UNIT 1 BASIC CONCEPTS OF ACCOUNTING

Structure

1.0 OBJECTIVES

After studying this unit you should be able to :

- appreciate the need for accounting
- define accounting and outline its scope
- distinguish between book-keeping, accounting and accountancy
- identify the parties interested in accounting information
- describe the advantages and limitations of accounting
- explain the accounting concepts to be observed at the recording stage
- explain the systems of book-keeping
- classify accounts
- analyse the transactions and identify the accounts to be debited and credited
- identify the stages involved in accounting

1.1 INTRODUCTION

In business numerous transactions take place every day. It is humanly impossible to remember all of them. Hence the need to record them. The recording of business transactions is the main function served by Accounting. With the help of accounting records the businessman is able to ascertain the profit or loss and the financial position of his Business at the end of a given period and communicate such information to all interested parties. In this unit we intend to have an overview of Accounting and discuss its nature, scope and importance. We shall also discuss the basic concepts which are to be observed at the recording stage and explain the principle of double entry i.e., the rules of debit and credit.

8.2 ACCOUNTING—AN OVERVIEW

You know there is a limit to human memory. You cannot remember everything you do or each transaction you make. If you are given Rs. 5,000 and asked to buy a number of items you will find it difficult to remember the detail of various items you purchased. Hence, it becomes necessary for you to write them on a piece of paper or a note book. It is still more difficult in case of business which usually involves a large number of transactions. In business you have to buy and sell more frequently. You make payments and receive payments every now and then. It becomes almost impossible to remember all these transactions. So, unless you record them properly you cannot obtain any financial information you need. For example, you cannot easily ascertain the amounts to be received from various customers to whom the goods were sold on credit. You will not know the detail of how much you owe to your suppliers. You may also find it difficult to work out the profit earned or loss incurred during a particular period. It is, therefore, necessary to maintain a proper record of all the transactions which take place from time to time. The recording of business transactions in a systematic manner is the main function served by accounting. Whichever the form of business organisation—a sole proprietorship, a partnership, a company, or a co-operative society—it has to maintain proper accounts. The accounting information is useful both for the management and the outside agencies like tax authorities, banks, creditors etc. The management needs it for purposes of planning, controlling and decision making. The banks and creditors require it for assessing the credit worthiness of the business and the tax authorities use it for determinirig the amount of income tax, sales tax, etc. In fact, accounting is necessary not only for business organisations but also for non-business organisations like schools, colleges, hospitals, clubs etc.

1.2.1 Objectives of Accounting

The objectives of accounting can be stated as follows :

1 To maintain systematic records: Accounting is used to maintain systematic record of all financial transactions like purchase and sale of goods, cash receipts and cash payments, etc. It is also used for recording various assets and liabilities of the business,

2 To ascertain net profit or net loss of the business: A businessman would be interested in periodically finding the net result of his business operations i.e., whether the business has earned profit or incurred some loss. A proper record of all income and expenses helps in preparing a Profit and Loss Account and ascertain the net result of business operations during a particular period.

3 To ascertain the financial position of the business: The businessman is also interested in ascertaining the financial position of his business at the end of a particular period i.e., how much it owns and how much it owes to others. He would also like to know what happened to his capital, whether it has increased or decreased or remained constant. A systematic record of assets and liabilities facilitates the preparation of a position statement called Balance Sheet which provides the necessary information.

4 To provide accounting information to interested parties: Apart from owners there are various parties who are interested in the accounting information. These are: bankers, creditors, tax authorities, prospective investors etc. They need such information to assess the profitability and the financial soundness of the business. The accounting information is communicated to them in the form of an annual report.

1.2.2 Definition and Scope of Accounting

The subject of 'Accounting' has been defined in different ways by different authorities. So, it is very difficult to define the subject through a single definition. However, the following definitions would give a general understanding of the subject.

According to the American Accounting Association "Accounting is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information". This definition stresses three aspects viz., identifying, measuring, and communicating economic information.

In the words of the Committee on Terminology, appointed by the American Institute of Certified Public Accountants, "Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof'. This is a popular definition of accounting and it outlines fully the nature and scope of accounting activity.

You know a business is generally started with the proprietor's funds known as capital. The proprietor may also borrow some funds from hanks end other agencies. These fundb are utilised to acquire the assets needed for the business and also to carry out'various business activities. In the process a number of transactions *take* place. The accountant·has to identify the transactions to be recorded, measure them in terms of money, and record them in appropriate books of account. Then he has to classify them under separate heads of account, prepare a summary in the form of Profit and Loss Account and Balance Sheet, and analyse, interpret and communicate the results to the interested parties. This is the sum and substance of accounting. The scope of accounting can, therefore, be outlined as follows :

1 Accounting is concerned with the transactions and events which are of a financial character. Such transactions have to be identified by the accountant. He can do so with the help of various bills and receipts.

2 Having identified the transactions, they should be measured orpxpressed in terms of money, if not expressed already. Every transaction is recorded in books only in terms of money and not in terms of physical quantities.

3 The transactions which are identified and measured are to be recorded in a book called 'Journal' or in one of its sub-divisions.

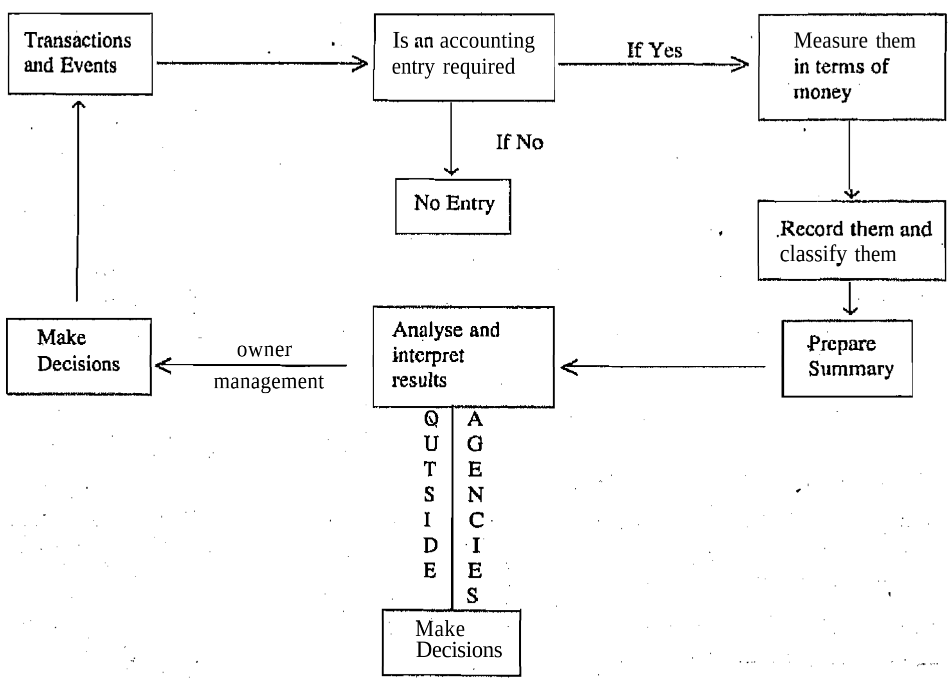
4 The recorded transactions have to be classified with a view to group transactions of similar nature at one place. This work is done in a separate book called 'Ledger'. In the ledger, a separate account is opened for each item so that all transactions relating to it can be brought at one place. For example, salaries paid at different times are brought under 'Salaries Account'.

5 The transactions which are recorded and classified will result in a mass of financial data. It is, therefore, necessary to summarise such data periodically (at least once a year) in a significant and meaningful fonn. This is done in the form of a Profit and Loss Account which reveals profit or loss, and a Balance Sheet which indicates the financial position of the business.

6 The summarised results have to be analysed and interpreted with the help of statistical tools like ratios, averages, etc., and examined critically. Later on, this data will be communicated in the form of reports to the interested parties.

Look at Figure 1.1 and note the activities involved in accounting which starts with identifying the transactions to be recorded and ends with communicating the results to ,owners, management and the other interested parties who use them for decision making.

Figure 1.1: Accounting Activities



1.2.3 Book-keeping, Accounting and Accountancy

According to **G.A.** Lee, the accounting system has following two stages:

i) the making of routine records, in prescribed form and according to set rules, of all events which affect the financial state of the organisation; and

ii) the summarisation from time to time of the information contained in the records, its presentation in a significant form to interested parties, and its interpretation as an aid to decision making by these parties.

Stage (i) is called Book-keeping and stage (ii) is called Accounting.

Book-keeping is thus a narrow term concerned mainly with the maintenance of the books of account and covers the first four activities listed in the scope of accounting **viz.,** identifying the transactions and events to be recorded, measuring them in terms of money, recording them in the books of prime entry, and posting them into ledger. Accounting, on the other hand, is concerned with summarising the recorded data, interpreting the financial results and communicating them to all interested parties. In other words, accounting starts where book-keeping ends. But in practice, the accountants also direct and review the work of book-keepers and therefore the term accounting is generally used in a broader sense covering all the accounting activities, Thus, Book-keeping is regarded as a part of Accounting.

The term 'Accountancy' refers to a systematised knowledge of accounting and is regarded as an academic subject like economics, statistics, chemistry, etc. It explains 'why to do' and 'how to do' of various'aspects of accounting. In other words, while Accounting refers to the actual process of preparing and presenting the accounts, Accountancy tells us why and how to prepare the books of account and how to summarise the accounting information and communicate it to the interested parties. **Thus, Accountancy is a science (a body of systematised knowledge) whereas Accpunting is the art of putting such knowledge into practice.**

In general usage, however, Accountancy and Accounting are used as synonyms (meaning the same thing). But, of late, the term accounting is becoming more and more popular.

1.2.4 Parties Interested in Accounting Information

You have learnt that many people are interested in examining the financial information provided in the form of a Profit and Loss Account and a Balance Sheet. This helps them

a) to study the present position of business,

b) to compare its present performance with that of its past years, and

c) to compare its performance with that of similar enterprises.

Now let us see who such parties are and how accounting information is useful to them.

Owners: Owners contribute capital and assume the risk of business. Naturally, they are interested in knowing the amount of profit earned by the business and so also its financial position. If, however, the management of the business is entrusted to paid managers, the owners also use the accounting information to evaluate the performance of the managers.

Managers: Accounting information is of immense use to managers. It helps them to plan, control and evaluate all business activities. They also need such information for making various decisions.

Lenders: Initially the funds are provided by the owners. But, when the business requires more funds, they are usually provided by banks and other lenders of money. Before lending money they would like to know about the solvency (capacity to repay debts) of the enterprise so as to satisfy themselves that their money will be safe and the repayments will be made on time.

Creditors: Those who supply goods and services on credit are called creditors. Like lenders, they too want to know about credit worthiness of the enterprise. This helps them to determine the limits up to which credit can be granted.

Prospective Investors: A person who wants to become a partner in a firm or a person who wants to become a shareholder of a company, would like to know how safe and rewarding the proposed investment would be.

Tax Authorities: Tax authorities of the Government are interested in the financial statements so as to assess the tax liability of the enterprise.

Employees: The employees of the enterprise are also interested in knowing the state of affairs of the organisation in which they are working, so as to know how safe their interests are in that organisation.

1.2.5 Branches of Accounting

Accounting as we know it today has evolved over many centuries in response to the changing economic, social and political conditions. The economic development and technological improvements have resulted in an increase in the scale of operations and the advent of the company form of business organisation. This has made the management function more and more complex and increased the importance of accounting information. This gave rise to special branches of accounting. These are briefly explained below.

Financial accounting: The purpose of this branch of accounting is to keep a record of all financial transactions so that

a) the profit earned or loss incurred by the business during an accounting period can be worked out,

b) the financial position of the business as at the end of the accounting period can be ascertained, and

c) the financial information required by the management and other interested parties can be provided.

Financial Accounting is mainly confined to the preparation of financial statements and their communication to the interested parties.

Cost Accounting: The purpose of cost accounting is to analyse the expenditure so as to ascertain the cost of various products manufactured by the firm and fix the prices. It also helps in controlling the costs and providing necessary costing information to management for decision making.

Management Accounting: The purpose of management accounting is to assist the management in taking rational policy decisions and to evaluate the impact of its decisions and actions. Examples of such decisions arc: pricing decisions, make or buy decisions, capital expenditure decisions, etc. This branch of accounting is primarily concerned with providing the necessary accounting information about funds, costs, profits, etc., to the management which may help them in such decisions and also in planning and controlling business operations.

1.2.6 Advantages of Accounting

1 **Replaces memory:** Since all the financial events are recorded in the books, there is no need to rely on memory. The books of account will serve as historial records. Any information required at any time can be easily had from these records.

2 **Provides control over assets:** Accounting provides information regarding cash in hand. cash at bank, the stock of goods, the amounts receivable from various parties and the amounts invested in various other assets. Information about such matters help the owners and the management to make use of the assets in the best possible way.

3 **Facilitates the preparation of financial statements:** With the help of information contained in the accounting records the Profit and Loss account and the Balance Sheet can be easily prepared. These financial statements enable the businessman to know the net result of business operations during the accounting period and the financial position of the business as at the end of the accounting period.

4 **Meets the information requirements:** Various interested parties such as owners, lenders, creditors, etc., get the necessary information at frequent intervals which help them in their decision making.

5 **Facilitates a comparative study:** With the help of accounting information one can compare the present performance of the enterprise with that of its past and with that of similar organisations. This enables the management to draw useful conclusions about the business and make efforts to improve the performance.

6 **Assists the management in many other ways:** The accounting information provided to the management helps them in taking rational decisions and in planning and controlling all business activities.

7 **Difficult** to conceal fraud or **theft:** It is difficult to conceal fraud, theft, etc. because of the periodic balancing of books of account. Further, in big organisations the book-keeping work is divided among many persons which minimises the chances for committing fraud.

8 Tax matters: The Government levies various taxes such as customs duty, excise duty, sales tax, and income tax. Properly maintained accounting records will help in the settlement of all tax matters with the tax authorities.

9 Ascertaining value of business: In the event of sale of a business firm, the accounting records will help in ascertaining the correct value of business.

10 Acts as reliable evidence: Systematic record of business transactions is generally treated by courts as good evidence in case of disputes.

1.2.7 Limitations of Accounting

The accounting information is used by various parties who form judgement about the profitability and the financial soundness of a business on the basis of such information. It is, therefore, necessary to know about the limitations of accounting. These are as follows:

1 They do not record transactions and events which are not of a financial character. Hence, they do not reveal a complete picture because facts like quality of human resources, licences possessed, locational advantage, business contacts, etc. do not find any place in books of account.

2 The data is historical in nature. The accountants adopt historical cost as the basis in valuing and reporting all assets and liabilities. They do not reflect current values. It is quite possible that items like land and buildings may have much more value than what is stated in the balance sheet.

3 Facts recorded in financial statements are greatly influenced by accounting conventions and personal judgements. Hence, they do not reveal the true picture. In many cases, estimates may be used to determine the value of various items. For example, debtors are estimated in terms of collectibility, inventories are based on marketability, and fixed assets are based on useful working life. All these estimates are materially affected by personal judgements.

4 Data provided in the financial statements is insufficient for proper analysis and decision making. It only provides information about the overall profitability of the business. No information is given about the cost and profitability of different activities.

Check Your Progress **A**

1 What is Accounting?

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2 List the activities involved in Accounting.

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3 Name the parties interested in accounting information.

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4 State whether each of the following statements is True or False.

i) Accounting is concerned only with the recording of transactions. ....

ii) Accounting records only those transactions which are of a financial character. ....

iii) Book-keeping and Accounting are synonymous terms. ....

iv) Cost Accounting helps in ascertaining and controlling costs. ....

v) Management Accounting provides necessary information to management which helps them in planning, controlling and decision making. ....

vi) The main objective of financial accounting is to ascertain the profit or loss and the financial position of the business. ....

1.3 BASIC ACCOUNTING CONCEPTS

Accounting is a system evolved to achieve a set of objectives as outlined earlier (refer to 1.2.1). In order to achieve these objectives we maintain systematic record of all business transactions and prepare annual reports for the interested parties. Any activity that you perform is facilitated if you have a set of rules to guide you. When you are driving your vehicle you keep to the left. You are in fact following a traffic rule. If drivers do not follow this rule, there will be a chaos on the road. The same thing is true of accounting which has evolved over a period of several centuries. During this period, certain rules and conventions have been adopted which serve as guidelines in identifying the events and transactions to be accounted for, measuring them, recording them in books of account, summarising them, and reporting them to the interested parties. These rules and conventions are termed as 'Generally Accepted Accounting Principles'. To explain these principles, the writers have used a variety of terms such as concepts, postulates, conventions, underlying principles, basic assumptions, etc. The same rule may be described by one author as a concept, by another as a postulate and still by another as a convention. This often confuses the learners. Hence, it is better to call all rules and conventions which guide accounting activity and practice as 'Basic Accounting Concepts' These are the fundamental ideas or basic assumptions underlying the theory and practice of financial accounting and are the broad working rules for all accounting activities developed and accepted by the accounting profession. This brings about uniformity in the practice of accounting.

These concepts can be classified into two broad groups as follows :

i) concepts to be observed at the recording stage i.e., while recording the transactions, and

ii) concepts to be observed at the reporting stage i.e., at the time of preparing the final accounts.

It must however be remembered that some of them are overlapping and even contradictory.

1.3.1 Concepts to be observed at the recording stage

The concepts which guide us in identifying, measuring and recording the transactions are :

1 Business Entity Concept

2 Money Measurement Concept

3 Objective Evidence Concept

4 Historical Record Concept

5 Cost Concept

6 Dual Aspect Concept

Let us take them one by one and learn the accounting implications of each concept.

Business Entity Concept: Business entity means a unit of organised business activity. In that sense, a provision store, a cloth dealer, an industrial establishment, an electricity supply undertaking, a bank, a school, a hospital, etc. are all business entities.

From the accounting point of view every business enterprise is an entity separate and distinct from its proprietor(s)/owner(s). The accounting system gives information only about the business and not its owner(s). In other words, we record those transactions in the books of account which relate only to the business. The owner's personal affairs (his expenditure on housing, food, clothing, etc.) will not appear in the books of accounr of his business. However, when personal expenditure of the owner is met from business funds it shall also be recorded in the business books. It will be recorded as drawings by the proprietor and not as business expenditure.

Another implication of business entity concept is that the owner of a business is to be treated as a creditor who also has a claim over the assets of the business. As such, the amount invested by him (capital) is regarded as a liability for the business.

The business entity concept is applicable to all forms of business organisations. This distinction can be easily maintained in the case of a limited company because the company has a legal entity of its own. But such distinction becomes difficult in case of a sole proprietorship or partnership, because in the eyes of the law the partner or the sole proprietor are not considered separate entities. They are personally liable for all business transactions. Eut for accounting purposes, they are to be treated as separate entities. This enables them to ascertain the profit or loss of business more conveniently and accurately.

Money Measurement Concept: Usually, business deals in a variety of items having different physical units such as kilograms, quintals, tons, metres, litres, etc. If the sales and purchases of different items are recorded in tenns of their physical units, adding them together will pose problotns. But, if these are recorded in a common denomination, their total becomes homogeneous and meaningful. Therefore, we need a common unit of measurement. Money does this function. It is adopted as the common measuring unit for the purpose of accounting. All recording, therefore, is done in terms of the standard currency of the country where business is set up. For example, in India it is done in terms of Rupees, in USA it is clone in terms of US Dollars, and so on.

Another implication of rnoney measurement concept is that only those transactions and events are to be recorded in the books of account which can be expressed in terms of money such as purchases, sales, payment of salaries, goods lost in accident, etc. Other happenings (non-monetary) like death of an efficient manages or the appointment of an accountant, howsoever important they may be, are not recorded in the books of account. This is because their effect is not measurable or quantifiable in terms of money.

This approach has its own drawbacks. The value of money changes over a period of time. The value of rupee today is much less than what it was in 1961. Such a change is nowhere reflected in accounts. That is why the accounting data does not reflect the true and fair view of the affairs of the business.

Hence, now-a-days, it is considered desirable to provide additional data showing the effect of changes in the price level on the reported income and the assets and liabilities of the business.

Objective Evidence Concept: The term objectivity refers to being free from bias or free from subjectivity. Accounting measurements are to be unbiased and verifiable independently. For this purpose, all accounting transactions should be evidenced and supported by documents such as invoices, receipts, cash memos, etc. These supporting documents (vouchers) form the basis for making entries in the books of account and for their verification by auditors afterwards. AS for the items like depreciation and the provision for doubtful debts where no documentary evidence is available, the policy statements made by management are treated as the necessary evidence.

