account, Memorandum Trading Account, etc. After ascertaining the required information, it will be possible to prepare a trial balance. Now, one can prepare final accounts in the usual manner since full information as under double entry system is available. Hence, under conversion method net profit is ascertained by conversion of single entry system into double entry system.

Under conversion method, firstly statement of affairs in the beginning is prepared to ascertain capital in the beginning. For preparing this statement, the students should ascertain the informations on debtors in the beginning or creditors or cash in khand or cash at bank or any other items, if these are missing. This is done by preparing a cash book, total debtors account, total creditors account, bills receivable account, bills payable account, etc. These various accounts will help in revealing a missing figure of cash, bank, credit sales, cash sales, creditors or debtors balance either in the beginning or at the end or any other information. After preparing these accounts the students should calculate total sales by adding credit sales and cash sales; total purchases by adding cash purchases and credit purchases. Information relating to nominal accounts can be ascertained from the cash book. Real accounts and amounts outstanding will be available by way of information. Now, it will be possible to prepare a trial balance. However, in practice trial balance is skipped and only such information is collected which is required for preparing the Trading and Profit and Loss Account, and Balance Sheet of the business.

In order to prepare trading and profit and loss account and balance sheet, the students needs the following information:

1. Opening stock and closing stock
2. Purchases
3. Direct expenses
4. Sales
5. Indirect expenses and other incomes
6. All assets and all liabilities
7. Capital in the beginning
8. Profit made during the year

The following illustrations would enable you to calculate the amount of the various items given above.

Opening Stock and Closing Stock: The amount of Opening and Closing Stock can be ascertained by preparing a Memorandum Trading Account.

Illustration 4: From the following particulars, find out the amount of Opening Stock:

	Rs.		
Purchases	40,000	Rate of Gross Profit on sales	20%
Sales	60,000	Closing Stock	Rs. 20,000

Solution

MEMORANDUM TRADING ACCOUNT

	Rs.		Rs.
To Opening Stock (balancing figure)	28,000	By Sales	60,000
To Purchases	40,000	By Closing stock	20,000
To Gross Profit (20% of Sales)	12,000		
	80,000		80,000

Illustration 5: From the following figures, find out the amount of Closing Stock.

	Rs.		Rs.
Opening Stock	20,000	Sales	80,000
Purchases	60,000	Rate of Gross Profit on sales	20%

Solution

MEMORANDUM TRADING ACCOUNT

	Rs.		Rs.
To Opening Stock	20,000	By Sales	80,000
To Purchases	60,000	By Closing Stock (balancing figure)	16,000
To Gross Profit (20% of Sales)	16,000		
	96,000		96,000

2. **Purchases:** Purchases are calculated by adding cash purchases and credit purchases. Cash book reveals the amount of cash purchases. The amount of credit purchases can be ascertained by preparing (i) total creditors account, and (ii) bills payable account.

Illustration 6: From the following information, ascertain the amount of Credit Purchases for the year 2005.

	Rs.		Rs.
Balance of Creditors (on 1.1.2005)	22,800	Returns Outward	7,200
		Bills accepted	13,800
Cash paid to Creditors	60,000	Creditors on 31.12.1997	28,500
Discount allowed by them	1,500	Cash Purchases	20,000

Solution

TOTAL CREDITORS ACCOUNT

	Rs.		Rs.
To Cash	60,000	By Balance b/d	22,800
To Discount	1,500	By Credit purchases (balancing figure)	88,200
To Returns Outward	7,200		
To Bill Payable a/c	13,800		
To Balance c/d	28,500		
	1,11,000		1,11,000

If we are required to find total purchases, it will be found out simply by adding cash purchases and credit purchases i.e. total purchases = 20,000 + 88,200 = 1,08,200

Solution

STATEMENT OF AFFAIRS OF ANIL AND SUNIL
AS ON 31ST DECEMBER, 2004

Liabilities	Rs.	Assets	Rs.
Creditors	1,60,000	Cash at Bank	40,000
Combined Capital	3,80,000	Debtors	1,40,000
(Balancing Figure)			
		Stock	1,20,000
		Furniture	80,000
		Machinery	1,60,000
	5,40,000		5,40,000