Historical **Record** Concept: You know that after identifying the transactions and measuring them in terms of money we record them in the books of account. According to the historical record concept, we record only those transactions which have actually taken place and not those which may take place (future transactions). It is because accounting record presupposes that the transactions are to be identified and objectively evidenced. This is possible only in the case of past (actually happened) transactions. The future transactions can hardly be identified and measured accurately. You also know that all transactions are to be recorded in chronological (datewise) order. This leads to the preparation of a historical record of all transactions. It also implies that we simply record the facts and nothing else.

As you will study later, we also make provision for some expected losses such as doubtful debts. This may be contrary to what is stated in historical record concept. But this is done only at the time of ascertaining the profit or loss of the business. It is not a routine item. This is done in accordance with another concept called Conservatism Concept about which you will study later.

Cost Concept: Business activity, in essence, is an exchange of money. The price paid (or agreed to be paid in case of a credit transaction) at the time of purchase is called cost. According to the cost concept, all assets are recorded in books at their original purchase price. This cost also forms an appropriate basis for all subsequent accounting for the assets. For example, if the business buys a machine for Rs. 80,000 it would be recorded in books at Rs. 80,000. In case its market value increases to Rs. 1,00,000 later on (or decreases to Rs. 50,000) it will continue to be shown at Rs. 80,000 and not at its market value.

This does not mean, however, that the asset will always be shown at cost. You know that with passage of time the value of an asset decreases. Hence, it may systematically be reduced from year to year by charging depreciation and the asset be shown in the balance sheet at the depreciated value. The depreciation is usually charged as a fixed percentage of cost. It bears no relationship with changes in its market value. In other words, the value at which the assets are shown in the balance sheet has no relevance to its market value. This, no doubt, makes it difficult to assess the true financial position of the business and is therefore regarded as an important limitation of the cost concept. But this approach is preferred because, firstly it is difficult and time consuming to ascertain the market values, and secondly there will be too much of subjectivity in assessing the current values. However, this limitation has been overcome with the help of inflation accounting.

Dual Aspect Concept: This is a basic concept of accounting. According to this concept every business transaction has a two-fold effect. In commercial context it is a famous dictum that "every receiver is also a giver and every giver is also a receiver". For example, if you purchase a machine for Rs. 8,000, you receive machine on the one hand and give Rs. 8,000 on the other. Thus, this transaction has a two-fold effect i.e., (i) increase in one asset and (ii) decrease in another asset. Similarly, if you buy goods worth Rs. 500 on credit, it will increase an asset (stock of goods) on the one hand and increase a liability (creditors) on the other. Thus, every business transaction involves two aspects: (i) the receiving aspect, and (ii) the giving aspect, In case of the first example you find that the receiving aspect is machinery and the giving aspect is cash. In the second example the receiving aspect is goods and the giving aspect is the creditor. If complete record of transactions is to be made, it would be necessary to record both the aspects in books of account. This principle is the core of double entry book-keeping and if this is strictly followed, it is called 'Double Entry System of Book-keeping' about which you will learn in detail later.

Let us understand another accounting implication of the dual aspect concept. To start with, the initial funds (capital) required by the business are contributed by the owner. If necessary, additional funds are provided by the outsiders (creditors). As per the dual aspect concept all these receipts create corresponding obligations for their repayment. In other words, a contribution to the business, either in cash or kind, not only increases its resources (assets), but also its obligations (liabilities/equities) correspondingly. Thus, at any given point of time, the total assets and the total liabilities must be equal.

This equality is called 'balance sheet equation' or 'accounting equation'. It is stated as under :

$$\text{Liabilities (Equities)} = \text{Assets}$$
or
$$\text{Capital} + \text{Outside Liabilities} = \text{Assets}$$

The term 'assets' denotes the resources (property) owned by the business while the term 'equities' denotes the claims of various parties against the business assets. Equities are of two types: (i) owners' equity, and (ii) outsiders' equity. Owners' equity called capital is the claim of the owners against the assets of the business. Outsiders' equ'ity called liabilities is the claim of outside parties like creditors, bank, etc. against the assets of the business. Thus, all assets of the business are claimed either by the owners or by the outsiders, Hence, the total assets of a business will always be equal to its liabilities.

When various business transactions take place, they effect the assets and liabilities in such a 'way that this equality is always maintained. Let us take a few transactions and see how this equality is maintained.

1 Mr. **Gyan Chand** started business **with Rs.** 50,000 **cash:** The cash received by the business is its asset. According to the business entity concept, business and the owner are two separate entities. Hence, the capital contributed by Mr. Gyan Chand is a liability to the business. Thus :

Capital = Assets
Rs. 50,000 = Rs. 50,000 (cash)

2 He purchased goods on credit from Chakravarty **for** Rs. **5,000:** This increases an asset (stock of goods) on the one hand and a liability (creditors) on the other. Now the equation will be :

Capital + Liabilities = Assets
Rs. 50,000 + Rs. 5,000 = Rs. 5,000 + Rs. 50,000
Capital Creditors Stock Cash

3 He purchased furniture worth Rs. **10,000** and paid cash: This increases one asset (furniture) and decreases another asset (cash). Now the equation will be :

Capital t Liabilities = Assets
Rs. 50,000 + Rs. 5,000 = Rs. 10,000 + Rs. 5,000 + Rs. 40.000
Capital Creditors Furniture Stock Cash

This equation can be presented in the form of a Balance Sheet (a statement of assets and liabilities) as follows :

Gyan Chand's Balance Sheet

Capital nnd Liabilities	**Rs.**	**Assets**	**Rs.**
Capital	50,000	Furniture	10,000
Creditors		Stock of goods	5,000
(Mr. Chakravarty)	5,000	Cash	40,000
	55,000		55,000

Note that the totals on both sides of the Balance Sheet are equal. This equality remains valid irrespective of the number of transactions and the items affected thereby. It is so because of their dual effect on the assets and liabilities of the business.

1.3.2 Concepts to be observed at the reporting stage

The following concepts have to be kept in mind while preparing the final accounts.

1 Going Concern Concept
2 Accounting Period Concept
3 Matching Concept
4 Conservatism Concept
5 Consistency Concept
6 Full disclosure Concept
7 Materiality Concept

You will learn about these concepts in Unit 6.

Check Your Progress B

1 What do you understand by business entity concept?

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2 Fill in the blanks.

i) Basic accounting concepts are broad .... for the accounting activity.

ii) According to the business entity concept the owner's capital in business is to be treated as a .... for the business.

iii) Every business pansaction has a dual effect on assets and .... of the business.

iv) An asset is recorded in books of account at ....

v) The system of recording transactions based on dual aspect concept is called ....

3' Mr. Radhey Lal has a shoe factory. A few transactions and events are given below. State which of these will be recorded in the books of his business.

i) Purchased a machine for the factory.

ii) A pair of shoes taken home for his'son.

iii) Appointed Ganesh as an assistant accountant.

iv) Borrowed Rs. 8,000 from Saraf for the business.

v) He paid salary to his domestic servant.

vi) The production manager went on medical leave.

vii) He paid wages for the month of May to factory workers.

viii) Appointed Ballu Shoe & Co. as dealers for the town.

4 Show the dual effect of the following transactions on assets and liabilities of the business.

i) Purchased goods for cash for Rs. 8,000.

ii) Purchased a delivery van on credit for Rs. 40,000.

iii) Paid Rs. 5,000 to a creditor.

iv) The proprietor took Rs. 2,000 from the business for personal expenses.

5 Find out the missing amounts on the basis of the accounting equation.

i) Capital Rs. 40,000 + Liabilities Rs. 15,000 = Assets Rs. ....

ii) Capital Rs. 65,000 + Liabilities Rs. .... = Assets Rs. 80,000

iii) Capital Rs.......... + Liabilities Rs. 30,000 = Assets Rs. 90,000.

1.4 SYSTEMS OF BOOK-KEEPING

Book-keeping as explained earlier is the art of recording business transactions in a systematic manner. Broadly, there are two systems of book-keeping: (i) Double Entry System, and (ii) Single Entry System.

1.4.1 Double Entry System

Under the dual aspect concept you learnt that every business transaction has two aspects: (i) the receiving aspect, and (ii) the giving aspect. For example, when you purchase goods for cash, goods come in arid cash goes out. Thus, a transaction affects two items (also called accounts) at the same time. When you record the transactions in the books of account of a business, it would be better if you record the effects relating to both the items. In the above example the items affected are goods and cash, stock of goods increases and cash decreases. So, we should record the increase in stock of goods and also the decrease in cash. This involves two entries, one in Goods Account and the other in Cash Account. This method of recording business transactions is called 'Double Entry System'. It recognises and records both the aspects of every transactions. According to this system the account which involves receiving aspect is debited and the account which involves giving aspect is credited. Thus, for every debit there will be an equivalent credit. For this purpose certain rules have been framed. These are discussed in detail later in this unit.

The advantages of Double Entry System are as follows :

1 It provides complete and reliable record of all business transactions because it records both the aspects.

2 It supplies full information about the incomes, expenses, assets and liabilities of the business. This helps the management in taking appropriate decisions.

3 The arithmetical accuracy of the books of account can be easily verified by preparing a trial balance.

4 The financial result of business organisations i.e., profit or loss, can be correctly ascertained.

5 The financial position of the business can also be ascertained at any point of time.

1.4.2 Single Entry System

Single Entry System does not mean that only one aspect of a transaction is recorded. It simply refers to incomplele records or the defective double entry system. Under this system neither all the transactions are recorded nor all the account books are maintained. In certain cases the two aspects of a transaction are duly recorded while in others only one aspect is recorded. Sotne transactions are simply ignored, they are not recorded at all. The Single Entry System is thus a mixture of double entry, single entry and no entry. The accounts maintained under this system are incomplete and unsystematic and, therefore, not reliable. The main defect in this system is that the arithmetical accuracy of the books of account cannot be checked, because a trial balance cannot be prepared. It also becomes difficult to ascertain the correct amount of profit or Ioss. This system is normally followed by small business firms. You will learn more about it in Unit 15.

1.5 WHAT IS AN ACCOUNT ?

You have learnt that every business transaction has dual effect and that under Double Entry System entries are made in both the accounts affected. You also learnt that the account which involves receiving aspect is debited and the account which involves giving aspect is credited. In order to understand the rules of debit and credit you must know more about the term 'account'. An account is a summarised record of all transactions relating to a particular person, a thing, or an item of income or expense. It is vertically divided into two halves and resembles the shape of the English alphabet 'T' as under :

Name of the account

Dr. Cr.

The left hand side is called the 'debit side'. It is indicated by 'Dr.' (abbreviation for debit) on the left hand top corner of the account. The right hand side, known as the 'credit side', is indicnted by 'Cr.' (abbreviation for credit) on the right hand top comer of the account. The name of the account is written at the top in the centre. The ward 'Account' or its abbreviadon 'A/c' is added to the name of the account. For example, if the account is related to machinery, it is written as 'Machinery Account'.

1.6 CLASSIFICATION OF ACCOUNTS

All business transactions are broadly classified into three categories: (i) those relating to persons, (ii) those relating to property (assets), and (iii) those relating to incomes and expenses. Thus, three classes of accounts are maintained for recording all business transactions. They are: (i) Personal Accounts (ii) Real Accounts, and (iii) Nominal Accounts. Real and Nominal Accounts taken together are called Impersonal Accounts.

Personal **Accounts:** Accounts which show transactions with persons are called 'Personal Accounts'. A separate account is kept in the name of each person for recording the benefit! received from, or given to, the person in the course of dealings with **him.** Examples are: Krishna's Account, Gopal's Account, Loan from Ratanlal's Account, etc.

Personal accounts also include accounts in the names of firms, companies or institutions such as **Hiralal** & **Sons'** Account, Nagarjuna Finance Limited Account, The Andhra Bank Account, etc.

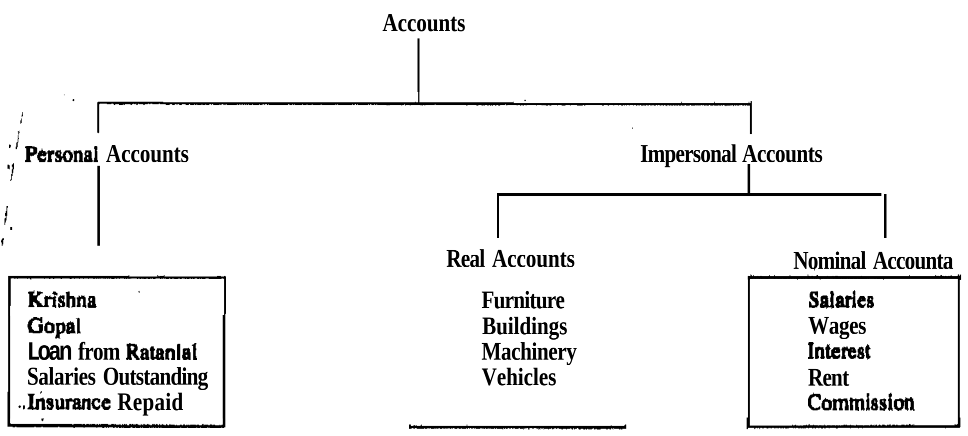
'The accounts which represent expenses payable, expenses paid in advance, incomes receivable, and incomes received in advance are also personal accounts, though impersonal in name. For example, the salaries due to employees, which have not been paid before closing of the books of account for the year, aie recorded in 'Salaries Outstanding Account'. It is regarded as a personal account because it represents the employees to whom salaries are payable by the business. Such a personal account is called 'Representative Personal Account'. Other examples of representative personal accounts are: Interest Outstanding Account, Prepaid Insurance Account, Rent Received in Advance Account, etc. Capital Account and Drawings Account are also treated as personal accounts as they show dealings with the owner of the business.

Real Accounts: Accounts relating to properties or assets are known as 'Real Accounts'. Every business needs assets such as machinery, furniture, etc. for running its activities. A separate account is maintained for each asset owned by the business. All transactions relating to a particular asset are recorded in the concerned asset account. Cash Account, Fumiture Account, Machinery Account, Building Account, etc., are some examples of real accounts. They are known as real accounts because they represent things of value owned by the business.

Nominal Accounts: Accounts relating to expenses, losses, incomes and gains are known as 'Nominal Accounts'. A separate account is maintained for each item of expense, loss; income or gain. Wages Account, Salaries Account, Commission Received Account, and Interest Received Account are some examples of nominal accounts.

Classification of accounts is presented in Figure 1.2

Figure 1.2: Classification of Accounts



1.7 RULES OF DEBIT AND CREDIT

You have learnt that every transaction affects two accounts and according to Double Entty System, entries have to be made in both the accounts. Before recording a transaction, therefore, it is necessary to find out which of the two accounts is to be debited and which is to be credited. The general rule, as stated earlier, is to debit the account which involves a receiving aspect and credit the account which involves a giving aspect. But, for convenience, three different rules have been laid down for the three classes of accounts. These are as follows:

1 For Personal Accounts: The account of the person receiving benefit (receiver) of the transaction (from the business) is debited and the account of the person giving the benefit (giver) of the transaction (to the business) is credited. Thus, the rule is 'debit the **receiver** and **credit** the **'giver'.**

2 For Real Accounts: When an asset is coming into the business, the accdunt of that asset is debited. When an asset is going out of the business, the account of that asset is, credited. Thus, the rule is **'debit what comes in and credit what goes out'.**

3 For Nominal Accounts: When an expense is incurred or loss suffered, the account representing the expense or the loss is debited because the business receives the benefit thereof. When any income is earned or gain made, the account representing the income or the gain is credited. This is because the business gives some benefit. Thus, the rule is 'debit all **expenses** and **losses** and credit all **incomes** and **gains'.**

We shall now see the application of these rules, taking a few transactions.

Example 1 : Paid cash to Ramesh & Co. Rs. 5,000.
la this case the two accounts affected are Ramesh & Co.'s Account and Cash Account. Ramesh & Co.'s Account is a personal account and Cash Account is a real account. Ramesh & Co. has received the benefit (cash Rs. 5,000) from the business and, therefore, it has to be debited as per the first part of the rule for personal accounts 'debit the receiver'. As cash has gone out, Cash Account will be credited according to the second part of the rule for real accounts 'credit what goes out'.

Example 2: Received sash from Ajay Rs. 1,000.
In this case Cash Account and Ajay's Account are the two accounts affected. Cash Account is a real account and Ajay's account is a personal account. As cash has come in, Cash Account will have to be debited according to the first part of the rule for real accounts 'debit what comes in'. Ajay has given the benefit (cash Rs. 5,000) to the business and, therefore, his account will liave to be credited as per the second part of the rule for personal accounts 'credit the giver'.

Example 3: Paid rent **Rs.** 1,000.
In this case, the accounts affected are Rent Account and Cash Account. Rent Account is a nominal account and Cash Account is a red account. As per the first part of the rule for nominal accounts 'debit expenses and losses', Rent Account will have to be debited as it is an expense to the business. As cash has gone out, Cash Account will have to be credited according to the second part of the rule for real accounts 'credit what goes out'.

Example 4: Received Rs. 400 as **commission.**
In this case, Cash Account and Commission Account are the two accounts affected. Cash Account is a real account and Commission Account is a nominal account. As cash has come in, Cash Account will liave to be debited according to the first part of the rule for real accounts 'debit what cotnes in'. As per second part of the rule for nominal accounts, 'credit incomes and gains', Commission Account will be credited as it is an income to the business.

You have seen that the three rules of debit and credit as explained above, make it convenient for you to analyse the transactions and identify the accounts to be debited and credited.

Check Your Progress C

1 State whether each of eke statements is True or False.

i) An Account is a summarised record of 211 transactions relating to a particular person'or an item. ....

ii) Right hand side of an account is called debit side. ....

iii) Account which represents an item of asset is called representative personal account. ....

ivj Accounts relating to assets held in the name of the firm are called nominal accounts. ....

v) Capital Account is a personal acccunt. ....

vi) Goodwill Account is a personal account. ....

2 Names of some accounts are given below. Classify them into Personal, Real or Nominal.

Name of Account	Class of Account
i) Bank A/c	....
ii) Interest A/c	....
iii) Interest outstanding A/c	....
iv) Patents A/c	....
v) Loan from Gopaldas A/c	....
vi) Loose Tools A/c	....
vii) Commission Received in Advance A/c	....
viii) Prepaid Salaries A/c	....
ix) Stationery and Printing A/c	....
x) Electricity Charges A/c	....

3 From the following transactions determine the accounts affected, classify them and state whether they are to be debited or credited; ---

		Rs.
i)	Purchased typewriter for cash	5,000
ii)	Purchased furniture from R & Co. on credit	50,000
iii)	Interest received	300
iv)	Paid wages	800
v)	Received cash from A	2,000
vi)	Additional capital introduced into the business	5,000
vii)	Paid cash to B	1,500
viii)	Paid carriage	200
ix)	Purchased goods from F & Co. on credit	12,000
x)	Sold goods for cash	1,400

1.8 ACCOUNTING PROCESS

The accounting process consists of the following four stages:

i) Recording the Transactions

ii) Classifying the Transactions

iii) Summarising the Transactions

iv) Interpreting the Results

Let us now briefly discuss these stages.

Recording the Transactions: The accounting process begins with recording of all transactions in the book of original entry. This book is called 'Journal'. All transactions are recorded in the Journal in a chronological order (datewise) with the help of various vouchers such as cash memos, cash receipts, invoices, etc.

Classifying the Transactions: The second stage consists of grouping the transactions of similar nature and posting them to the concerned accounts in another book called 'Ledger'. For example, all transactions related to cash me posted to Cash Account and the transactions related to different persons are entered separately in the account of each person. The objective of classifying the transactions in this manner is to ascertain the combined effect of all transactions of a given period in respect of each account, For this purpose, all accounts are balanced periodically.

Summarising the Transactions: The next step is to prepare a year-end summary known as 'Final Accounts'. But before preparing the final accounts, we prepare a statement called Trial Balance in order to check the arithmetical accuracy of the books of account. If the Trial Balance tallies, it means that the transactions have been currently recorded and posted into ledger. Then, with the help of the Trial Balance and some other relevant information we prepare the final accounts. The objectives of preparing the final accounts are (i) to know the net result of business activities, and (ii) to ascertain the financial position of the business. The final account consists of an income statement called 'Trading and Profit land Loss Account' and a position statement called 'Balance Sheet'. The Trading and Profit and Loss Account gives us the information about the amount of profit made or the loss incurred during the year and the Balance Sheet shows the position of assets and liabilities of the business as at the end of the year.

Interpreting the Results: The last stage consists of analysing and interpreting the results shown by the final accounts. This involves computation of various accounting ratios to assess the liquidity, solvency, and profitability of the business. Such analysis is meant for interested parties like management, investors, bankers, creditors, etc. The balances on various accounts appearing in the Balance Sheet will then be transferred to the new books of account for the next year, Thereafter the process of recording transactions for the next year starts again.

1.9 LET US SUM UP

In business a number of transactions take place every day. It is not possible to remember all of them. Hence the need to record them. The recording of business transactions in a systematic manner is the main function served by accounting. It enables us to ascertain the profit and loss and the financial positions of the business. It also provides the necessary financial information to all interested parties.

Accounting is the process of identifying, measuring, recording, classifying and summarising the transactions, and analysing, interpreting and communicating the results thereof. The accounting system has two stages: (i) Book-keeping, and (ii) Accounting. Book-keeping is mainly concerned with the maintenance of books of account, while accounting is concerned with summarising the recorded data, interpreting the financial results and communicating them to all interested parties. Changes in economic environment and increasing complexity of management have given rise to the specialised branches of accounting such as financial accounting, cost accounting and management accounting,

The accountants, over a period of time, have developed certain guidelines for all accounting work. These are called basic concepts of accounting. Certain concepts are to be observed at the time of recording the transactions, while others are relevant at the summarising and reporting stages. The concepts to be observed at the recording stage are business entity, money measurement, objective evidence, historical record, cost and the dual aspect concepts.

According to Dual Aspect concept every business transaction involves two aspects (i) the receiving aspect, and (ii) the giving aspect. Under 'Double Entry System' both the aspects must be recorded in books of account. As per rules the receiving aspect is recorded on the debit side of account affected by transaction and giving aspect on the credit side of the account affected, For convenience, accounts have been classified into personal, real and nominal accounts and separate rules have been framed for debiting and crediting different classes of accounts. These are called Rules of Debit and Credit.

The accounting process is divided into four stages: (i) recording the transactions in the books of original entry, (ii) classifying the transactions, (iii) summarising the transactions, and (iv) Interpreting the results.

1.10 KEY WORDS

Account! A summarised statement of transactions relating to a particular person, thing expense or income,

Accounting Period: **A** period of twelve months for which the accounts are usually kept.

Asset: Anything having an economic value, a ptoperty.

Balance Sheet: A statement of assets and liabilities as at the end of an accounting period.

Books of **Account:** Books in the form of bound registers or loose sheets wherein transactions are recorded.

Business: Any activity carried on with profit motive.

Business Unit: A unit formed for the purpose of carrying on some kind of business activity.

Capital: Owner's investment and equity in the business.

Company: An association of persons registered under the Companies Act.

Credit: **It** represents the giving aspect of a transaction.

Creditor: **A** person to whom the business owes.

Debit: It represents the receiving aspect of a transaction.

Debtor! **A** peraon owing to the business.

Expenditure: Spending of money or incurring a liability for some benefit, service or asset received by the business.

Expense: An expenditure incurred for some benefit or service.

Equity: A claim or right over the business. It includes both the owners' and creditors' claims.

Financial **Position:** Position of assets and liabilities of a business at a given point of time.

Financial Statement: Summary of accounting information such as Profit and Loss Account and Balance Sheet prepared at the end of an accounting period. These are also called Final Accounts.

Income: Amount earned through business operations.

Liability: Amount owed by the business to outsiders.

Nominal Accounts: Accounts relating to incomes and expenses.

Partnership Firm: A business unit owned by two or more persons who have agreed to share the profits of the business carried on by all or any of them acting for all.

Personal Accounts: Accounts relating to persons, firms and institutions.

Profit: Excess of income over expenses during a given period.

Profit and Loss Account: An account showing profit or loss of the business during an accounting period.

Real Accounts: Accounts relating to the properties of business.

Sole Proprietorsliip: A business unit owned by one person.

Transaction: Transfer of money or money's worth between the two business units.

1.11 SOME USEFUL BOOKS

1 Harold Bierman Jr. and Allan R. Drebin, 1978: *Financial Accounting,* An *Introduction,* W.B. Saunders Company, Philadelphion, London. (Chapters 1-3)

2 Maheshwari, S.N., 1986. ***Introduction to Accounting,*** Vikas Publishing House: New Delhi. (Chapters 1, 2)

3 Patil, V.A. and J.S. Korlahalli, 1986. ***Principles and Practice of Accounting, R.*** Chand & Co., New Delhi. (Chapters 1-3)

4 Gupta, R.L. and M. Radhaswarny, 1986. ***Advanced Accountancy,*** Sultan Chand & Sons: New Delhi. (Chapter 1, 2)

1.12 ANSWERS TO CHECK YOUR PROGRESS

A. 4 i) False ii) True iii) False iv) True v) True vi) True

B. 2 i) Working rules ii) liability iii) liabilities iv) cost v) Double Entry System

3 i, ii, iv, and vii will be recorded in books of his business.

4 i) Stock of goods increases, cash decreases

ii) An asset increases, creditors increase

iii) Creditors decrease, cash decreases

v) Capital decreases, cash decreases

5 i) Rs. 55,000

ii) Rs. 15,000

iii) Rs, 60,000

C. 1 i) True ii) False iii) False iv) False v) True vi) False

2 i) Personal ii) Nominal iii) Personal iv) Real v) Personal vi) Real vii) Personal viii) Personal ix) Nominal. x) Nominal

Transaction	Account to be debited	Nature of account	Account to be credited	Nature of account
i)	Typewriter A/c	Real	Cash A/c	Real
ii)	Furniture A/c	Real	R & Co. A/c	Personal
iii)	Cash A/c	Real	Interest A/c	Nominal
iv)	Wages A/c	Nominal	Cash A/c	Real
v)	Cash A/c	Real	A's A/c	Personal
vi)	Cash A/c	Real	Capital A/c	Personal
vii)	B's A/c	Personal	Cash A/c	Real
viii)	Carriage A/c	Nominal	Cash A/c	Real
ix)	Goods A/c	Real	F & Co. A/c	Personal
x)	Cash A/c	Real	Goods A/c	Real

1.13 TERMINAL QUESTIONS

1 **Define** Accounting and explain its scope.

2 What are the objectives of Accounting? Name the different parties interested in accounting information and state why they want it.

3 Write notes on:

a) Advantages of Accounting

b) Branches of Accounting

c) Accounting Process

d) Types of Accounts

4 **Briefly** explain the accounting concepts which guide the accountant at the recording stage.

5 What do you understand by Dual Aspect Concept? Explain its accounting implications.

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 2 THE ACCOUNTING PROCESS

Structure

2.0 OBJECTIVES

After studying this unit you should be able to:

- explain what a journal is
- describe how different, types of transactions will he recorded in the journal
- post journal entries in the concerned ledger accounts
- balance a ledger account and explain the significance of balances in different types of accounts
- prepare a trial balance to test the arithmetical accuracy of recording in the books of account
- explain what an opening entry is and how it is posted into ledger

2.1 INTRODUCTION

In Unit 1 you learnt that the accounting process involves four stages: (i) recording the transactions, (ii) classifying the transactions, (iii) summarising the transactions, and (iv) interpreting the results. Thus, you are aware that all transactions are recorded first in the books of original entry viz., Journal, and then posted into the concerned accounts in the ledger. You have also learnt the basic accounting concepts to be observed at the recording stage and the rules of debit and credit. With the help of these rules we shall discuss in this unit how various transactions are recorded in the Journal and how they will be posted into the concerned ledger accounts. We shall also explain how to balance different accounts and prepare a Trial Balance in order to test the arithmetical accuracy of the books of account.

2.2 JOURNAL

Journal is a daily record of business transactions. It is also called a 'Day Book' and is used for recording all day to day transactions in the order in which they occur. It is a book of prime entry (also called book of original entry) because all transactions are recorded first in this book. The process of recording a transaction in the journal is called 'Journalising' and the entries made in this book are called 'Journal Entries'. The proforma of Journal is given in Figure 2.1.

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Figure 2.1: Journal

Date	Particulars	L. F.	Dr. Amount	Cr. Amount
			Rs.	Rs.

The Journal is divided into five columns. The first column is used for writing the date of the transaction. It is customary to write the year at the top of the column only once and then in the next line the month and date are written.

The second column called 'Particulars' column, The names of the two accounts affected by the transaction are to be recorded in this'column. The name of the account to be debited is written first. The abbreviation 'Dr.' for debit is also written against the name of the account to be debited. It is written on the same line very close to the L. F. column. In the next line, the name of the account to be credited is written. It is always preceded by the word 'To'. It is not necessary to write 'Cr.' against the name of the account to be credited. In the next line, a brief description of the transaction is also given within brackets. It is called 'Narration'. After writing the narration a line is drawn in the particulars column to separate one entry from the other.

The third column L. F. (Ledger Folio) is meant for writing the page number of the ledger where the concerned account appears. This column is filled at the time of posting into the ledger. The fourth and the fifth columns are meant for recording the amounts with which the two accounts have been affected, The amount to be debited is entered in the debit amount column against the name of the account debited, and the amount to be credited is entered in the credit amount column against the name of the account credited. Both the amounts will always be equal.

Let us take a transaction and see how it will be recorded in the Journal.

Purchased Machinery for Rs.10,000 on May 1,1988

In this transaction, the two accounts affected are Machinery Account and Cash Account. You know both are real accounts. According to rules relating to real accounts, the Machinery Account is to be debited and the Cash Account is to be credited. The entry will be made in the Journal as follows

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1988			Rs.	Rs.
May 1	**Machinery Account Dr.**	**22***	**10,000**	
	To Cash Account			**10,000**
	(Being machinery purchased)			

*Imaginary figure.

2.2.1 Transactions Relating to Goods

The term goods refer to articles which are traded by the firm **i.e.,** articles bought for resale. For example, for a book-seller books are goods, for an electrical store fans and other electrical items are goods, for a furniture dealer table and chairs are goods. Articles bought for using them in business are not to be treated as goods. They may be fixed assets or consumables and are to be treated as such in books of account.

The transactions relating to goods include purchases, sales, purchases returns and sales returns. Normally, as per rules, when goods are bought you will debit the Goods Account and when they are sold you will credit the Goods Account. Similarly, when goods are returned by your customer you will debit the Goods Account and when you return goods to the suppliers, you will credit the Goods Account. In other words, for all transaction relating to goods you will maintain only one account viz., Goods Account. **But, in practice, five separate account are maintained, as shown below:**

i) Purchases Account—for recording all purchases of goods

ii) Sales Account—for recording all sales of goods

iii) Returns Onwards Account or Purchases Returns Account—for recording goods returned to suppliers

iv) Returns Inwards Account or Sales Returns Account—For recording goods returned by customers

v) Stock Account—for goods in stock (unsold goods) as at the end of the year

Thus, when goods are purchased you will debit the Purchases Account and when they are sold you will credit the Sales Account. Similarly, when goods are returned by your customers you will debit the Returns Inwards Account (or Sales Returns Account) and when you return goods to the suppliers you will credit Returns Outwards Account (or Purchases Returns Account). There will be no Goods Account at all. This helps in ascertaining the amount of purchases and sales more quickly and correctly.

2.2.2 Receipts and Payments by Cheque

You must be aware that most of the payments in business are made by cheques these days. This involves the bank where the firm has opened its account. Hence, when payment is made by cheque, you will credit the Bank Account because bank is the giver. Similarly, when payment is received by cheque, the amount will be debited to the Bank Account because cheque is deposited in the bank who is the receiver.

2.2.3 Transactions with the Proprietor

You have learnt that the business and its proprietor are treated as separate entities. This implies that separate accounts must be maintained in the ledger for recording transactions between the proprietor and the business. Usually, two accounts viz., Capital Account and Drawings Account are maintained for this purpose. Whatever the proprietor brings into the business is treated as his capital and credited to his Capital Account. Similarly, when he withdraws cash from the business for his personal use, he is to be debited with the amount withdrawn by him. Such a debit is given to his Drawings Account. Drawings Account is also debited when the proprietor takes goods from business for domestic use. Note that the proprietor can be charged only by the cost of goods taken and not its selling price. In practice, the cost of such goods are credited to the Purchases Account because it is assumed that it was purchased for him and should therefore be excluded from the purchases for the business.

Look at Illustration 1 and study how various transactions are recorded in the Journal.

Illustration 1

Journalise the following transactions in the journal of Krishna.

1988			Rs.
Jan.	1	Commenced business with cash	10,000
"	2	Paid into Canara Bank	1,000
"	4	Goods purchased for cash	2,000
"	6	Bought furniture and paid by cheque	500
"	9	Bought goods from Anand	5,000
"	10	Sold gbods for cash	4,000
"	16	Sold goods to Sunil	1,000
"	20	Sold goods for cash to Anil	1,500
"	29	Drew cash for private expenses.	500
"	31	Paid salaries	300

Solution:

JOURNAL

Date	Particulars	L. F.	Dr. Amount	Cr. Amount
1988			Rs.	Rs.
Jan. 1	Cash Account Dr. To Capital Account (Being capital brought in)		10,000	 10,000
" 2	Bank Account Dr. To Cash Account (Being cash deposited into bank)		1,000	 1,000

Date	Particulars		L. F.	Dr. Amount	Cr. Amount
1988				Rs.	Rs.
Jan, 4	Purchases Account To Cash Account (Being purchases of goods for cash)	Dr.		2,000	2,000
" 6	Furniture Account To Bank Account (Being furniture purchased nnd paid by cheque)	Dr.		500	500
" 9	Purchases Account To Anand's Account (Being goods bought on credit)	Dr.		5,000	5,000
" 10	Cash Account To Sales Account (Being goods sold for cash)	Dr.		4,000	4,000
" 16	Sunil's Account To Sales Account (Being goods sold on credit)	Dr.		1,000	1,000
" 20	Cash Account To Sales Account (Being goods sold for cash)	Dr.		1,500	1,500
" 29	Drawings Account To Cash Account (Being cash withdrawn for personal use)	Dr.		500	500
" 31	Salaries Account To Cash Account (Being payment of salaries)	Dr.		300	300

Note: The following explanations with regard to some transactions will help you to understand their journal entries,

Jan. 1: The credit has been given to Capital Account because Krishna, the proprietor of the business, brought cash into the business.

Jan. 2: Cash deposited in Canara Bank implies that a bank account has been opened for the business. Any money deposited in the bank is debited to Bank Account and any withdrawal from the bank is to be credited to Bank Account.

Jan. 4: When goods are purchased you would normally debit Goods Account as goods come in. But as explained, purchases of goods are debited to Purchases Account since no Goods Account is to be maintained.

Jan. 6: Furniture is not goods for this business. It is a fixed asset and hedce debited to Furniture Account and not the Purchases Account. Since the payment has been made by cheque which leads to withdrawal from the bank, the amount has been credited to Bank Account.

Jan, **10:** When goods are sold you would normally credit the Goods Account as goods go out. But, as explained earlier, sales of goods are credited to Sales Account since no Goods Account is to be maintained.

Jan. 29: Any amount withdrawn by the proprietor for personal use is treated as drawings by the proprietor and hence debited to Drawings Account.

2.2.4 Transactions Relating *to* Cash Discount

There are two types of discounts allowed to customers: (i) trade discount, and (ii) cash discount. Trade discount is a reduction in selling price allowed at the time of sale. The buyer pays only the net price and the recording in books is made for the net amount **only.** No **entry is made in books for the trade discount.** Cash discount, on the other hand, is a reduction in the net amount due. It is allowed only if the customer makes payment before the due date. Cash discount must be recorded in the books of account. This is because **when** goods were sold to the customer his account was debited with the net amount due. Later, when he makes the payment and is allowed some cash discount, it must be adjusted in his personal account so that his account stands cleared.

When cash discount is allowed to the debtor, it is a loss to the business. So, it is debited to the Discount Allowed Account and credited to the personal account of the debtor. Similarly, when cash is paid to the creditor (the party from whom goods had been purchased on credit) he may also allow some cash discount to the business. Such discount will be a gain to the business. So, it is credited to the Discount Received Account and debited to the personal account of the creditor. The entries relating to cash discount will be illustrated under Compound Journal Entry (Section 2.2.5).

2.2.5 Compound Journal Entry

Sometimes, two or more transactions of the same nature may occur on the same day. In such a situation instead of passing a separate entry for each transaction we may pass a single journal entry, known as Compound Journal Entry. For example, on May 5, 1988 you sold goods on credit to Ram for Rs. 600 and to Shyam for Rs. 800. Both of these transactions took place on the same day (May 5, 1988) and are of the same nature (credit sale of goods). You can pass compound entry for both the transactions as follows:

		Rs.	Rs.
Ram's Account	Dr.	500	
Shyam's Account	Dr.	800	
To Sales Account			1,300
(Being goads sold on credit to them)			

A compound Journal entry can also be passed for a transaction which involves more than two accounts. For example, paid cash to Rarnesh Rs. 950 and he allowed Rs. 50 as discount, This transaction involves three accounts : (i) Ramesh's Account, (ii) Cash Account, and (iii) Discount Received Account. As per rules, Ramesh's Account is to be debited with Rs. 1,000 (Rs. 950 for cash and Rs. 50 for discount), Cash Account is to be credited with Rs. 950, and Discount Received Account is to be credited with Rs. 50. You can pass the following compound journal entry for this transaction :

		Rs.	Rs.
Ramesh's Account	Dr.	1,000	
To Cash Account			950
To Discount Received Account			50
(Being cash paid to him, discount received Rs. 50)			

In practice, a compound journal entry is recorded when

i) one account is to be debited and two or more accounts are to be credited, or

ii) two or more accounts are to be debited and one account is to be credited, or

iii) two or more accounts are to be debited and two or more accounts are to be credited.

2.2.6 Transactions Relating to Bad Debts

When a debtor becomes insolvent, the business shall not be able to realise the full amount due from him. A part of it remains unrealized. The unrealised amount is called 'bad debts'. For example, Rs, 2,000 was due from Kaushal for the goods sold to him on credit. He became insolvent and only Rs. 1,200 could be realised from him. The remaining amount of Rs. 800 will be treated as bad debts. It is a loss to the business and so debited to Bad Debts Account and credited to the personal account of the debtor. The journal entry for the above transaction will be:

		Rs.	Rs.
Cash Account	Dr.	1,200	
Bad Debts Account	Dr.	800	
To Kaushal's Account			2,000
(Being Kaushal became insolvent and only Rs.1,200 could be recovered)			

If any amount treated as bad debts is recovered later on, it shall be a gain to the business. Hence, it shall be credited to Bad Debts Recovered Account and debited to Cash Account. Note that the bad debts so recovered shall not be credited to the personal account of the debtor because his account had already been closed. In the example given above, suppose Rs. 800 is recovered from Kaushal later on, the journal entry will be:

		Rs.	Rs.
Cash Account	Dr.	800	
To Bad Debts Recovered Account			800
(Being bad debts recovered)			

Look at illustration 2 and note how journal entries for transactions of February 18, 25, 27 and 29 have been made.

Illustration 2

Record the following transactions in the Journal of Sunil Kumar.

1988			Rs.
Feb.	1	Commenced business with cash	70,000
"	2	Paid into Bank	40,000
"	4	Furniture purchased from Keshav	2,000
"	5	Goods purchased for cash	10,000
"	6	Sold goods to Santosh	5,000
"	9	Bought goods from Harish	10,000
"	10	Paid for cartage	50
"	12	Paid for postage	60
"	13	Goods returned by Santosh	500
"	15	Goods returned to Harish	1,000
"	17	Goods sold for cash	5,000
"	18	Paid to Keshav	1,900
		He allowed discount	100
"	20	Sold goods to Akash	2,000
"	25	Received from Santosh	4,300
		Allowed him discount	200
"	27	Cash drawn for personal use	1,000
"	27	Paid to Harish by cheque	9,900
		He allowed us discount	100
"	28	Paid rent by cheque	2,500
"	28	Paid salaries	4,000
"	29	Gkash becomes insolvent and only Rs. 1500 could be realised from him	
"	29	An old debt written off as bad in 1987 is recovered	2,000

Solution:

Journal

Date		Particulars		L.F.	Dr. Amount	Cr. Amount
1988					Rs.	Rs.
Feb.	1	Cash A/c	Dr.		70,000	
		To Capital A/c				70,000
		(Being business commenced with cash)				
"	2	Bank A/c	Dr.		40,000	
		To Cash A/c				40,000
		(Being cash paid into bank)				

"	Furniture A/c	Dr.	2,000	
	To Keshav			2,000
	(Being furniture bought on credit)			
" 5	Purchases A/c	Dr.	10,000	
	To Cash A/c			10,000
	(Being goods purchased for cash)			
" 6	Santosh	Dr.	5,000	
	To Sales A/c			5,000
	(Being goods sold on credit)			
" 9	Purchases A/c	Dr.	10,000	
	To Harish			10,000
	(Being goods purchased on credit)			
" 10	Cartage A/c	Dr.	50	
	To Cash A/c			50
	(Being cartage paid)			
" 12	Postage A/c	Dr.	60	
	To Cash A/c			60
	(Being postage paid)			
" 13	Returns Inwards A/c	Dr.	500	
	To Santosh			500
	(Being goods returned by Santosh)			
" 15	Harish	Dr.	1,000	
	To Returns Outwards A/c			1,000
	(Being goods returned to Hnrish)			
" 17	Cash A/c	Dr.	5,000	
	To Sales A/c			5,000
	(Being goods sold for cash)			
" 18	Kcshav	Dr.	2,000	
	To Cnsh A/c			1,900
	To Discount A/c			100
	(Being cash paid and discount received)			
" 20	Akash	Dr.	2,000	
	To Sales A/c			2,000
	(Being goods sold on credit)			
" 25	Cash A/c	Dr.	4,300	
	Discount A/c	Dr.	200	
	To Santosh			4,500
	(Being cash received and discount allowed)			
" 27	Drawings A/c	Dr.	1,000	
	To Cash A/c			1,000
	(Being cash withdrawn for personal use)			
" 27	Harish	Dr.	10,000	
	To Bank A/c			9,900
	To Discount A/c			100
	(Being payment made by cheque and discount received)			
" 28	Rent A/c	Dr.	2,500	
	To Bank A/c			2,500
	(Being rent paid by cheque)			
" 28	Salaries A/c	Dr.	4,000	
	To Cnsh A/c			4,000
	(Being salaries paid)			
" 29	Cash A/c	Dr.	1,500	
	Bad Debts A/c	Dr.	500	
	To Akash			2,000
	(Being Akash became insolvent and only Rs. *1,500* could be recovered)			
" 29	Cash A/c	Dr.	2,000	
	To Bad Debts Recovered A/c			2,000
	(Being the amount treated as bad debts in **1987**, now recovered)			

Note: In this illustration you will notice that

a) Instead of writing full word 'Account' its abbreviation 'A/c' has been used againgt the names of the accounts debited and credited. This is a common practice. In fact the latest trend is not to write anything, just the name of the account is enough.

b) The word Account or its abbreviation 'A/c' has not been written against personal names. This again is a common practice. Writing 'A/c' is confined to the real and nominal accounts only.