STATEMENT OF AFFAIRS OF ANIL AND SUNIL
AS ON 31ST DECEMBER, 2005

	Rs.		Rs.
Creditors	1,20,000	Cash at bank	50,000
Combined Capital	6,80,000	Debtors	1,90,000
(Balancing Figure)		Stock	1,60,000
		Furniture	1,00,000
		Machinery	3,00,000
	8,00,000		8,00,000

STATEMENT OF PROFIT AND LOSS
FOR THE YEAR ENDED 31ST DECEMBER, 2005

	Rs.	Rs.
Capital as on 31.12.2005	6,80,000	
Less capital in the beginning	3,80,000	
Profit for the year (Before Adjustment)		3,00,000

PROFIT AND LOSS ACCOUNT OF SUNIL AND ANIL
FOR THE YEAR ENDED 31ST DECEMBER, 2005

Particulars		Rs.	Particulars	Rs.
To Interest on Capital			By Profit for the year	3,00,000
Anil	14,250			
Sunil	4,750	19,000		
To Depreciation:				
Furniture	5,000			
Machinery	30,000	35,000		
To provision for bad and Doubtful Debts	4,750			
To Net Profit transferred				
Anil	144,750			
Sunil	96,500	2,41,250		
		3,00,000		3,00,000

BALANCE SHEET OF ANIL AND SUNIL
AS ON 31ST DECEMBER, 2005

Liabilities		Rs.	Assets		Rs.
Creditors		1,20,000	Cash at bank		50,000
Capitals:			Debtors	1,90,000	
Anil*	2,85,000		Less provisions for bad and doubtful	4,750	1,85,250
Add Interest	14,250				
Add Profit	1,44,750	4,44,000	Stock		1,60,000
Sunil*	95,000		Furniture	1,00,000	
Add Interest	4,750		Less depreciation	5,000	95,000
Add Profit	96,500	1,96,250	Machinery	3,00,000	
			Less depreciation	30,000	2,70,000
		7,60,250			7,60250

Illustration

From the following information ascertain

Opening stock (i.e on 1-1-96)

	Rs.
Purchases mae during 1996	2,50,000
Sales made during 1996	3,25,000
Stock on 31-12-1996	60,000
Wages	3,000
Rate of gross profit on cost	25%

Solution:

Memorandum Trading A/C for the year ending 31-12-96

	Rs.		Rs.
To opening stock(bal.fig)	67,000	By sales	3,25,000
To purchases	2,50,000	By closing stock	60,000
To wages	3,000		
To gross profit {3,25,000 *25/125}			
	3,85,000		3,85,000

Stock 1-1-96 - Rs.67,000

Illustration

From the following details, find out the net credit sales for the year;

	Rs.
Opening balance of sundry debtors (dr)	20,000
Cheque collection during the year	1,80,000
Cash collection during the year	25,000
B/R received during the year	5,000
Closing balance of sundry debetors (Dr.)	24,000
Bad debts written off	2,500
Discount allowed	1,000
Goods returned by customers	2,500
Cheque dishonoured	500

Solution;

Total Debtors A/c

	Rs.		Rs.
To balance b/d	20,000	By bank	1,80,000
To Bank	500	By cash	25,000
To sales –credit (bal.fig)	21,19,500	By B/R	5,000
		By bad debts	2,500
		By Discount allowed	1,000
		By sales return	2,500
		By balancec/d	24,000
	2,40,000		2,40,000

Illustration

From the following particulars find out net credit purchases:

	Rs.
Opening balance of sundry creditiors	40,000
Payment by cheques	2,35,000
Payment by bill payable	25,000
Payment in cash	5,000
Discount received	2,500
Purchases returns	5,000
Closing balance of sundry creditors	47,500