Check Your Progress A

1 What is Journal?

....

....

....

....

....

2 What is the purpose of writing narration?

....

....

....

....

....

3 Name the five accounts which are maintained in lied of Goods Account.

i) ....

ii) ....

iii) ....

iv) ....

v) ....

4 Distinguish between trade discount and cash discount..

....

....

....

....

....

5 Indicate the correct alternative in the following cases by putting a tick at the number:

a) Sale of goods to Rakesh for cash should be debited to
   i) Rakesh's Account
   ii) Cash Account
   iii) Sales Account

b) Purchase of machinery should be debited to
   i) Machinery Account
   ii) Goods Account
   iii) Equipment Account

c) Goods returned by Mahesh should be debited to
   i) Goods Account
   ii) Mahesh's Account
   iii) Returns Inwards Account

d) Wages paid to Rahim should be debited to

i) Rahim's Account

ii) Wages Account

iii) Repairs Account

e) Loan taken from Vikas should be credited to

i) Vikas's Account

ii) Cash Account

iii) Loan from Vikas Account

f) Cash discount allowed by a creditor should be credited to

i) Creditors Account

ii) Discount Received Account

iii) Allowance Account

g) The amount of bad debts should be debited to

i) Debtor's Account

ii) Bad Debts Account

iii) Discount Account

h) Rupees 500 received from Gopal whose account was previously written off as bad debts should be credited to

i) Gopal's Account

ii) Bad Debts Account

iii) Bad Debts Recovered Account

2.3 LEDGER

You know that the Journal is just a chronological record of all business transactions. It does not provide all information regarding a particular item at one place. This makes it difficult to know the net effect of various transactions affecting a particular item. For example, if you want to know the amount due to a particular supplier or the amount due from a particular customer, you will have to go through the whole journal. To overcome lhis difficulty, we maintain another book called 'Ledger'. In this book we open separate accounts for each item and all transactions related to a particular item as recorded in journal are posted in the concerned account. For example, all transactions related to a particular supplier, say Mohan, are posted to Mohan's Account. Similarly, all cash payments and cash receipts can be posted to Cash Account. Thus, you will have no problem in knowing the amount due to Mohan or the balance in Cash Account, and so on.

Thus, ledger is a book where all accounts relating to different items are maintained and into which all journal entries must be posted. In fact, ledger is the principal book of entry which provides complete information about various transactions relating to all parties and all items of asset, incomes and expenses. Some persons have even suggested that we should record all transactions directly into ledger and do away with Journal. But, it is not advisable because in that case we will not have any date-wise record of the transactions and the details thereof. Such record is considered necessary for future reference.

You learnt about the 'T' form of an account which divides it into two parts. The left hand side is called the debit side and the right hand side the credit side. The proper form of a ledger account is given in Figure 2.2.

Figure 2.2 : LEDGER

Name of the Accopnt

Dr.							Cr.
Date	Particulars	F	Amount	Date	Particulars	F	Amount
			Rs.				Rs.

You will notice that both sides of the account have date, particulars, folio and amount columns. Now, let us see how postings are made into the ledger accounts.

2.3.1 Posting into Ledger

The journal entries form the basis for recording in the ledger accounts, and the process of entering transaction in the ledger is called 'Posting'. When a journal entry has to be posted in the concerned ledger accounts, the following procedure is adopted.

1 **Every** journal entry will have to be posted into all those accounts which have been debited and credited in the journal entry. For example, for cash sales, Cash Account is debited and Sales Account is credited in the joumal. When this entry is posted in the ledger, it must be posted in Cash Account as well as in Sales Account.

2 Posting will be made on the debit side of the account which has been debited in the journal, and the credit side of the account which has been credited in the journal. In case of the above example of cash sales, posting will be made on the debit side of Cash Account, as it has been debited in journal and the credit side of Sales Account, as it had been credited in the journal.

3 Whether the posting is made on the debit side or the credit side, first of all the date of the transaction (as given in the journal) will be entered in the date column. The method of recording the date in the ledger account is the same as in the joumal.

4 While posting on the debit side of an account in the particulars column, we shall write the name of the account which had been credited in the journal and add the word 'To' before the **name. Similarly,** while posting on the credit side of an account, we shall write the name of the account which has been debited in the journal and add the word 'By' before the name. In case of the above example, we shall write 'To Sales A/c' in the particulars column on the debit side of Cash Account, and 'By Cash A/c' in the Particulars Column on the credit side of the Sales Account.

5 The journal entries contain 'narration'. But it is not required in the ledger accounts. Similarly, there is no need to draw a line between the two entries in an account as is done in the journal. Note that posting in the ledger account is considered complete only when both the debit and the credit aspects of all journal entries have been posted.

6 In the folio column, we shall mention the page number of the journal where concerned journal entry appears. At the same time, the page number of the ledger accounts will be entered in the 'L. F.' column in the journal so as to complete the cross reference.

7 The amount involved in the journal entry shall be entered in amount columns of both the accounts.

Now let us **take** a transaction, joumalise it, and then show how the posting is done in the ledger.

Purchased machinery for.cash, Rs. 50,000 on April 4,1988: This transaction will appear in the joumal and the ledger as under :-

JOURNAL

Date	Particulars	L.F	Dr. Amount	Cr. Amount
1988			Rs.	Rs.
April 4	Machinery A/c Dr.		50,000	
	To Cash A/c			50,000
	(Being machinery purchased)			

LEDGER

Machinery Account

Dr. Cr.

Date	Particulars	F	Amount	Date	Particulars	F	Amount
1988			Rs.				
Apr. 4	To Cash A/c		50,000				

Cash Account

Date	Particulars	F	Amount	Date	Particulars	F	Amount
				1988			Rs.
				Apr. 4	By Machinery A/c		50,000

2.3.2 Balancing Ledger Accounts

Whenever one wants to know the net effect of various transactions in a particular account, we have to work out its balance, Balance is the difference between the totals of the debit and the credit side of an account. The process of finding out the balance is known as **balancing.** The procedure for balancing is as follows:

i) Total the two sides of an account.

ii) Find out the difference between the totals of the two sides.

iii) Put the difference in the amount column of the side showing less total.

iv) If the difference is entered on the debit side, write against it in the particulars column 'To Balance c/d' (c/d stands for carried down). In case the difference is entered on the credit side, write against it in the particulars column 'By Balance c/d'.

v) Now, total both the sides and you will find that both the totals are equal.

vi) The closing balance (balance c/d) is going to be the opening balance for the subsequent period, The opening balance is shown on the next date in the account by writing 'To Balance b/d' (b/d stands for brought down) or 'By Balance b/d' as the case may be. Note that if the closing balance was on the debit sides, the opening balance would be shown on the credit side and if the closing balance was shown on the credit side, the opening balance would be shown on the debit side. In fact, an account is said to have a debit balance if its debit side total is bigger and a credit balance if its credit side total is bigger. Thus, the opening balance is shown according to the nature of the balance i.e., the debit balance on the debit side and the credit balance on the credit side.

vii) Sometimes the totals of the debit side and the credit side of an account are equal. It implies that the account has nil balance. In such a situation the account is said to have closed having no closing and opening balances,

Look at Illustration 3 and study how various transactions have been recorded in the Journal, posted into various accounts in the ledger, and how ledger accounts are balanced.

Illustration 3

Journalise the following transactions, post them into ledger and balance the accouhts.

1987			Rs.
Dec.	1	Anil commenced business with cash	1,00,000
"	2	Purchased goods from Prakash	30,000
"	2	Purchased furniture for cash	7,000
"	3	Goods sold to Prem	6,000
"	4	Sold goods to Ramlal	5,000
"	5	Goods purchased from Ramesh for Cash	5,000
"	7	Paid wages	100
"	11	Sold goods to Ashok	8,000
"	13	Ashok returned goods	500
"	14	Received from Ram Lal in full settlement	4,950
"	15	Stationery purchased for cash	400
"	17	Goods sold to Arun for cash	4,000
"	20	Withdrew for personal use	1,000
"	22	Paid to Prakash	20,000
"	23	Sold goods to Prem	2,000
"	25	Received from Prem	5,000
"	26	Cash sales	8,000
"	27	Paid for interest	500
"	28	Received from Ashok	7,000
"	29	Paid rent	2,000
"	30	Paid salaries for the month	3.000
"	31	Prem becomes insolvent and a dividend of 50 paise in the rupee is received.	

Solution:

JOURNAL

Date	Particulars		L..	Dr. Amount	Cr. Amount
1987				Rs.	Rs.
Dec. 1	*Cash* A/c To Capital A/c (Being capital brought in)	Dr.		1,00,000	1,00,000
" 2	Purchases A/c To Prakash (Being goods purchased on credit)	Dr.		30,000	30,000
" 2	Furniture A/c To Cash A/c (Being furniture purchased for cash)	Dr.		7,000	7,000
" 3	Prem To Sales A/c (Being goods sold on credit)	Dr.		6,000	6,000
" 4	Ram Lal To Sales A/c (Being goods sold on credit)	Dr.		5,000	5,000
" 5	Purchases A/c To Cash A/c (Being goods purchased for cash)	Dr.		5,000	5,000
" 7	Wages A/c To *Cash* A/c (Being wages paid)	Dr.		100	100

"	11	Ashok Dr. To Sales A/c (Being goods sold on credit)		8,000	8,000
"	13	Returns Inwards A/c Dr. To Ashok (Being goods returned by him)		500	500
"	14	Cash A/c Dr. Discount A/c Dr. To Ram Lal (Being cash received in full settlement of his account)		4,950 50	5,000
"	15	Stationery A/c Dr. To Cash A/c (Being stationery purchased)		400	400
"	17	Cash A/c Dr. To Sales A/c (Being goods sold for cash)		4,000	4,000
"	20	Drawings A/c Dr. To Cash A/c (Being cash withdrawn for personal use)		1,000	1,000
"	22	Prakash Dr. To Cash A/c (Being cash paid to Pmkash)		20,000	20,000
"	23	Prem Dr. To Sales A/c (Being goods sold on credit)		2,000	2,000
"	25	Cash A/c Dr. To Prem (Being cash received from Prem)		5,000	5,000
"	26	Cash A/c Dr. To Sales A/c (Being goods sold for cash)		8,000	8,000
"	27	Interest A/c Dr. To Cash A/c (Being interest pnid)		500	500
"	28	Cash A/c Dr. To Ashok (Being cash received)		7,000	7,000
"	29	Rent A/c Dr. To Cash A/c (Being rent paid)		2,000	2,000
"	30	Salaries A/c Dr. To Cash A/c (Being salaries paid)		3,000	3,000
"	31	Cash Account Dr. Bad Debts Account Dr. To Prem (Being a dividend of 50 paise in a rupee received from Prem)		1,500 1,500	3,000

Notes:

1 Transaction on December 14: Ram **Lal** paid Rs, 4,950 in full settlement of **Rs. 5,000** due from him on account of the goods sold to him on December 4. It implies that Rs. 50 (Rs. 5000- Rs. 4,950) was allowed to him as cash discount,

2 Transaction on December 30 : Prem becomes insolvent. The **firm** could recover only 50 paise in a rupee **i.e.,** 50% of the amount due, Goods worth Rs. 8,000 were sold to him (Rs. 6, 000 on December 3 and Rs. 2,000 on December 23). He paid Rs. 5,000 on December 25 leaving a balance of Rs, 3,000. Of this, the firm could recover Rs. 1,500 (50% of **Rs.** 3,000). The remaining amount of Rs. 1,500-has been treated as bad debts.

Cash Account

Dr. Cr.

1987			Rs.	1987			Rs.
Dec. 1	To capital A/c		1,00,000	Dec. 2	By Furniture A/c		7,000
" 14	To Ram Lal		4,950	" 5	By Purchases A/c		5,000
" 17	To Sales A/c		4,000	" 7	By Wages A/c		100
" 25	To Prem		5,000	" 15	by Stationery A/c		400
" 26	To Sales A/c		8,000	" 20	By Drawings A/c		1,000
" 28	To Ashok		7,000	" 22	By Prakash		20,000
" 30	To Prem		1,500	" 27	By Interest A/c		500
				" 29	By Rent A/c		2,000
				" 30	By Salaries A/c		3,000
				" 31	By Balance c/d		91,450
			1,30,450				1,30,450
1988							
Jan. 1	To Balance b/d		91,450				

Purchabes Account

1987			Rs.	1987	By Balance c/d		Rs.
Dec. 2	To Prakash		30,000	Dec. 31	By Ba		35,000
" 5	To Cash A/c		5,000				
			35,000				35,000
1988							
Jan. 1	To Balance b/d		35,000				

Furniture Account

1987			Rs.	1987			Rs.
Dec. 2	To Cash A/c		7,000	Dec. 31	By Balance c/d		7,000
1988							
Jan. 1	To Balance b/d		7,000				

Wages Account

1987			Rs.	1987			Rs.
Dec. 7	To Cash A/c		100	Dec. 31	By Balance c/d		100
1988							
Jan. 1	To Balance bld		100				

Returns Inwards Account

1987			Rs.	1987			Rs.
Dec. 13	To Ashok		500	Dec. 31	By Balance c/d		500
1988							
Jan. 1	To Balance bld		500				

Prem's Account

1987			Rs.	1987			Rs.
Dec. 3	To Sales A/c		6,000	Dec. 25	By Cash A/c		5,000
" 23	To Sales A/c		2,000	" 31	By Cash A/c		1,500
				" 31	By *Bad Debts A/c*		1,500
			8,000				8,000

Sales Account

1987			Rs.	1987			Rs.
Dec. 31	By Balance c/d		33,000	Dec. 3	By Prem		6,000
				" 4	By Ram Lal		5,000
				" 11	By Ashok		8,000
				" 17	By Cash A/C		4,000
				" 23	By Prem		2,000
				" 26	By Cash A/c		8,000
			33,000				33,000
				1988 Jan. 1	By Balance b/d		33,000

Capital Account

1987			Rs.	1987			Rs.
Dec. 31	To Balance c/d		1,00,000	Dec. 1	By Cash A/c		1,00,000
			1,00,000				1,00,000
				1918 Jnn. 1	By Balance b/d		1,00,000

Prakash's Account

1987.			Rs.	1987			Rs.
Dec. 22	To Cash A/c		20,000	Dec. 2	By Purchases A/c		30,000
" '31	To Balance c/d		10,000				
			30,000				30,000
				1988 Jan. 1	By Balance b/d		10,000

Ram Lal's Account

1987			Rs.	1987			Rs.
Dec. 4	To Sales A/c		5,000	Dec. 14	By Cash A/c		4,950
				" 14	By Discount		50
			5,000				5,000

Ashok's Account

1987			Rs.	1987			Rs.
Dec. 11	To Sales A/c		8,000	Dec. 13	By Returns Inwards A/c		500
				" 28	By Cash A/c		7,000
				" 31	By Balance C/d		500
			8,000				8,000
1988 Jan. 1	To Balance b/d		500				

Discount Allowed Account

1987			Rs.	1987			Rs.
Dec. 14	To Ram Lal		50	Dec. 31	By Balance c/d		50
1988 Jan. 1	To Balance b/d		50				

Stationery Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
1987 Dec. 15	To Cash A/c		400	1987 Dec. 31	By Balance c/d		400
1988 Jan. 1	To Balance b/d		400				

Drawings Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
Dec. 20	To Cash A/c		1,000	Dec. 31	By Balance c/d		1,000
Jan. 1	To Balance b/d		1,000				

Interest Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
1987 Dec. 27	To Cash A/c		500	1987 Dec. 31	By Balance c/d		500
1988 Jan. 1	To Balance b/d		500				500

Rent Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
1987 Dec. 29	To Cash A/c		2,000	1987 Dec. 31	By Balance c/d		2,000
1988 Jan. 1	To Balance b/d		2,000				

Salaries Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
1987 Dec. 30	To Cash A/c		3,000	1987 Dec. 31	By Balance c/d		3,000
1988 Jan. 1	To Balance b/d		3,000				

Bad Debts Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
1987 Dec. 30	To Prem			1987 Dec. 31	By Balance c/d		1,500
1988 Jan. 1	To Balance b/d						

Note: Nominal accounts like Wages Account, Discount Account, Stationery Account, etc. and the accounts relating to purchases, sales and returns of goods are not to be balanced. As per rules, they are simply closed by transfer to the Trading and Profit and Loss Account at the time of preparing the final accounts. In the above illustration, however, they have been balanced for the purpose of preparing the Trial Balance which is being discussed in the next section,

2.3.3 Significance of Balances

You have learnt that the 'balance' in an account signifies the net effect of all transactions related to it during a given period. It may be a debit balance or a credit balance or a nil balance depending upon whether the debit or the credit total is higher. Let us now understand the significance of a balance in respect of the various types of accounts in the ledger.

Personal **Accounts:** Personal accounts are more frequently balanced as compared to any other class of accounts. Balance in a personal account indicates whether the party concerned owes to thk business or the business is owing to him. When it shows a debit balance, it means that the party owes that amount to the business and he is a debtor to the business. Similarly, when it shows a credit balance, it would mean that the business owes that amount to him and he is a creditor of the business. If, however, the account shows a nil balance, it means that the account has been cleared, nothing is due to him or due from him.

Real Accounts: Real accounts are normally balanced at the end of the accounting period primarily for the purpose of preparing the final accounts. The Cash Account, however, is balanced everyday because the actual cash is to be verified and confirmed with the closing balance shown by Cash Account. All real accounts show a debit balance as these are assets (property) accounts.

Nominal Accounts: Nominal accounts are not to be balanced. They are simply closed by transfer to the Trading and Profit and Loss Accounts, at the time of preparing the final accounts. However, for the purpose of understanding the procedure involved, nominal accounts have also been balanced. Even otherwise, the difference between the debit side and credit side totals have to be worked out for preparing the Trial Balance. Note that the accounts which relate to expenses or losses will show a debit balance; whereas those relating to incomes and gains will have a credit balance. This is because all expenses and losses are debited and all incomes and gains are credited.

Check Your Progress B

1 State whether each of the following statements is True or False.

i) Ledger is the principal book of entry. ....

ii) Process of joumalising is called posting. ....

iii) Posting will be made on the debit side of the account that had been debited in the Journal ....

iv) The word 'By' is written before the name of an account in the particulars column while posting on the credit side of an account ....

v) Writing narration is necessary while posting into ledger accounts ....

vi) Real accounts always show debit balances ....

2 Why do you balance an account?

....

....

....

....

....

What do you mean by a debit balance of an account?

....

....

....

....

....

2.4 TRIAL BALANCE

After posting the journal entries into the ledger and balancing all accounts, we prepare a statement called Trial Balance. This statement shows the balances of all the accounts which appear in the ledger. The debit balances are shown in one column and the credit balances in the other. It is usually prepared just before preparing the final accounts. The purpose is to check the arithmetical accuracy of the books of account.

You know that under the Double Entry System for every debit'there is an equal and corresponding credit. So, the total of debits given to different accounts must be equal to the total of credits given to different accounts. Similarly, the total of debit balances in different accounts must be equal to the total of credit balances in different accounts. Now if the Trial Balance tallies i.e., the total of its debit balances column is equal to the total of its credit balances column, it would mean that both the aspects of each transaction have been correctly recorded in the ledger. If, however, the two totals do not tally it implies that some errors have been committed while posting the transactions into ledger.