Total creditors A/c

	Rs.		Rs.
To Bank	2,35,000	By balance b/d	40,000
To B/P	25,000	By purchases – credit	2,80,000
To Cash	5,000	(bal.fig)	
To Discount received	2,500		
To Purchases returns	5,000		
To Balance c/d	47,500		
	3,20,000		3,20,000

Illustration

Find out purchases and sales from the following details by making necessary accounts:

	Rs.
Opening balance of sundry debtors	30,000
Opening balance of sundry creditors	10,000
Collections from debtors	1,60,000
Discount received	2,500
Bad debts	1,000
Payment to creditors	14,000
Discount allowed	1,500
Returns inwards	2,000
Returns outwards	3,000
Cash purchases	6,000
Cash sales	10,000
Closing balance of debtors	35,000
Closing balance of crditors	15,000

Solution:

(i) Calculation of credit sales

Total debtors A/c

	Rs.		Rs.
To balance b/d	30,000	By cash	1,60,000
To sales –credit (bal.fig)	1,69,500	By bad debts	1,000
		By discount allowed	1,500
		By Return inwards	2,000
		By balance c/d	35,000
	1,99,500		1,99,500

(ii) Calculation of credit purchases

Total creditors A/C

	Rs.		Rs.
To cash	14,000	By balance b/d	10,000
To discount received	2,500	By purchases – credit (bal.fig)	24,500
To return outwards	3,000		
To balance c/d	15,000		
	34,500		34,500

Total purchases:

Cash	6,000	
Credit	24,500	
Total sales		30,500
Cash	10,000	
Credit	1,69,500	
		1,79,500

SUMMARY

Single entry system is a system of book-keeping in which as a rule only records of cash and of personal accounts are maintained. In this way both the aspects of business transactions and events are not recorded. The single entry system is more economical, suitable for small firms, suitable where more cash transactions and large number of personal accounts but having a lot of disadvantages in comparison to double entry system. In the single entry system, profit or loss made during the year is calculated by using two methods namely increase in net worth method and conversion method. Under the increase in net worth method, profit can be calculated by comparing the net worth in the beginning of the year and at the end of the year. Any decrease in net worth is taken as loss, but any increase in net worth is taken as profit.

Under the conversion method, the missing information from the books of accounts and other sources are ascertained. The missing information can be ascertained by preparing total debtors account, receipts and payments account, total creditors account and memorandum trading account, then it will be possible to prepare a trial balance. Now one can prepare final accounts in the usual manner since full information as under double entry system is available. Hence, under conversion method, net profit is ascertained by conversion of single entry system into double entry system.

5.6 KEYWORDS

Balance Sheet: A statement of the financial position of an enterprise as at a given date.

Capital: The amount invested in an enterprise by its owners also called net worth.

Personal Account: Accounts which are related to any person or institution.

Double Entry System: System of accounting in which every transaction and event affects two accounts.

Statement of Affairs: A statement of the financial position of an enterprise under single entry system.

Cash Book: A subsidiary book in which only cash transactions are recorded.

5.7 SELF ASSESSMENT QUESTIONS

1. State whether the following statements are 'true' or 'false':

(a) Trial Balance can be easily prepared when the books are kept according to Single Entry System.

(b) Single Entry System is not suitable for a small business firm.

(c) Limited companies are free to choose ether single entry or double entry system of accounting.

(d) Under Single Entry System usually the personal accounts of suppliers and customers and the cash book is maintained.

(e) According to Networth Method, the N et Profit is equal to: Capital at the end + Drawings + Fresh capital introduced – Capital in the beginning of the accounting period.

(f) Under the Conversion Method, credit purchases and credit sales are found out by preparing the total creditors and total debtors accounts respectively.