There are two methods of preparing the Trial Balance: (i) Totals Method, and (ii) Balances Method. Under the first method we show the totals of each side of an account in the Trial Balance. The debit side total of an account is shown in the debit column of the Trial Balance and the credit side total of the account in the credit column. Under the second method we show only the balances of each account in the Trial Balance. The second method is more convenient and commonly used because it eliminates all those accounts which have nil balance.

Now, let us prepare the Trial Balance from the ledger accounts prepared. Under Illustration 3 you will notice that all the accounts which appear in the ledger have been included and their balances entered in the appropriate column. The total of debit balances column in the Trial Balance is equal to the credit balances column. This means that all postings have been correctly made in different ledger accounts.

Trial Balance as on December 31,1987

S. No.	Name of Account	L.F.	Dr. Balance	Cr. Balance
			Rs.	Rs.
1	Cash Account		91,450	
2	Capital Account			1,00,000
3	Furniture Account		7,000	
4	Purchases Account		35,000	
5	Sales Account			33,000
6	Prakash's Account			10,000
7	Wages Account		100	
8	Returns Inwards Account		500	
9	Ashok's Account		500	
10	Discount Account		50	
11	Stationery Account		400	
12	Drawings Account		1,000	
13	Interest Account		500	
14	Rent Account		2,000	
15	Salaries Account		3,000	
16	Bad Debts Account		1,500	
	Total		1,43,000	1,43,000

2.5, OPENING ENTRY

When an accounting year begins. the previous year's balances in different accounts are brought forward to the new books of account. This is done by means of a journal entry—all assets accounts are debited and all liabilities accounts (including the proprietor's capital account) are credited. In **case the Capital Account balance is not given, it can be calculated by deducting the other liabilities from the total assets. This will** be clear from Illustration 4.

Illustration 4

Ashok has the following balances on December 31, 1987: Cash in hand Rs. 5,000; Debtors Rs, 7,200 (Ramesh Rs. 6,000; Lalwani Rs. 1,200); Stock of goods Rs. 18,800; Machinery Rs. 8,000; Furniture Rs. 3,000; Creditors Rs. 1,500 (Ravi & Co.) ; Bank Loan Rs. 3,000. Pass the opening entry on January 1,1988.

Solution :

JOURNAL

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
1988				Rs.	Rs.
Jan. 1	Cash Account	Dr.		5,000	
	Ramesh	Dr.		6,000	
	Lalwani	Dr.		1,200	
	Stock Account	Dr.		18,800	
	Machinery Account	Dr.		8,000	
	Furniture Account	Dr.		3,000	
	To Ravi & Co.				1,500
	To Bank Loan Account				3,000
	To Capital Account				37,500
	(For the balance brought forward from the previous year)				

Posting the Opening Entry into Ledger: The posting of an Opening entry into ledger is slightly different from the posting of other journal entries. We have to open the accounts for all items that appear in the opening entry. Then, in the accounts which have been debited in opening entry, we shall write 'To Balance b/f' on their debit side, and in the account which have been credited in the opening entry, we shall write 'By Balance b/f' on their credit side. The date, folio and amount columns are completed in the usual manner. As a matter of fact, the accounts which have been debited and credited through the opening entry merely represent the closing balances of various personal and real accounts from the previous year. The posting of the opening entry as given in Illustration 4 will be made as follows:

Cash Account

Dr. Cr.

1988		Rs.			
Jan. 1	To Balance b/f	5,000			

Ramesh's Account

1988		Rs.			
Jan. 1	To Balance b/f	6,000			

Lalwani's Account

1988		Rs.			
Jan. 1	To Balance b/f	1,200			

Stock Account

1988		Rs.			
Jan. 1	To Balance b/f	18,800			

Machinery Account

1988		Rs.			
Jan. 1	To Balance b/f	8,000			

Furniture Account

1988		Rs.			
Jan. 1	To Balance b/f	3,000			

Ravl & C0.'s Account

			1988		Rs.
			Jan. 1	By Balance b/f	1,500

Bank Loan Account

			1988		Rs.
			Jan. 1	By Balance b/f	3,000

Capital Account

			1988		Rs.
			Jan. 1	By Balance b/f	37,500

2.6 LET US SUM UP

Journal is a book of original entry wherein all business transactions are recorded in a chronological order. The journal shows the accounts to be debited and those to be credited in respect of each transaction. The journal does not provide all information regarding a particular item at one place. Hence, we maintain another book called Ledger. In this book we open separate accounts for each item. An account has two sides, the debit side and the credit side. When an account is balanced, it shows the net effect of all transactions relating to that account during a given period. Before preparing a summary in the form of final accounts, a statement called Trial Balance is prepared to check the arithmetical accuracy of posting into Ledger. This statement shows the balances of all the accounts and if the total of debit balances tally with the total of credit balances it is assumed that the transactions have been correctly recorded in the ledger.

2.7 KEY WORDS

Bad Debt: The amount of debt which is irrecoverable.

Cash Discount: An allowance given by the creditor to the debtor for making prompt payment of the amount due from him.

Cheque: An instrument used for withdrawing money from the bank.

Compound Entry: A journal entry involving more than two accounts.

Drawings: Amount withdrawn by the proprietor from the business for personal use.

Insolvent: A person who is not in a position to, pay his debts in full and is so declared by the Court.

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

Posting: The process of entering transactions into the ledger accounts.

Returns Inwards; Goods returned by customers i.e., sales returns.

Returns Outwards: Goods returned to suppliers i.e., purchase returns.

Stock: Goods lying unsold with the business. It also includes unused raw materials and the stock for semi-finished goods.

Trade Discount: An allowance given by the seller to the buyer on the list price at the time of sale.

Good: Articles bought for resale and usually traded by the business unit.

2.8 SOME USEFUL BOOKS

1 Maheshwari, S.N., 1986. *Introduction to Accounting,* Vikas Publishing House: New Delhi. (Chapters 3,4)

2 Patil, V.A. and J.S. Korlahalli, 1986. *Principles and Practice of Accounting, R.* Chand & Co., New Delhi. (Chapters 4,5)

3 Gupta R.L. and M. Radhaswamy 1986. *Advanced Accountancy,* Sultan Chand & Sons: New Delhi. (Chapter 3)

2.9 ANSWERS TO CHECK YOUR PROGRESS

A 3 Purchases Account, Sales Account, Purchases Returns Account, Sales Returns. Account and Stock Account.

5 (a) ii (b) i (c) iii (d) ii
(e) iii (f) ii (g) ii (h) iii

B 1 (i) True (ii) False (iii) True
(iv) True (v) False (vi) True

2.10 TERMINAL QUESTIONS/EXERCISES

Questions

1 " Ledger is said to be the principal book of entry and the transactions can even be directly entered into the ledger account." Elaborate on the statement and explain why Journal is necessary.

2 What does balancing an account mean? Explain how an account is balanced?

3 What is the significance of debit and credit balance in different types of accounts?

4 What do you understand by an opening entry? How is an opening entry posted into the ledger?

5 What is Trial Balance? Explain how it is prepared?

Exercises

1 Journalise the following transactions :

1988			Rs.
Jan.	1	Mohan commenced business with cash	1,00,000
"	2	Paid into bank	50,000
"	3	Purchased goods for cash	10,000
"	4	Bought furniture from Karim for cash	3,000
"	5	Sold goods for cash	2,000
"	8	Sold goods to Rakesh	4,000
"	10	Paid cartage	50
"	11	Purchased goods from Sunil	6,000
"	15	Purchased stationery	100
"	18	Received commission	50

Jan.	20	Received from Rakesh	3,900
		Allowed him discount	100
"	25	Returned goods to Sunil	500
"	28	Paid to Sunil in full settlement	5,450
"	30	Paid rent by cheque	1,000
"	30	Paid wages	2,000
"	31	Paid salaries	5,000

2 Journalise the following transactions':

1988			Rs.
Jan.	1	Gopal Rao commenced business with cash	60,000
"	2	Bought a building	20,000
"	4	Purchased furniture from Lalaji on credit	2,000
"	5	Purchased goods for cash	15,000
"	6	Sold goods to Ranga Rao on credit	5,000
"	6	Sold goods to Augustine & Co. on credit	8,000
"	8	Purchased goods from Manohar Singh on credit	5,000
"	9	Goods returned by Ranga Rao	1,000
"	15	Goods returned to Manohar Singh	500
"	17	Purchased goods from Krishna Rao	20,000
"	20	Purchased investments	10,000
"	25	Paid to Manohar Singh	4,500
"	26	Received from Augustine by cheque	7,000
"	27	Amount drawn for personal use by the proprietor	500
"	27	Stationery purchased	400
"	28	Paid to Lalaji in full settlement of his account	1,950
"	30	Salaries paid to clerk	1,200
"	30	Electricity charges paid	200
"	31	Ranga Rao became insolvent, Received final composition of 50 paise in a rupee.	

Hint: You can pass a compound journal entry for sales made to Ranga Rao and Augustine & Co. on January 6, 1988.

3 For the following transactions, pass journal entries, prepare ledger accounts and balance them.

1987			Rs.
Dec.	1	Nagender commenced business with cash	2,00,000
"	2	Bought building	30,000
"	3.	Bought machinery	40,000
"	4	Purchased typewriter for cash	5,000
"	6	Purchased stationery	200
"	7	Goods purchased from Mahender	15.000
"	9	Goods sold for cash	10,000
"	10	Goods returned to Mahender	500
"	11	Goods sold to Rameswar	5,000
"	12	Goods purchased from Mahender for cash	5,000
"	13	Goods returned by Rameswar	1,000
"	14	Received from Rameswar	4,000
"	16	Amount paid to Mahender	5,000

Dec.	20	Amount drawn for personal use of Nagender	1,000
"	22	Telephone bill paid	600
"	24	Municipal taxes paid	200
"	26	Goods sold for cash	6,000
"	27	Advertisement expenses paid	400
"	28	Paid for printing & stationery	500
"	30	Salaries paid to sales girls	2,000
"	31	Commission received	500

4 **Journalise** the following transactions, enter them in the Ledger and prepare the Trial Balance.

1988			Rs.
Jan.	1	Siva Prasad started business with	2,50,000
"	2	Bought buildings	1,00,000
"	2	Deposited into bank	1,00,000
"	3	Purchased furniture and paid by cheque	50,000
"	4	Purchased stationery	250
"	5	Purchased goods on credit fmm Balaji & Co.	25,000
"	6	Purchased goods on cash	15,000
"	7	Sold goods to Venkateswara & Co.	20,000
"	8	Sold goods on cash	5,000
"	9	Goods returned by Venkateswara & Co.	2,000
"	11	Goods returned to Balaji & Co.	1,500
"	13	Purchased goods from Vivekananda & Co.	20,000
"	15	Sold goods to Balaji & Co.	10,000
"	16	Repairs paid	2,000
"	18	Goods returned by Balaji & Co.	500
"	20	Paid to Balaji & Co. by cheque	14,000
"	22	Goods returned to Vivekananda & Co.	2,000
"	25	Paid to Vivekananda & Co.	14,000
"	27	Cash received from Venkateswara & Co.	10,000
"	28	Municipal taxes paid	1,000
"	30	Salaries paid	5,000
"	30	Telephone charges paid	450
"	30	Electricity bills paid	500

(Answer : Total of Trial Balance Rs. 2,92,500)

Note: These questions and exercises will help you to understand the unit better. Try to write answers for them. But do not send your answers to the University. These are for your practice only.

UNIT 3 CASH BOOK AND BANK RECONCILIATION

Structure

3.0 OBJECTIVES

After studying this unit you should be able to :

- explain the need for sub-division of journal
- prepare different types of cash books
- post cash book entries into ledger
- ascertain the causes of difference between the cash book and pass book balances
- prepare a bank reconciliation statement
- adjust the cash book balance
- describe the importance of bank reconciliation statement
- prepare petty cash book and post it into ledger.

3.1 INTRODUCTION

In Unit 2 you learnt that all business transactions are first recorded in the journal and then posted into ledger. In practice, the number of transactions is so large that it becomes difficult to record all of them in one book of prime entry. Hence, the journal is sub-divided into a number of special journals called Subsidiary Books. Each book is used for recording transactions of one category only. For example, Cash Book is used for recording all cash transactions, Purchases Book is used for recording all credit purchases of goods, Sales Book is used for recording all credit sales of goods, and so on. This enables us to divide the work among different persons and ensure prompt recording of transactions,

In this unit you will learn about the most important subsidiary book called Cash Book. We shall discuss various types of cash books and study how transactions are recorded in each type of cash book and posted from cash book to ledger. You will also learn about the banking transactions, their recording in Three Column Cash Book and the preparation of a Bank Reconciliation Statement.

3.2 SUB-DIVISION OF JOURNAL

As stated earlier, it is practically impossible to record all transactions in one book of prime entry. Hence, the journal is sub-divided into a number of subsidiary books. These are also called special journals. The sub-division is done in such a way that a separate book is used for each type of transactions which are repetitive in nature and are sufficiently large in number, In any large business the subsidiary books generally used are as follows :

1 Cash Book: It is used for recording all cash receipts and cash payments including cash purchases and cash sales.

2 Purchases Journal: It is used for recording all credit purchases of goods.

3 Sales Journal: It is used for recording all credit sale of goods.

4 Purchases Returns Journal: It is used for recording the returns of goods to suppliers. It is also known as 'Returns Outwards Book'.

5 Sales Returns Journal: It is used for recording the returns of goods by customers. It is also known as 'Returns Inwards Book'.

6 Bills Receivable Journal: This book is meant for recording transactions relating to bills of exchange and promissory notes received from debtors.

7 Bills Payable Journal: This book is meant for recording bills of exchange and promissory notes accepted by the business in favour of creditors.

8 Journal Proper: In this book only such transactions are recorded which are not covered by any of the above named subsidiary books, for example, credit purchases of fixed assets, opening entry, rectification entries, etc.

The advantages of having a number of subsidiary books as listed above are as follows :

i) Classification of transactions becomes automatic: As there is a separate book for each type of transactions, the transactions of same nature are automatically brought at one place. For example, all credit purchases of goods are recorded in the Purchases Journal and all credit sales are recorded in the Sales Journal.

ii) Reference becomes easy: If any reference is required, it can be traced easily by referring to the appropriate subsidiary book. You do not have to go through all the transactions recorded in the journal.

iii) Facilitate division of work: Sub-division of journal into various subsidiary books facilitates division of work among many persons. This, in turn, facilitates prompt recording of transactions and saves a lot of time.

iv) More particulars: More details about the transactions can be given in subsidiary books than would be possible in one book.

v) Responsibility can be fixed: The work of maintaining a particular book can be entrusted to a particular person. He will be responsible for keeping it up-to-date and in order.

vi) Facilitates checking: When the Trial Balance does not agree, the location of errors will be relatively easy.

3.3 CASH BOOK

You know that in any business there would be numerous transactions which involve either receipt or payment of cash. Cash sales, receipts of cash from debtors, cash purchases, payment of cash to creditors, payment of expenses such as salaries, rent, taxes, etc. are examples of cash transactions. All these transactions are recorded in a separate book called Cash Book. The ruling of cash book is similar to that of a ledger account. All cash receipts are recorded on the debit side and all cash payments on the credit side. Thus, it serves the function of a Cash Account, As a matter of fact, cash book plays a dual role. It is a book of prime entry as well as ledger account. Hence, when cash book is maintained there is no need to have a Cash Account in the ledger.

There are different types of cash books in use by the business. These are :

i) Simple or Single Column Cash Book

ii) Two or Double Column Cash Book

iii) Three or Triple Column Cash Book.

We shall now consider them one by one and learn how they are prepared and posted into ledger.

3.3.1 Single Column Cash Book

The simplest form of cash book is the Single Column Cash Book. It is like an ordinary Cash Account. Look at Figure 3.1 for its proforma.

Figure 3.1 : Single Column Cash Book

Dr. **Cr.**

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
			Rs.				Rs.

As stated earlier, the debit side of the cash book is used for recording all cash receipts and the credit side for all cash payments. In particulars column we write the name of the account in respect of which the amount is received or paid. The ledger folio(**L.F.**) column is used for writing the page number of the account where the entry has been posted in the ledger.

Posting the Cash **Book :** You must remember that there is no need to open a Cash Account. It is because when a cash transaction is recorded in the cash book the posting of cash aspect of the transactions stands duly covered. We are to make **postings** only to the other concerned accounts in the ledger in order **to complete** the double entry, The rules of posting are :

i) for all transactions entered on the debit side of the cash book, credit the concerned accounts in the ledger by writing 'By Cash **A/c'** in the particulars column, and

ii) for all transactions entered on the credit side of the cash book, debit the concerned **accounts** in the ledger by writing 'To Cash **A/c'** in the particulars column.

Thus, you will notice that all transactions appearing on the debit side of the cash **book** are to be posted on the credit side of the concerned accounts and those appearing on the credit side of the cash book are to **be** posted on the debit side of the concerned accounts.

Balancing the Cash **Book:** It is similar to the balancing of Cash Account. The cash book will always show a debit balance because cash payments can never exceed **the amount of** cash available. Hence, the total of the debit side in the cash book will always be more than the total of the credit side. The difference between the two indicates the cash in hand.

Look at illustration **1** and study how recording, posting and balancing of a Simple Cash Book is done.

Illustration 1

From the following particulars of **M/s Samir Bros.,** prepare a Simple Cash Book, balance it and post it into ledger.

1988			Rs.
Jan.	1	Commenced business with cash	3,000
"	2	Deposited in bank account	1,000
"	4	Bought **goods for** cash'	800
"	9	Cash sales	600
"	12	Cash **received** from **Bhushan**	500
"	15	Paid for wages	50
"	20	Cash paid to **Narender**	200
"	25	**Drew for personal use**	300
"	30	Paid Rent	400

Solution:

Samir Bros.

CASH BOOK

Dr. Cr.

Date		Particulars	L.F.	Amount	Date		Particulars	L.F.	Amount
1988				Rs.	1988				Rs.
Jan.	1	To Capital A/c		3,000	Jan.	2	By Bank A/c		1,000
"	9	To Sales A/c		600	"	4	By Purchases A/c		800
"	12	To Bhushan		500	"	15	By Wages A/c		50
					"	20	By Narender		200
					"	25	By Drawings A/c		300
					"	30	By Rent A/c		400
					"	31	By Balance c/d		1,350
				4,100					4,100
Feb.	1	To Balance b/d		1,350					

LEDGER

Capital Account

Dr. Cr.

			1988 Jan. 1	By Cash A/c	Rs. 3,000

Sales Account

			1988 Jan. 9	By Cash A/c	Rs. 600

Bhushan's Account

			1988 Jan. 12	By Cash A/c	Rs. 500

Bank Account

1988 Jan. 2	To Cash A/c	Rs. 1,000			

Purchases Account

1988 Jan. 4	To Cash A/c	Rs. 800			

Wages Account

1988 Jan. 15	To Cash A/c	Rs. 50			

Narender's Account

1988 Jan. 20	To Cash A/c	Rs. 200			

		Rs.			
Jan. 25	To Cash A/c	300			

Rent Account

1988		Rs.			
Jan. 30	To Cash A/c	400			

3.3.2 Two Column Cash Book

As you know, when cash is received from a debtor some cash discount may be allowed to him. Similarly, when payment is made to a creditor he may also allow some cash discount. While recording such transactions in the journal you learnt that cash and discount would go together in the form of a compound entry. So, when receipts from debtors and payments to creditors are to be recorded in the cash book, it is considered desirable to record the cash discount also in the cash book. For this purpose, an additional amount column is provided on both sides of the Cash Book. The discount **allowed** to debtors is recorded on the debit side and the discount received from creditors on the credit side. Thus, you will have two amount columns on each side of the cash book, one for discount and the other for cash. That is why it is called Two Column Cash Book.

The procedure for posting the discount column of the cash book to the ledger is as follows :

i) Post the amounts entered in the discount allowed column to the credit side of the concemed personal accounts of the debtors by writing 'By Discount Allowed A/c'.

ii) Post the amounts entered in the discount received column to the debit side of the concerned personal accounts of the creditors by writing 'To Discount Received A/c'.

iii) Open Discount Allowed Account and Discount Received Account in the ledger.

iv) Total the discount allowed and discount received columns of the cash book.

v) Post the total of the discount allowed column to the debit of the Discount Allowed Account by writing 'To Sundries as per Cash Book'.

vi) Post the total of the discount received column to the credit of Discount Received Account by writing 'By Sundries as per Cash Book'.

You will observe that the posting of discount column is different from the posting of the cash column. In case of cash columns, the postings are to be made only to the respective personal accounts while in case of discount columns postings are to be made not only to the personal accounts but also to the discount accounts. The total of discount allowed colutnn is posted to the debit of Discount Allowed Account and the total of discount received column is posted to the credit of Discount Received Account. It is because the cash book does not serve the purpose of a discount account and the double entry is not complete until postings are also made to the discount accounts.

As for the balancing of Two Column Cash Book, you should note that **only** the cash columns are to be balanced. The discount columns are not balanced, they are simply totalled. It is because the two discount columns relate to the two different heads of account, the discount allowed and the discount received. By totalling the two discount columns you can find out the total amounts of ttie discount allowed and the discount received during a given period and complete their posting into the ledger.

Look at Illustration 2 and study how entries are made in the Two Column Cash Book, how they are posted to the concemed ledger accounts and how this cash book is balanced.

Illustration 2

From the following transactions of M/s Raj Kumar & Sons, prepare a Two Column Cash Book and show the concerned ledger accounts.

1988			Rs.
Jan,	1	Cash in hand	5,000
"	6	Purchased furniture for cash	500

1988			Rs.
Jan.	7	Bought goods for cash	2,000
"	10	Cash sales	3,000
	13	Cash received from Gopal	1,450
		Allowed him discount	30
"	15	Paid for wages	100
"	19	Paid cash to Ganga Ram	480
"		He allowed discount	20
"	20	Bought an old typewriter	2,000
"	22	Received cash from Motu Ram in full settlement of his debt of Rs. 1,000	980
"	24	Sold goods for cash to Manohar	400
"	27	Bought goods from Bansilal for cash	500
"	30	Paid salary	300
	30	Paid rent	800
"	30	Deposited into bank Account	3,000

Solution :

Raj Kumar & Sans

Cash Book (With Discount and Cash Columns)

Dr. Cr.

Date	Particulars	L.F.	Discount Allowed	Amount	Date	Particulars	L.F.	Discount Received	Amount
1988			Rs.	Rs.	1988			Rs.	Rs.
Jan. 1	To Balance b/d			5,000	Jan. 6	By Furniture A/c			500
Jan. 10	To Sales A/c			3,000	" 7	By Purchases A/c			2,000
" 13	To Gopal		30	1,450	" 15	By Wages A/c			100
" 22	To Motu Ram		20	980	" 19	By Ganga Ram		20	480
" 14	To Sales A/c			400	" 20	By Typewriter A/c			2,000
					" 27	By Purchases A/c			500
					" 30	By Salary A/c			300
					" 30	By Rent A/c			800
					" 30	By Bank A/c			3,000
					" 31	By Balance c/d			1,150
			50	10,830				20	10,830
Feb. 1	To Balance b/d			1,150					

LEDGER

Sales Account

Dr. Cr.

			1988		Rs.
			Jan. 10	By Cash A/c	3,000
			" 24	By Cash A/c	400

Gopal's Account

			1988		Rs.
			Jan, 13	By Cash A/c	1,450
			" 13	By Discount Allowed A/c	30

Motu Ram's Account

			1988		Rs.
			Jan. 22	By Cash A/c	980
			" 22	By Discount Allowed A/c	20

Furniture Account

1988		Rs.			
Jan.6	To Cash A/c	500			

Purchases Account

1988		Rs.			
Jan .7	To Cash A/c	2,000			
" 27	To Cash A/c	500			

Wages Account

1988		Rs.			
Jan. 15	To Cash A/c	100			

Ganga Ram's Account

1988		Rs.			
Jan. 19	To Cash A/c	480			
" 19	To Discount, Received A/c	20			

Typcwrlter Account

1988		Rs.			
Jan. 20	To Cash A/c	2,000			

Salaries Account

1988		Rs.			
Jan. 30	To Cash A/c	300			

Rent Account

1988		Rs.			
Jan. 30	To Cash A/c	800			

Bonk Account

1988		Rs.			
Jan. 30	To Cash A/c	3,000			

Discount Allowed Account

1988		Rs.			
Jan. 31	To Sundries As per Cash Book	50			

Discount Received Account

			1988		Rs.
			Jan. 31	By Sundries as per Cash Book	20

3.3.3 Three Column. Cash Book

While recording transactions in the Simple Cash Book you learnt that when cash is deposited into the bank, an entry is made'on the credit side of the cash book and when cash is withdrawn from the bank it is entered on the debit side of the cash book. When these entries are posted into ledger we open a Bank Account and post all deposits into bank on its debit side and all withdrawals from the bank on its credit side. The difference between the debit and the credit reflects the balance with the bank.

Now-a-days bank plays a very important role in business and almost every firm has an account with a bank. The businessman generally retains a small amount of cash and deposits the rest in his bank account. Most of the receipts and payments are made through cheques. As such, bank transactions are more numerous than the cash transactions. They can also be recorded in the cash bóok by providing an additional column for bank on both sides of the cash book. All deposits made in the bank are to be recorded in the bank column on the debit side and all withdrawals from the bank in the bank column on the credit side. The bank column would thus serve the purpose of a Bank Account and there will be no need to open a Bank Account in the l'edger.

The cash book containing a bank column, in addition to cash and discount columns, is called Three Column Cash Book. All receipts are recorded on the debit side of this cash book and all payments on the credit side. When the amount is received or paid in cash, it is recorded in cash column and when it is done by cheque, it is recorded in the bank column. If discount is also involved, it will be shown in the appropriate discount column.

Contra Entry: There are some transactions which affect Cash Account and Bank Account in such a manner that one is to be debited while the other is to be credited. This happens only when either cash is deposited in the bank or cash is withdrawn from the bank. When cash is deposited into the bank you have to debit the Bank Account and credit the Cash Account, and in case of withdrawal from the bank, you have to debit the Cash Account and credit the Bank Account. When these transactions are recorded in a Three Column Cash Book both aspects appear in the Cash Book itself. One aspect is recorded on the debit side and the other on the credit side. For example, when cash is deposited in the bank it is recorded (i) in bank column on the debit side of the cash book, and (ii) in cash column on the credit side of the cash book. Similarly, when cash is withdrawn from the bank it is recorded (i) in cash column on the debit side of the cash book, and (ii) in bank column on the credit side of the cash book. Thus, the double entry of the transaction is complete in the cash book itself. Such an accounting entry is known as 'Contra Entry'. The word 'contra' means 'the'other side' or 'the opposite side'. Thus, contra entry implies that the corresponding aspect of the transaction is entered on the other side of the cash book. Contra entries are not to be posted in the ledger because you do not have Cash Account and Bank Account in the ledger and the double entry is completed in the cash book itself. The capital letter 'C' is written in the L.F. column on both sides of the cash book. This indicates that it is a contra entry. Look at the entries made on December 20 and 24 under Illustration 3.

Posting the Three Column Cash Book : All entries recorded in the Three Column Cash Book are to be posted to their respective ledger accounts, except the contra entries. For posting the entries recorded on the debit side of the cash book, credit the accounts concerned in the ledger by writing 'By Cash A/c' if the entry is in cash column, and 'By Bank A/c' if the entry is in bank column. If discount is also involved, credit the concerned personal account by writing 'By Discount Allowed A/c'. A similar procedure is followed for posting the entries on the credit side of the cash book. Totals of the discount allowed and discount received columns shall be posted to the respective discount accounts the same way as for the Two Column Cash Book.

Balancing the Three Column Cash Book : The cash and bank columns are balanced separately like any other ledger account. As stated earlier, the Cash Account always shows a debit balance. The Bank Account also normally shows a debit balance. But, sometimes it may show a credit balance which indicates the overdraft. It reflects the amount withdrawn from the bank in excess of what is deposited in the bank. Of course, it is done with a prior arrangement with the bank and is a common practice in business. The procedure of recording the closing and opening balances is the same as in Two Column Cash Book. Note that the discount column are not to be balanced. They are simply totalled.

Special points regarding cheques received: When a cheque is received from a party, normally it is deposited in the bank on the same day and entered in the bank column on the debit side of the cash book. Sometimes, for some reason, the cheque may not be deposited in the bank on the day of receipt. In such a situation it is kept in the cash box and entered in the cash column on the debit side of the cash book. Later on, when the cheque is deposited in the bank, it is recorded in the cash book as cash deposit in the form of a contra entry. In other words, it will be entered in the bank column on the debit side of the cash book and in the cash column on the credit side of the cash book. Look at illustration 3 and see how entries are made for the cheque received from Harish on December 28 and deposited in the bank on December 29. Normally this procedure is avoided. The entry is made directly in the bank column on the day the cheque is deposited in the bank. In the absence of any specific instructions, it can be presumed that the cheque received from a party was sent to the bank for collection on the same day.

Sometimes, a cheque received from a party may not be deposited in the bank, but may be endorsed in favour of a creditor of the business. In that case the cheque received will be entered first in the cash column on the debit side of the cash book and then on its credit side in the cash column. This ensures entries in the personal accounts of (i) the party from whom it is received, and (ii) the party to whom it is endorsed (refer to entries in Illustration 3 for the cheque received from Vikas on December 26 which is endorsed in favour of Rakesh on December 27).

Sometimes a cheque sent to the bank for collection may be dishonoured which means that, for some reason, the bank on which cheque was drawn refused its payment. In such a situation, the party from whom the cheque was received is to be debited and the Bank Account is to be credited. Hence, entry for the dishonour will be recorded in the bank column on the credit side of the cash book. This would nullify the effect of the entry made at the time of receiving and depositing the cheque. Look at the entry made on December 31 under Illustration 3 in respect of the dishonoured cheque of Harish.

Study Illustration 3 carefully and you will be able to understand clearly the recording, posting and balancing of a Three Column Cash Book.

Illustration 3

From the following particulars, prepare a Three Column Cash Book and post it into ledger.

1987			Rs.
Dec.	11	Cash in hand	10,000
	11	Balance in bank account	40,000
"	13	Bought goods for cash	5,000
"	15	Bought furniture and paid by cheque	7,000
"	17	Cash sales	6,000
"	19	Bought goods and issued cheque	15,000
"	20	Deposited cash in bank	5,000
"	22	Received cash from Suresh Discount allowed	2,450 50
"	23	Paid sundry expenses	500
"	24	Cash withdrawn for office use	5,000
"	25	Paid for stationery	500
"	26	Received cheque from Vikas	540
		Allowed him discount	10
"	26	Cheque received from Satish and deposited in bank	2,000

1987			Rs.
Dec.	27	Endorsed the cheque received from Vikas in favour of Rakesh	540
"	27	Paid Roshan Lal by cheque	4,960
		Received discount	40
"	28	Cheque received from Harish	1,000
"	29	Cheque of Harish deposited in bank	1,000
"	30	Paid Rent by cheque	2,000
"	31	Paid Salary by cheque	5,000
"	31	Withdrew from bank for personal use	2,000
"	31	Cheque received from Harish dishonoured	1,000
"	31	Bought machinery from Singh & Co. for cash	10,000

Solution :

CASH BOOK

(With Cash, Discount and Bank Columns)

Dr. Cr.

Date	Particulars	L.F.	Discount Allowed	Cash	Bnnk	Date	Particulars	L.F.	Discount Received	Cash	Bank
1987			Rs.	Rs.	Rs.	1987			Rs.	Rs.	Rs.
Dec. 11	To Balance b/d			10,000	40,000	Dec. 13	By Purchases A/c			5,000	
" 17	To Sales A/c			6,000		" 15	By Furniture A/c				7,000
" 20	To Cash A/c	C			5,000	" 19	By Purchases A/c				15,000
" 22	To Suresh		50	2,450		" 20	By Bank A/c	C		5,000	
" 24	To Bank A/c	C		5,000		" 23	By Sundry Expenses			500	5,000
" 26	To Vikas		10	540		" 24	By Cash A/c	C			
" 26	To Satish				2,000	" 25	By Stationery A/c			500	
" 28	To Harish			1,000		" 27	By Rakesh			540	
" 29	To Cash A/c	C			1,000	" 27	By Roshan Lal		40		4,960
						" 24	By Bank A/c	C		1,000	
						" 30	By Rent A/c				2,000
						" 31	By Salary A/c				5,000
						" 31	By Drawings A/c				2,000
						" 31	By Harish				1,000
						" 31	By Machinery A/c			10,000	
						" 31	By Balance c/d			2,450	6,040
			60	24,990	48,000				40	24,990	48,000
1988											
Jan. 1	To Bnlnnce b/d			2,450	6.040						

Notes:

1 **Transaction on December 20**

Cash deposited in the bank has been entered on both sides, in bank column on the debit side and in cash column on the credit side. It is a contra entry, so 'C' has been written in L. F. column on both the sides. These entries have not been posted in the ledger.

2 **Transaction on December 26**

A cheque for Rs. 540 was received from Vikas on December 26. It had not been deposited in the bank but endorsed in favour of Rakesh on December 27. It has been entered first in the cash column on the debit side on December 26 against the name of Vikas, and then in the cash column on the credit side on December 27 against the name of Rakesh. In the ledger, Vikas's Account gets the credit and Rakesh's Account gets the debit.

3 Transaction on December 28

A cheque for Rs. 1,000 received from Harish on December 28 is deposited in the bank on December 29. Hence, it has been entered in the cash column on December 28 and then shown as a cash deposit on December 29 by way of a contra entry.

4 Transaction on December 31

Cheque for Rs. 1,000 received from Harish on December 28 and sent to bank for collection on December 29 is returned dishonoured. It is recorded on the credit side in the bank column and posted to the debit side of Harish's Account. This nullifies the credit given to him on December 28.

LEDGER

Sales Account

Dr. Cr.

			1987		Rs.
			Dec. 17	By Cash A/c	6,000

Suresh's Account

			1987		Rs.
			Dec. 22	By Cash A/c	2,450
			" 22	By Discount Allowed A/c	50

Vikas's Amount

			1987		Rs.
			Dec. 26	By Cash A/c	540
			" 26	By Discount Allowed A/c	10

Satish's Account

			1987		Rs.
			Dec. 26	By Bank A/c	2,000

Harish's Account

1987		Rs.	1987		
Dec. 31	To Bank A/c	1,000	Dec. 28	By Cash A/c	1,000

Purchases Account

1987		Rs.			
Dec. 13	To Cash A/c	5,000			
" 19	To Bank A/c	15,000			

Furniture Account

1987		Rs.			
Dec. 15	To Bank A/c	7,000			

Sundry Expenses Account

1987		Rs.			
Dec. 23	To Cash N c	500			

1987			Rs.
Dec.	27	Endorsed the cheque received from Vikas in favour of Rakesh	540
"	27	Paid Roshan La1 by cheque	4,960
		Received discount	40
"	28	Cheque received from Harish	1,000
"	29	Cheque of Harish deposited in bank	1,000
"	30	Paid Rent by cheque	2,000
"	31	Paid Salary by cheque	5,000
"	31	Withdrew from bank for personal use	2,000
"	31	Cheque received from Harish dishonoured	1,000
"	31	Bought machinery from Singh & Co. for cash	10,000

Solution :

CASH BOOK

(With Cash, Discount and Bank Columns)

Dr. Cr.

Date	Particulars	L.F.	Discount Allowed	Cash	Bank	Date	Particulars	L.F.	Discount Received	Cash	Bank
1987			Rs.	Rs.	Rs.	1987			Rs.	Rs.	Rs.
Dec. 11	To Balance b/d			10,000	40,000	Dec. 13	By Purchases A/c			5,000	
" 17	To Sales A/c			6,000		" 15	By Furniture A/c				7,000
" 20	To Cash A/c	C			5,000	" 19	By Purchases A/c				15,000
" 22	To Suresh		50	2,450		" 20	By Bank A/c	C		5,000	
" 24	To Bank A/c	C		5,000		" 23	By Sundry Expenses			500	
" 26	To Vikas		10	540		" 24	By Cash A/c	C			5,000
" 26	To Setish				2,000	" 25	By Stationery A/c			500	
" 28	To Harish			1,000		" 27	By Rakesh			540	
" 29	To Cash A/c	C			1.000	" 27	By Roshan Lal		40		4,960
						" 29	By Bank A/c	C		1,000	
						" 30	By Rent A/c				2,000
						" 31	By Salary A/c				5,000
						" 31	By Drawings A/c				2,000
						" 31	By Harish				1,000
						" 31	By Machinery A/c			10,000	
						" 31	By Balance c/d			2,450	6,040
			60	24,990	48,000				40	24,990	48,000
1988											
Jan. 1	**To Balance b/d**			2,450	6.040						

Notes:

1 **Transaction on December** 20

Cash deposited in the bank has been entered on both sides, in bank column on the debit side and in cash column on the credit side. It is a contra entry, so **'C'** has been written in L. F. column on both the sides. These entries have not been posted in the ledger.

2 Transaction on **December** 26

A cheque for Rs. 540 was received from Vikas on December 26. It had not been deposited in the bank but endorsed in favour of Rakesh on December 27. It has been entered first in the cash-column on the debit side on December 26 against the name of Vikas, and then in the **cash** column on the credit side on December 27 against the name of Rakesh. In the ledger, Vikas's Account gets the credit and Rakesh's Account gets the debit.

3 Transaction on December 28

A cheque for Rs. 1,000 received from Harish on December 28 is deposited in the bank on December 29. Hence, it has been entered in the cash column on December 28 and then shown as a cash deposit on December 29 by way of a contra entry.

4 Transaction on December 31

Cheque for Rs. 1,000 received from Harish on December 28 and sent to bank for collection on December 29 is returned dishonoured. It is recorded on the credit side in the bank column and posted to the debit side of Harish's Account. This nullifies the credit given to him on December 28.

LEDGER

Sales Account

Dr. Cr.

			1987		Rs.
			Dec. 17	By Cash A/c	6,000

Suresh's Account

			1987		Rs.
			Dec. 22	By Cash A/c	2,450
			" 22	By Discount Allowed A/c	50

Vikas's Account

			1987		Rs.
			Dec. 26	By Cash A/c	540
			" 26	By Discount Allowed A/c	10

Satish's Account

			1987		Rs.
			Dec. 26	By Bank A/c	2,000

Harish's Account

1987		Rs.	1987		
Dec. 31	To Bank A/c	1,000	Dec. 28	By Cash A/c	1,000

Purchases Account

1987		Rs.			
Dec. 13	To Cash A/c	5,000			
" 19	To Bank A/c	15,000			

Furniture Account

1987		Rs.			
Dec. 15	To Bank A/c	7,000			

Sundry Expenses Account

1987		Rs.			
Dec. 23	To Cash A/c	500			

Stationery Account

1987		Rs.			
Dec. 25	To Cash A/c	500			

Rakesh's Account

1987		Rs.			
Dec. 27	To Cash A/c	540			

Roshan Lal's Account

1987		Rs.			
Dec. 27	To Bank A/c	4,960			
" 27	To Discount Received A/c	40			

Rent Account

1987		Rs.			
Dec. 30	To Bank A/c	2,000			

Salary Account

1987		Rs.			
Dec. 31	To Bonk A/c	5,000			

Drawings Account

1987		Rs.			
Dec. 31	To Bank A/c	2,000			

Machinery Account

1987		Rs.			
Dec. 31	To Cash A/c	10,000			

Discount Allowed Account

1987		Rs.			
Dec. 31	To Sundries—as per Cash Book	60			

Discount Received Account

			1987		Rs.
			Dec. 31	By Sundries—as per Cash Book	40

Check Your Progress A

1. Why is the journal sub-divided ?

....

....

....

....

2 Write the number of the correct alternative in the box.

a) A separate journal is kept for
   i) each transaction
   ii) each type of transactions
   iii) each type of transactions which are repetitive in nature and sufficiently large in number

b) Cash Book contains
   i) all receipts and payments of cash
   ii) all receipts only
   iii) all payments only

c) Journal Proper is meant for recording
   i) credit purchase of fixed assets only
   ii) returns of goods
   iii) all such transactions for which no special journal has been kept by the business

d) Purchases Journal is kept to record
   i) all purchases of goods
   ii) all credit purchases of goods
   iii) all credit purchases

e) Sales Journal is used to record
   i) cash sales
   ii) credit sales
   iii) credit sales of goods

Fill in the blanks

i) Cash Book also serves the purpose of a . . . . Account.

ii) Transactions entered on the debit side of the cash book are to be posted on the.........side of the concerned accounts in the ledger.

iii) Cash column of the cash book always shows .... balance.

iv) The total of a cash discount received column is posted to the .... side of the Discount Received Account.

v) If there is a credit balance in the bank column of the cash book it reflects an ...... in the bank.

vi) If debit as well as credit aspects of a transaction are recorded in the cash book itself, it is called a ....

vii) When a cheque is returned dishonoured, it is recorded on the ....side of the Cash Book in the bank column.

viii) When a cheque receiyed on a particular date is not deposited on the same day into the bank, it is entered in ....column on the debit side of the cash book.

4 Why discount columns in the cash book are not balanced?

....

....

....

....

....