2. Choose the most correct answer:

(i) The capital at the end of the accounting year is ascertained by

(a) Closing Statement of Affairs

(b) Cash Book

(c) Total Creditors Account

(ii) Under Net Worth Method of Single Entry System, the basis for finding the profit is
(a) The difference between the capital in the beginning and at the end.
(b) The difference between the gross assets in the beginning and at the end.
(c) The difference between the liabilities in the beginning and at the end.
(iii) The closing balance in the Creditors Account can be ascertained from
(a) Cash Account
(b) Total Creditors Account
(c) Balance Sheet at the end of the accounting period
(iv) If the rate of gross profit is 20% on cost of goods sold and the sales are Rs. 3,00,000, the amount of gross profit will be
(a) Rs. 60,000; (b) Rs. 75,000; (c) Rs. 50,000
(v) Cash received from debtors needed for the construction of cash account can be had from
(a) Total debtors account (b) Balance sheet (c) Analysis of cash book

3. Explain the single entry system of book-keeping. How does a business man ascertain the profit under such a system?

4. Define single entry system. Distinguish it from double entry system.

5. What are the steps required to convert "single entry system of book-keeping" into double entry system.

6. Bring out the defects of the single entry system of book keeping. Also discuss the procedure of calculating profit by statement of affairs method.

7. H keeps his books by single entry system. His position on January 1, 1998 was a follows:
Cash at Bank Rs. 5,000 Cash in hand Rs. 1,000; Stock Rs. 7,000; Sundry Debtors Rs. 8,400 ; Machinery and Plant Rs. 6,500; Bills Receivable Rs. 2,600; Creditors Rs. 2,500; Bills Payable Rs. 4,000.
On December 31, 1998, his position was as follows:
Cash at Bank Rs.4,300; Cash in hand Rs. 1,700; Stock Rs. 9,000; Sundry Debtors Rs. 6,000; Machinery and Plant Rs. 6,500; Bills payable Rs. 3,200; Bill Receivable Rs. 3,200; Creditors Rs. 1,600. During the year A introduced further capital of Rs. 2,000 and his drawings were Rs. 800 per month.
Depreciate machinery and Plant by 5% and create a Reserve for Bad and Doubtful debts @ 5%
From the above information, prepare a statement showing the profit or loss made by him for the year ended December, 31,1998.

8.Calculate missing figure from the following for the year 2020

Particulars	**Amount Rs.**
Profit earned	1200
Closing capital	4000
Additional capital	1000
Drawings during the year	600
Opening capital	???

9. Calculate missing figure from the following for the year 2021

Particulars	**Amount Rs.**
Profit earned	3000
Closing capital	13000
Additional capital	4000
Drawings during the year	???
Opening capital	8000

10. Calculate missing figure from the following for the year 2017

Particulars	**Amount Rs.**
Loss	(500)
Closing capital	9000
Additional capital	1500
Drawings during the year	2000
Opening capital	???

11. Calculate missing figure from the following for the year 2015

Particulars	**Amount Rs.**
Profit earned	???
Closing capital	21000
Additional capital	3000
Drawings during the year	1500
Opening capital	15000

12. Find out profit from the following information of Mr. Lokesh for the year 2021

Particulars	1-1-2021	31.12.2021
Cash	2000	125000
Bank	2250	58000
Stock	150000	56200

Furniture	10750	29000
Debtors	95000	68250
Plant	23800	72200
Creditors	31000	50700
Bank OD	25000	Nil

13. Find out profit from the following information of M/s.Saiteja Enerprises

Particulars	1-1-2022	31.3.2022
Cash and bank	5000	225000
investments	4250	68000
Stock	250000	66200
Furniture	20750	39000
Debtors	105000	78250
Plant	33800	82200
Creditors	41000	60700
Loan Dr	-	35000

14. Find out profit from the following information of M/s.Rani Foundations

Particulars	1-1-2020	31.12.2020
Cash and bank	115000	2225000
investments	114250	268000
Stock	1250000	266200
Furniture	120750	239000
Debtors	1105000	278250
Plant	133800	282200
Creditors	141000	260700
Loan Dr	-	235000

Additional information:

1. Depreciate fixed assets @ 10%
2. Interest on capital is allowed @8%pa
3. Provision ofr bad debts is needed @10%
4. Investment loss is Rs.12000
5. Outstanding expenses- Rs.25000.

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