3.4 BANK 'RECONCILIATION STATEMENT

You learnt that the firm records all transactions relating to its bank account 'in a Three Column Cash Book. All deposits into the bank are recorded on the debit side of the cash book and all withdrawals from the bank on the credit side. The bank also maintains the firm's account in its books. It credits customer's account with all deposits made by him and debits his account with all withdrawals made by him. The bank provides a copy of this account to the customer in the form of a bank statement or a pass book. The proforma of such a statement or the pass book is given in Figure 3.2.

Figure 3.2 : Proforma of Pass Book

Date	Particulars	Dr. Withdrawals	Cr. Deposits	Dr. or Cr.	Balance	Initials

When the businessman receives the bank statement or the pass book from the bank, he compares it with the cash book. Normally, entries in the cash book would tally with those in the pass book and the balances shown by both the books should also be the same. But in practice, they generally differ. This happens if there are some entries which have been recorded in the cash book but they do not appear in the pass book. Similarly, there may be some entries which have been recorded in the pass book but they do not appear in the cash book. The difference can also arise on account of errors committed either by the firm or by the bank in the recording of various transactions, Let us therefore understand clearly the exact causes of differences in the balances of these two books before we reconcile the balances of these two books.

3.4.1 Causes of Difference

The main causes that lead to disagreement in the balances of the cash book and the pass book are as follows :

1 Cheques issued but not yet presented for payment: Whenever a payment is made by cheque, the businessmen immediately records it in his cash book. But, the bank debits the firm's account only when the cheque is presented for payment. You know that there is always a time lag between the issue of cheques and its presentation for payment and so the date on which it will be recorded by the bank will always be later than the date of its recording in the cash book. It is quite possible that on a particular date when the bank submits the statement of account, there may be some cheques which have been issued but not yet presented for payment and so not recorded by the bank. Consequently, the balance shown by the pass book will be higher than the balance shown by the cash book. For example, a firm issued a cheque for Rs. 3,000 in favour of a creditor on December 28, 1987 which is presented to the bank for payment on January 2, 1988. The firm would record it in the cash book on December 28, 1987 whereas the bank would record it on January 2, 1988. When the firm would receive the pass book completed up to December 31, 1987 they would find the balance shown by the pass book is different from the balance shown by the cash book. The pass book balance would be higher by Rs. 3,000.

2 Cheques deposited into the bank but not yet collected: When a payment is received by cheque, the firm sends it to the bank for collection and records it immediately on the debit side of the cash book. This increases the bank balance as per cash book. But the bank will not credit the firm's account till the cheque is actually collected. So, the balance, in the pass book remains unaffected till the proceeds of the cheque are collected and credited. Thus, on a particular date, it is possible that certain cheques which were sent for collection might not have been collected by the bank and so not shown in the pass book. All such cheques pending collection would make the cash book balance different from the pass book balance, For example, the firm sends a cheque of Rs. 2,000 on June 28 to the bank for collection. The cheque is collected on July 6. Now, if the balances as on June 30 are compared, they will be different because the credit of Rs. 2,000 will not appear in the pass book.

3 Bank Charges: The bank usually charges some amount from their customers for various services provided by them. They may charge for collection of outstation cheques, for making or collecting payments on standing instructions, and so on. The bank debits the customer's account for such charges from time to time. However, the firm will know about these charges only when it goes through the pass book. So, on the date of reconciliation the pass book balance may differ from the balance as per cash bonk.

4 Interest allowed by **the** bank : The banks normally do not allow any interest on the cunant account balances. But if such interest is allowed, the bank credits it to the customer's account. This increases the balance in the pass book. The finn would pass the corresponding entry in the cash book only when it receives the intimation from the bank or when it notices it in the pass book. Hence, the cash book balance will be lower till such entry is made.

5 Interest on overdraft: When the businessman requires more funds he may request the bank for overdraft facility which means permitting him to draw more than the amount available in his account. When the businessman actually withdraws more than the available amount, he is said to have utilised the overdraft facility. The bank charges interest on the amount overdrawn and debits the same to his account periodically. The firm records the corresponding entry for interest on overdraft only when the pass book is received. Hence, the balance in the two books would differ till the entry is passed in the cash book.

6 Amount collected by bank on **standing instructions:** The businessman often issues standing instructions authorising his banker to collect on his behalf certain amounts due to him such as interest, dividends, etc. The bank credits the customer's account as and when it collects such amounts and sends the necessary intimation to him. The firm will pass'the corresponding entry in the cash book when it receives such intimation or when it notices it in the pass book. Thus, as' on the date of reconciliation, the balance as per cash book may be lower than the balance as per pass book.

7 **Payment** made by the bank as per the standing instructions: 'The businessman may also issue standing instructions to his banker to make certain payments on his behalf such as insurance premium, rent, etc. When the banker makes such payments, he would immediately debit the customer's account. So, the balance in the pass book would get reduced. If the corresponding entries for such payments have not been recorded in the cash book, the balance as per cash book would remain unchanged.

8 Direct payments into the bank made by firm's customers: Sometimes, a customer may directly deposit an amount into the firm's account. The firm shall record it in the cash book only when it learns about such deposit. But, the pass book would show the entry on the date of deposit itself. If, by the date of reconciliation, such entry has not been passed in the cash book, the balance shown by pass book will be higher than the balance as per cash book.

9 Dishonbur of cheques or bills: As already stated whencheques are sent to the bank for collection they are entered in the cash book immediately. But no entry appears in the pass book till they are collected by the bank. Sometimes, for one reason or the other, the cheques are dishonoured. In that case the bank will not make any entry in its books and returns such cheques to the firm. The same thing applies to the bills receivable sent for collection to the bank. On receiving the dishonoured cheques or bills the firm has to pass a reverse entry in the cash book. But, till such entry is passed the balances shown by the cash book and the pass book would differ.

10 Errors: It is quite possible that while recording the transactions in the cash book some errors might have been committed by the firm. For example, a cheque deposited in the bank may not be recorded at all, or is recorded on the wrong side in the cash book. Similarly, the bank may also commit some errors while recording entries in the customer's account. For example, a cheque collected on behalf of a customer is entered in some other account. Such errors would also lead to the disagreement of the balances in the cash book and the pass book.

3.14.2 What is Bank Reconciliation Statement?

By comparing the entries in the cash book with those in the pass book you can easily ascertain the exact causes of difference between the balance as per cash book and the balance as per pass book. In order to reconcile these balances every firm prepares a statement showing all the causes of differences. This statement is called Bank Reconciliation Statemefit and is prepared periodically. The main objective of preparing such a statement is to account for the difference between the cash book and the pass book balances and pass the necessary correcting entries in the books of the firm.

Thus, Bank Reconciliation Statement can be defined as a statement which reconciles the balance as per cash book and the balance as per pass book showing all causes of difference between the two.

3.4.3 Preparation-of Bank Reconciliation Statement

The Bank Reconciliation Statement is prepared at the end of a quarter, half year or a year as the firm may consider desirable and convenient. It can be prepared in two ways :

i) Take the balance as per cash book as the starting point, adjust the effect of each item causing the difference, and arrive at the balance as per pass book.

ii) Take the balance as per pass book as the starting point, adjust the effect of each item causing the difference, and arrive at the balance as per cash book.

Whatever be the method, first of all you must analyse the effect of each item on the balance of the book which you are using as the starting point. In other words, whether it has led to a higher balance or a lower balance in that book. This helps you to decide whether a particular item is to be added to, or subtracted from, such a balance.

Suppose, you start with cash book balance as the base and the item causing the difference is the bank charges of Rs. 100. This item appears in the pass book but not in the cash book. The bank charges would appear in the withdrawals column of the pass book which means that the pass book balance had decreased by Rs. 100. Since it has not been shown in the cash book, the cash book balance remained unaffected, it did not decrease. Hence the cash book balance would be higher than the pass book balance by Rs.100. If we now subtract this amount from the cash book balance it will reconcile with the pass book balance. Take another example. The bank collected Rs. 500 as interest on securities on behalf of the firm. But, the same had not been recorded in the cash book. This item would appear in the deposit column of the pass book which means the pass book balance had increased by Rs. 500. Since it had not been shown in the cash book, the cash book balance remained unaffected, it did not increase. Hence, the cash book balance would be lower than the pass book balance by Rs. 500. If we now add this amount to the cash book balance it will reconcile with the pass book balance.

If you were to start with pass book balance as the base you would do just the reverse of what you did when you started with cash book balance as the base. You will add Rs. 100 relating to the item of bank charges because it leads to a lower balance in the pass book and subtract Rs. 500 relating to interest on securities collected by the bank because it had increased the pass book balances.

Generally, the firms adopt the first method because the Bank Reconciliation Statement is prepared primarily for the verification of the bank balaqce as shown by the cash book.

From the above examples it should be clear to you that in case you start with cash book balance you should add all those items which have been responsible for lower balance in the cash book and subtract those which have been responsible for a higher balance. Let us, for convenience, list the items which would generally be added and subtracted when cash balance is used as the starting point.

To be added

1 Cheques issued but not yet presented

2 Interest allowed by the bank

3 Interest and dividends collected but not recorded in the cash book

4 Direct deposits by customers in the firm's bank account.

To be subtracted

1 Cheques deposited but not yet collected

2 Bank charges

3 Interest on overdraft

4 Amounts paid by the bank under standing instructions but not recorded in the cash book

5 Cheques dishonoured but no entry made in the cash book for the dishonour

If the pass book balance is taken as the starting point, just reverse the above process. Add those which are to be subtracted from the cash book balance as per the above list and subtract those which are to be added to the cash book balance as per the above list.

The above analysis will help you to prepare the Bank Reconciliation Statement correctly. Look at Illustration 4 and study how a Bank Reconciliation Statement is prepared with cash book balance as the starting point.

Illustration 4

From the following particulars, prepare a Bank Reconciliation Statement as on December 31, 1987:

On December 31, 1987 Mohan's cash book showed a debit balance of Rs. 7,800. The balance as per pass book was Rs. 10,300. On comparing the cash book with the pass book, the following discrepancies were found :

1 Two cheques for Rs. 1,600 and Rs. 2,000 issued on December 23 have not been presented to the bank for payment.
2 A cheque for Rs. 1,200 was deposited in the bank on December 29, but it was credited by the bank on January 5, 1988.
3 There was a credit entry in the pass book for Rs. 520 in respect of dividend received by the bank on behalf of Mohan. This had not been recorded in the cash book.
4 Rs. 300 was deposited by a customer directly into the bank.
5 The bank charged Rs. 60 as their commission for collecting an outstanding cheque. No entry for this appeared in the cash book.
6 A cheque for Rs. 500 received from Gopi and deposited in the bank was dishonoured, but no entry was recorded in the cash book for the dishonour.
7 A cheque for Rs. 160 was entered in the cash book but it was not sent to the bank for collection.

Solution:

Bank Reconciliation Statement as on December 31, 1987

	Rs.	Rs.
Balance as per Cash Book		7,800
Add: Cheques issued but not yet presented for payment	3,600	
Dividends collected by bank but not yet recorded in the cash book	520	
Amount deposited by a customer directly in the bank	300	
		4,420
		12,220
Less: Cheque deposited hut'not yet collected by bank	1,200	
Bunk charges debited by bank but not yet recorded in the cash book	60	
Cheque dishonoured but no entry mude in cash book for the dishonour	500	
Cheque received from a customer entered in the cnsh book but not sent to the bank for collection	160	
		1,920
Balance as per Puss Book		10,300

Note: The statement bears a heading 'Bank Reconciliation Statement' and mentions the date for which reconciliation is done. So, whenever you prepare a Bank Reconciliation Statement, make sure that it bears this heading along with the date of reconciliation.

The Bank Reconciliation Statement can also be prepared by 'plus and minus method'. In that case you will have two separate amount columns, one for additions and the other for subtractions. The first column is called 'plus column' and the second column is called 'minus column'. The Bank Reconciliation Statement prepared according td this method will appear as follows:

Bank Reconciliation Statement as on December 31, 1987

Particulars	Plus Column	Minus Column
	Rs.	Rs.
Balance as per Cash Book	7,800	
1 Cheques issued but not yet presented for payment	3,600	
2 Cheque deposited but not yet collected by bank		1,200

	Particulars	Plus Column	Minus Column
3	Dividends collected by bank, not yet recorded in the cash book	520	
4	Amount deposited by a customer directly in the bank	300	
5	Bank charges debited by bank but not yet recorded in the cash book		60
6	Cheque dishonoured but no entry made in cash book for the dishonour		500
7	Cheque received from the customer entered in the cash book not sent to bank for collection		160
		12,220	1,920
	Balance as per Pass Book (Rs. 12,220— Rs. 1,920)	10,300	

Now, look at Illustration 5 and study how a Bank Reconciliation Statement will be prepared with pass book balance as the starting point.

Illustration 5

From the following, prepare a Bank Reconciliation Statement of Radhey Lal as on March 31,1988. Balance as per pass book as on March 31,1988 was Rs. 22,000.

1. Cheques amounting to Rs. 9,000 were deposited in the bank during March, but credit was given only for Rs. 7,000.
2. The bank paid insurance premium of Rs. 300 on March 20, but it was not entered in the cash book.
3. A discounted bill receivable for Rs.1,500 was returned dishonoured to the bank on March 27, but the corresponding entry in the cash book was made in April.
4. A cheque for Rs, 800 received on March 29 was entered in the cash book, but it was sent to the bank on April 3.
5. Of the cheques amounting to Rs. 3,000 issued to creditors, the cheques for Rs. 1,800 only were presented for payment.
6. The bank charges debited in the pass book amounted to Rs. 50.
7. Interest on securities collected and credited by the bank amounting to Rs. 1,000 was not entered in the cash book.

Solution:

Bank Reconciliation Statement
as on March 31,1988

	Particulars	Plus Column	Minus Column
		Rs.	Rs.
	Balnnce as per Pass Book	22,000	
1	Cheques deposited but not yet collected	2,000	
2	Insurance premium paid by bank but not yet recorded in the cash book	300	
3	B/R dishonoured but not yet recorded in the cash book	1,500	
4	Cheque received from a customer entered in the cash book but not yet sent to the bank for collection	800	
5	Cheques issued but not yet presented for payment		1,200
6	Bank charges debited by bank not yet recorded in the cash book	50	
7	Interest on securities collected by bank but not yet recorded in the cash book		1,000
		26,650	2,200
	Balance as per Cash Book (Rs. 26,650— Rs. 2,200)	24,450	

3.4.4 When there is an Overdraft ?

You know when a businessman withdraws from the bank more money than is available in his account, it is said that he has an overdraft (an unfavourable balance) in his bank account. It is one of the most commonly used method of borrowing money from the bank.

You have learnt the method of preparing a Bank Reconciliation Statement when the firm has a favourable balance in the bank. Let us now study how Bank Reconciliation Statement will be prepared when the firm has an unfavourable balance (an overdraft).

You know when the firm has a favourable balance the cash book shows a debit balance. But when the firm has an overdraft, it will show a credit balance because, in such a situation, the bank is a creditor for the firm. As for the pass book, when the firm has favourable balance it shows a credit balance and when the firm has an overdraft it will show a debit balance, because for the bank the firm is n debtor when there is an overdraft. In other words it can be stated that when cash book shows a credit balance or, when pass book shows a debit balance, the firm has an overdraft.

The preparation of the Rank Reconciliation Statement does not differ much whether there is a favourable balance or an overdraft, specially if you follow the 'plus and minus method'. You know when the firm has a favourable balance, it is shown in plus column of the Bank Reconciliation Statement. But, if there is an overdraft it will be shown in the minus column. This is the main point you have to remember while preparing a Bank Reconciliation Statement when there is an overdraft. The treatment with regard to items causing difference between the balances of the two books remains the same.

If, however, you do not follow the plus and minus method you will have to analyse first the effect of each discrepancy on the overdraft and then decide whether the amount involved is to be added or subtracted. When you make such analysis you will observe that the effect of each discrepancy on overdraft will be just the reverse of what it would be on a favourable balance. For example, if bank charges are found to be unrecorded in the cash book which shows a favourable balance, this omission is considered responsible for a higher balance in the cash book and so, while preparing Bank Reconciliation, it is subtracted from the balance. But in case of an overdraft omitting to record the bank charges would mean a lower amount of overdraft in the cash book and so, while preparing the Bank Reconciliation Statement it will have to be added. Thus, you will find that when you prepare a Bank Reconciliation Statement with an overdraft as per cash book as the starting point you will have to add all items which were subtracted when you started with a favourable balance as per cash book, and'vice-versa. This makes the preparation of the Bank Reconciliation quite complicated. Hence, you are advised to follow plus and minus method. In that case by simply showing the overdraft in the minus column you will automatically have the desired effect of each item duly adjusted in the overdraft. Look at Illustration 6. It starts with an overdraft as per cash book. The overdraft is shown in the minus column of the Bank Reconciliation Statement but all other items have been treated in the same way as in Illustration 5.

Illustration 6

From the following particulars ascertain the balance as would appear in the bank pass book of Ram Prasad on January 31, 1988. The cash hook showed a credit balance of Rs. 8,200.

		Rs.
1	Cheques issued but not cashed by January 31,1988	2,300
2	Cheques paid into bank but not cleared by January 31, 1988	3,000
3	Interest charged on overdraft appeared in the pass book only	120
4	Bank charges debited by bank but not recorded in the cash book	50
5	Interest on debentures collected by bank but not recorded in the cash book	600
6	Bank paid insurance premium as per standing instructions	220
7	A customer paid into firm's bank account directly	1,000

Solution:

Bank Reconciliation Statement
as un January 31, 1988

Particulars	Plus Column	Minus Column
	Rs.	Rs.
Overdraft as per Cash Book		8,200
1 Cheques issued but not yet presented for payment	2.300	
2 Cheques deposited into bank but not yet credited		3,000
3 Interest on overdraft not yet recorded in the cash book		120
4 Bank charges not yet recorded in the cash book		50
5 Interest on debentures collected by bank not yet recorded in the cash book	600	
6 Insurance premium paid by bank but not yet recorded in the cash book		220
7 Amount deposited by a customer directly into bank	1,000	
	3,900	11,590
Overdraft as per Pass Book (Rs. 11,590 — Rs. 3,900)		7,690

In Illustration 6, the starting point was the overdraft as per cash book. Let us see how a Bank Reconciliation Statement is prepared if the starting point is overdraft as per pass book. Look at Illustration 7 and compare it with Illustration 5. You will find that the treatment of all items is the same. The difference lies only in showing the pass book balance. Since it is an overdraft, it has been shown in the minus column.

Illustration 7

From the following particulars, ascertain the bank balance as it would appear in cash book of Rati Ram on December 31,1987. His Pass Book showed an overdraft of Rs. 7,500.

		Rs.
1	Cheques issued but not presented for payment till December 31, 1987	1,000
2	Cheques deposited in bank on December 29,1987 but not credited till December 31, 1987	2,500
3	Bank charges recorded in pass book	40
4	Bank collected dividend on shares on behalf of Rati Ram	1,200

Solution:

Bank Reconciliation Statement
as on December 31, 1987

Particulars	Plus Column	Minus Column
	Rs.	Rs.
Overdraft as per Pass Book		7,500
1 Cheques issued but not yet presented for payment		1,000
2 Cheques deposited in bank but not yet collected	2,500	
3 Bank charges not yet recorded in the cash book	40	
4 Dividend collected by bank not yet recorded in the cash book		1,200
	2.540	9,700
Balance as per Cash Book (overdraft) (Rs. 9,700— Rs. 2.540)		7,160

Illustration 8

The pass book of Roshan showed a credit balance of Rs. 12,000 on March 31, 1987, while the bank column of his cash book showed an overdraft of Rs. 9,000. Starting with the pass book balance, prepare the Bank Reconciliation Statement using the following information.

1 Of the cheques amounting to Rs. 8,000 deposited in the bank up to March 31, 1987, a cheque of Rs. 1,800 was collected by the bank on April 3,1987.

2 Cheque of Rs. 2,500 issued to Harish was wrongly entered twice in the cash book.

3 Cheques issued during the month amounted to Rs. 8,000 of which cheques for Rs. 1,000 were not presented to the bank up to March 31, 1987.

4 The pass book showed a credit of Rs.100 as interest for which there was no entry in the cash book.

5 The pass book showed a payment of Rs. 500 as life insurance premium for which no entry was made in the cash book.

6 The pass book showed a direct deposit of Rs. 10,000 from Mahesh on March 28, 1987. It was entered in the cash book only on April 2, 1987.

7 A cheque for Rs. 3,100 issued to a creditor was entered in the bank column of the cash book as Rs. 13,000.

8 The bank debited Roshan's account with a cheque for Rs. 200 received from Ajay which had been returned dishonoured. No entry for dishonour was passed in the cash book.

Solution:

Rank Reconciliation Statement
as on March 31,1987

Particulars	Plus Column	Minus Column
	Rs.	Rs.
Balance as per Pass Book	12,000	
1 Cheques deposited but not yet collected by the bank	1.800	
2 Cheque issued wrongly recorded twice in the cash book		2,500
3 Cheques issued but not yet presented fur payment		1,000
4 Interest allowed by bank not yet recorded in the cash book		100
5 Life insurance premium paid by bank not yet recorded in the cash book	500	
6 Direct deposit by a customer not yet recorded in the cash book		10,000
7 Excess amount recorded in the cash book by mistake for a cheque issued		9,900
8 Dishonoured cheque not yet recorded in the cash book	200	
	14,500	23,500
Overdraft as per Cash Book (Rs. 23,500— Rs. 14,500)		9,000

Note: In this illustration you find that the total of the minus column exceeds the total of the plus column. Hence the difference of Rs. 9,000 is treated as overdraft as per cash book.

3.4.5 Adjusting the Cash Book Balance

When you look at the various items that normally cause the difference between the cash book balance and the pass book balance, you will find a number of items which appear only in the pass book. Why not record such items in the cash book before preparing the Bank Reconciliation Statement? This shall reduce the number of items responsible for the difference. So, as soon as the pass book is received, the firm may record all those items in the cash book which appear only in pass book and work out a fresh balance of the cash book. This is called 'adjusted balance' or 'corrected balance' as per cash book. Similarly, it may also pass correcting entries for tlie errors committed in the cash book and adjust the cash book balance.

When you work out an adjusted balance of the cash book as above, the Bank Reconciliation Statement may be prepared with this adjusted balance, This would reduce the number of items shown in the Bank Reconciliation Statement. As a matter of fact, this is exactly what is done in practice.

The items which can usually be adjusted in the cash book are :

1 Interest allowed by bank
2 Amounts collected by bank as per standing instructions
3 Payments made by bank as per standing instructions
4 Bank charges
5 Interest on overdraft
6 Direct deposits by customers
7 Dishonoured cheques or bills receivable
8 Errors committed in the cash book

Look at the Illustration 4 again. You will find that out of the seven items causing the difference four items can be adjusted in the cash book as follows :

Cash Book
(Bank Column only)

Dr. | | | | | Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1987		Rs.			Rs.
Dec. 31	To balance b/d	7,800	Dec. 31	By Bank charges A/c	60
" 31	To Interest on Securities	520	" 31	By Gopi (cheque dishonoured)	500
" 31	To Customer's A/c	300	" 31	By Balance c/d	8,060
		8,620			8,620
1988 Jan. 1	To balance b/d	8,060			

The adjusted balance as per cash book is Rs. 8,060. Now, if we prepare the Bank Reconciliation Statement with the adjusted balance, it will appear as follows :

Bank Reconciliation Statement
as on December 31,1987

Particulars	Plus Column	Minus Column
	Rs.	Rs.
Balance as per Cash Book	8,060	
1 Cheques issued but not yet presented	3,600	
2 Cheques deposited but not yet collected by the bank		1,200
3 Cheques received from a customer but not yet sent to the bank for collection		160
	11,660	1,360
Balance as per Pass Book (Rs. 11,660 — Rs. 1,360)	10,300	

Thus, you observe that the Bank Reconciliation Statement prepared with the adjusted balance included only three items. These items could not be adjusted in the cash book because they had already been recorded in the cash book correctly. The difference arose only on account of the time lag.

It may however be emphasised that you should concentrate on preparing the Bank Reconciliation in the normal manner. The statement with an adjusted balance of the cash book is to be prepared only when it is specifically asked far.

3.4.6 Advantages of Bank Reconciliation Statement

The main purpose of preparing Bank Reconciliation Statement is to account for the difference between the cash book and the pass book balances. This would ensure the accuracy of entries made in the cash book as well as those in the pass book. Regular comparison of these two books is necessary for preparing the Bank Reconciliation Statement. This helps in the detection of errors and taking timely action to correct them. It is quite possible that the bank wrongly debits firm's account for cheques drawn by someone else. If reconciliatibn is not done, such mistakes will not be detected. Preparation of Bank Reconciliation Statement also helps in preventing frauds in banking transactions. The cashier, for example, may omit to deposit some bearer cheques in the bank and encash them himself. Such fraud is sure to be detected at the time of reconciliation when it is investigated as to why certain cheques remained uncollected. Thus, it acts as a moral check on the staff to refrain from indulging in such activities.

Bank Reconciliation Statement is alsorequired for audit purposes. The auditor has to verify the bank balance before he would certify. the accounts. For this he would insist on the Bank Reconciliation Statement and ensure that the bank balance shown in the cash book is correct.

Check Your Progress B

1 What is Bank Reconciliation Statement?

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2 Give two examples of items which are usually recorded first in the cash book and later in the pass book.

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3 Give two examples of items which are usually recorded first in the pass book and later in the cash book.

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4 Choose one of the alternatives and tick (✓) the correct answer.

a) Bank Reconciliation Statement is
   i) a part of the cash book
   ii) a statement showing the causes of difference between the cash book and the pass book balances
   iii) a ledger account

b) Bank Reconciliation Statement is prepared by
   i) business
   ii) bank
   iii) debtor

c) Debit balance in the cash book means
   i) overdraft
   ii) favourable balance
   iii) neither of the two

d) Debit balance in the pass book means
   i) overdraft
   ii) favourable balance
   iii) neither of the two

e) Overdraft as per cash book means
   i) debit balance in the cash book
   ii) credit balance in the cash book
   iii) nil balance in the cash book

f) When balance as per cash book is the starting point, unpresented cheques are
   i) added
   ii) subtracted
   iii) neither of the two

g) When balance as per pass book is the starting point, uncollected cheques are
   i) added
   ii) subtracted
   iii) neither of the two

h). When balance as per pass book is the starting point, direct deposits by customers are
   i) added
   ii) subtracted
   iii) neither of the two

5 What is an adjusted balance of cash book?

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3.5 PETTY CASH BOOK

You have so far learnt that all cash receipts and payments are recorded in the cash book. In practice you will find that almost in every business there are many small payments in cash such as stationery, postage, telegrams, cartage, conveyance, etc. If all these small payments are also recorded in cash book, the cash book will become bulky, and the cashier will also be overburdened with the work. In order to reduce the burden on the cashier, a separate book called 'Petty Cash Book' is maintained for recording all such small payments. A petty cashier is appointed for this purpose. He is paid a certain sum in advance. He keeps on making small payments out of this advance and records them in the Petty Cash Book. The amount of money given to petty cashier is called petty cash.

3.5.1 Imprest System

Generally, Petty Cash Book is maintained on imprest system. Under this system an estimate is made of the amount required for small payments for a certain period, say, a week or a month and this amount is paid to the petty cashier in advance. The petty cashier makes the small payments and records them in the Petty Cash Book. All such payments are supported by vouchers or receipts. At the end of the period , the petty cashier submits the account to the chief cashier. The chief cashier examines the account and pays to the petty cashier the amount spent by him so that at the beginning of the next period again he has the same amount as he had in the beginning. This system of advance is called the 'imprest system' and the amount given to the petty cashier as advance is known as the 'imprest money'. For example, on April 1, Rs. 300 is given as advance to the petty cashier. He spends Rs. 260 during the month and submits the account alongwith the vouchers to the chief cashier. After verifying the account, the chief cashier pays him Rs. 260. Thus, on May 1, the petty cashier again has Rs. 300 with him. The amount to be given to the petty cashier i.e., imprest money, should be carefully determined. It should neither be too large nor too small, it should be sufficient to make small payments for the fixed period.

3.5.2 Recording and Posting the Petty Cash Book

As you will observe in Illustration 9 the Petty Cash Book has a number of columns. The extreme left-hand column records the receipts of cash. But on the payment side a separate column is provided for each expense, such as postage, telegrams, stationery, cartage, wages, conveyance, etc. This facilitates the analysis of payments under different headings and also helps in posting to the concerned accounts. The number of columns depend upon the nature and size of the business. The columns provided for different expenses generally art: (i) printing and stationery, (ii) postage and telegrams, (iii) cartage, (iv) conveyance, (v) entertainment. and (vi) sundry expenses.

When the petty cashier receives money from the chief cashier, he records it in the particulars column of the Petty Cash Book by writing 'To Cash A/c' (if he receives cash) or 'To Bank A/c' (if he receives a cheque) and records the amount in receipts column. When payment is made, it is entered in the particulars column by writing the name of the expense incurred. The amount is first recorded in the 'total payments' column and then in the relevant column provided for it.

The Petty Cash Book is balanced periodically. The difference between the total receipts and total payments is the balance with the petty cashier. This balance is carried to the next period and the petty cashier is paid the amount actually spent by him. Thus, you will note that the procedure of balancing the Petty Cash Book is the same as you have adopted in the case of ordinary cash book.

A 'Petty Cash Account' is opened in the ledger. It is debited with the amount given to petty cashier. When Petty Cash Book is balanced, each expense account is individually debited with the periodic total as per the respective column by writing 'To Petty Cash A/c' and the 'Petty Cash Account' is credited with the total expenditure incurred during the peirod by writing 'By Sundries as per Petty Cash Book'. The Petty Cash Account is then balanced, It normally shows a debit balance which will be equal to the actual cash with the petty cashier.

Look at Illustration 9. It shows the recording of Petty Cash Book and its posting into the ledger.

Illustration 9
Enter the following transactions in Petty Cash Book, and post them into ledger.

1988			Rs.
Jan.	1	Received cash from chief cashier	300.00
"	2	Paid for postage	25.20
"	3	Paid for stationery	10.50
"	5	Paid conveyance to clerk	10.20
"	6	Paid for telegram	12.40
"	8	Paid for ink	6.10
"	9	Paid for tea for customers	5.00
"	10	Stamps purchased	13.00
"	12	Purchased pens	20.00
"	14	Paid for trunk call	27.50
"	15	Paid cartage	8.00
"	16	Paid for taxi fare	43.50
"	17	Purchased soap	5.60
"	18	Paid for typewriting paper	40.00
"	19	Cartage paid	10.00
"	20	Bus fare paid to clerk	8.20
"	21	Paid to coolie	10.50
"	22	Tips to peon	5.00
"	23	Purchased registers	20.00
"	28	Rickshaw charges	2.50
"	30	Paid for cold drinks for customers	7.50

Solution:

Petty Cash Book

Receipts	Date	Particulars	V. No.	Total	Stationery	Postage & Telegrams	Cartage	Conveyance	Entertainment Expenses	Sundry Expenses
Rs.	1988		Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	
300.00	Jan. 1	To Cash A/c								
	" 2	By Postage		25.20		25.20				
	" 3	By Stationery		10.50	10.50					
	" 5	By Conveyance		10.20				10.20		
	" 6	By Telegrams		12.40		12.40				
	" 8	By Ink		6.10	6.10					
	" 9	By Tea Expenses		5.00					5.00	
	10	By Stamps		13.00		13.00				
	" 12	By Pens		20.00	20.00					
	" 14	By Trunk Call		27.50		27.50				
	" 15	By Cartage		8.00			8.00			
	" 16	By Taxi Fare		43.50				43.50		5.60
	" 17	By Soap		5.60						
	" 18	By typewriting paper		40.00	40.00					
	" 19	By Cartage		10.00			10.00			
	" 20	By Bus Fare		8.20				8.20		
	" 21	By Coolies		10.50			10.50			5.00
	" 22	By Tips		5.00						
	" 23	By Registers		20.00	20.00					
	" 28	By Rickshaw		2.50				2.50		
	" 30	By cold drinks		7.50					7.50	
		Total Payments		290.70	96.60	78.10	28.50	64.40	12.50	10.60
	Jan 31	By Balance c/d	9.30							
		Total	300.00							
9.30	Feb.1	To Balance b/d								
290.70	" 1	To Cash A/c								

LEDGER

Petty Cash Account

Dr.					Cr.
1988		Rs.	1988		Rs.
Jan. 1	To Cash A/c	300.00	Jan. 31	By Sundries as per Petty Cash Book	290.70
			" 31	By Balance c/d	9.30
		300.00			300.00
Feb. 1	To Balance b/d	9.30			
" 1	To Cash A/c	290.70			

Stationery Account

1988		Rs.			
Jan. 31	To Petty Cash A/c	96.60			

Postage & Telegrams Account

		Rs.			
1988		78.10			
Jan. 31	To Petty Cash A/c				

Cartage Account

1988		Rs.			
Jan. 31	To Petty Cash A/c	28.50			

Conveynnce Account

1988		Rs.			
Jan. 31	To Petty Cash A/c	64.40			

Entertainment Account

1988		Rs.			
Jan. 31	To Petty Cash A/c	12.50			

Sundry Expenses Account

1988		Rs.			
Jan. 31	To Petty Cash A/c	10.60			

3.6 LET US SUM UP

When the number of transactions in a business are too large, it becomes difficult to record all of them in the Journal. Hence, it is sub-divided into a number of special journals called subsidiary books. Each subsidiary book is used for recording only one category of transactions. The subsidiary books generally used are: (i) Cash Book, (ii) Purchases Journal, (iii) Purchases Returns Journal, (iv) Sales Journal, (v) Sales Returns Journal, (vi) Bills Receivable Journal, (vii) Bills Payable Journal, and (viii) Journal Proper.

All cash transactions are recorded in Cash Book. There are three types of cash books. They are: (i) Simple Cash Book, (ii) Two Column Cash Book, and (iii) Three Column Cash Book. Simple Cash Book has only one amount column on both sides. All cash receipts are recorded on the debit side and all cash payments on the credit side. It serves the purpose of Cash Account. The Two Column Cash Book has an additional column for cash discount on both sides. The discount allowed is recorded on the debit side and the discount received on the credit side. The Three Column Cash Book provides one more column on both sides for recording the banking transactions. All deposits into the bank are recorded in the bank column on the debit side of the cash book and all withdrawals on the credit side. This serves the purpose of a Bank Account.

When cash book and the pass book are compared, it is often found that the balances shown by these two books differ. There may be many causes leading to difference. A Bank Reconciliation Statement is prepared to explain the causes of difference and take the necessary follow up action. It can be prepared either by taking cash book balance as the starting point or by taking pass book balance as the starting point, It can also be prepared by taking the adjusted balance of the cash book as the starting point. The adjusted balance of the cash book is arrived at by passing corresponding entries in the cash book for items which appeared in the pass book only.

A Petty Cash Book can also be prepared for recording payments of various petty expenses. It is maintained on imprest system which means advancing a fixed amount to the petty cashier. The maintenance of Petty Cash Book saves a lot of labour and time.

3.7 KEY WORDS

Bank: An organisation which deals in money by accepting deposits and lending money to those who need it. It also provides various other services to its customers.

Bank Charges: Amount charged by bank for providing various services to its customers.

Bank Reconciliation Statement: A statement reconciling the bank balance as shown by the cash book with that of the pass book by showing all causes of difference between the two.

Cheque: An instrument used for withdrawing money from the bank. It is an unconditional order on the bank made by its customer, instructing the bank to pay the amount specified therein to the person named in the cheque or to his order.

Contra **Entry:** When both the debit and the credit aspects of a transaction are recorded in the cash book itself, it is called a contra entry.

Dishonour: Refusal by bank to make payment against the cheque.

Endorsement: A written statement made and signed by the payee at the back of the cheque for its transfer.

Favourable Balance: Balance indicating that the customer has got money in his account with the bank.

Imprest System: A system of advancing a fixed amount to the petty cashier.

Pass Book: A book supplied by the bank to its customers showing his transactions with the bank.

Standing Instructions: Instructions to the bank for making certain payments and collections regularly on behalf of the customer.

Subsidiary Book: A special journal used for recording a particular category of transactions.

3.8 SOME USEFUL BOOKS

1 Maheshwari, S.N., 1986. *Introduction to Accounting,* Vikas Publishing House, New Delhi. (Chapters 5,7)

2 Patil, V.A. and J.S. Korlahalli, 1986. ***Principles and Practice** of **Accounting, R.*** Chand & Co., New Delhi. (Chapters 7,10)

3 William Pickles, 1982. ***Accoimtancy,*** E.L.B.S. and Pitman, London. (Chapter 2)

4 Gupta R.L. and M. Radhaswamy, 1986. ***Advanced Accountancy,*** Sultan Chand & Sons, New Delhi. (Chapters 3.10)

3.9 ANSWERS TO CHECK YOUR PROGRESS

A 2 (a) iii (b) i (c) iii (d) ii (e) iii

3 (i) Cash (ii) credit (iii) debit (iv) credit (v) overdraft (vi) contra entry (vii) credit (viii) cash

B 4 (a) ii (b) i (c) ii (d) i (e) ii (f) i (g) i (h) ii

3.10 TERMINAL QUESTIONS/EXERCISES

Questions

1 Why is journal sub-divided? Name the special journals generally maintained by the business and state the type of transactions entered in each of them.

2 Explain the following in about 50 words each,

a) Cash Book is both a journal and a ledger

b) Posting of the Two Column Cash Book

c) Imprest System

d) Advantages of preparing a Bank Reconciliation Statement

3 State various causes of disagreement between the balances shown by the cash book and the pass book.

4 Why is cash book adjusted? Explain how Bank Reconciliation Statement is prepared with an adjusted balance of cash book.

5 What are the advantages of maintaining a Petty Cash Book? Explain the method of balancing and posting the Petty Cash Book.

Exercises

1 From the following particulars, prepare a Simple Cash Book, balance it, and post it into ledger :

1987			Rs.
Nov.	1	Commenced business with cash	20,000
"	2	Deposited in Bank Account	10,000
"	3	Purchased furniture for cash	500
"	3	Paid cartage	70
"	4	Purchased goods for cash	5,000
"	8	Cash sales	4,000
"	10	Received from Shyam Lal	1,000
"	18	Withdrew from bank	5,000
"	20	Received cash from Mahesh	1,500
"	25	Purchased a typewriter	7,000
"	28	Paid wages	500
"	30	Deposited into bank	5,000
"	31	Paid rent for the month	1,000

(Answer: Cash in hand Rs. 2,430)

2 Enter the following transactions in Two Column Cash Book, balance it, and post it into ledger.

1987			Rs.
Dec.	1	Cash in hand .	10,000
"	2	Boughtgoods	4,000
"	3	Paid to Kapil	500
"	4	Cash sales	2,000
"	5	Cash sales	3,000
"	6	Bought goods on credit from Suresh	3,000
"	6	Paid cartage	60
"	8	Purchased stationery	100
"	10	Paid to Suresh	2,950
"		Discount allowed by him	50
"	15	Paid travelling expenses	100
"	16	Sold goods on credit to Shankar	1,600
"	18	Purchased furniture	2,500
"	20	Received from Shankar	1,550
"		Discount allowed to him	50
"	25	Purchased typewriter	5,000
"	27	Paid to Kumar Rs. 1,900 in full settlement of his account of Rs. 2.000.	
"	29	Received from Hari	2,470
		Discount allowed to him	30
"	31	Paid wages	500
"	31	Withdrew for personal use	200

Hint: Credit purchases and credit sales of goods are not entered in cash book. They are to be recorded in Purchases Journal and Sales Journal respectively.

(Answer: Cash Balance Rs. 1,210; Discount Allowed Rs. **80:** Discount Received Rs. 150)

3 Prepare a Three Column Cash Book from the following transactions and post them into ledger.:

1987			Rs.
Oct.	1	Cash in hand	2,000
		Cash at bank	10,000
"	3	Bought goods and paid by cheque	4,000
"	5	Purchased furniture for cash	1,000
"	7	Paid wages by cash	600
"	10	Sold goods to Harish for cash	2,000
"	12	Received cheque from Gopal	2,000
"	15	Paid to Manohar by cheque	2,450
		Discount received from him	50
"	17	Received cheque from Rajesh	500
"	18	Cheque received from Gopal deposited in the bank	2,000
"	19	Paid to Banarasi Das by cheque	3,000
"	20	Cheque of Rajesh endorsed to Ram	500
"	22	Deposited into bank	2,000
"	24	Sold goods and received a cheque	4,000
"	25	Withdrew from bank for personal use	600
"	26	Received from Rakesh	2,480
		Discount allowed to him	20
"	31	Paid rent by cheque	1,000
"	31	Paid salaries by cheques	3,000
"	31	Withdrew from bank for office use	2,000

(Answer: Cash Balance Rs. 4,880; Bank Balance Rs. 1,950; Discount Allowed Rs. 20; Discount Received Rs. 50)

4 Record the following transactions in a Three Column Cash Book and post them into ledger.

1987			Rs.
Nov.	1	Cash balance	900
		Bank overdraft	1,500
"	2	Cash sales	600
"	4	Received from Nafees	980
"		Discount allowed to him	20
"	6	Paid to Rao by cheque	1,000
"	7	Received a cheque from Mahesh	500
"	8	Paid wages	100
"	10	Purchased goods for cash	1,000
"	15	Paid for stationery	100
"	17	Received a cheque from Bansilal and endorsed it to Amar Nath	1,000
"	22	Cash sales	1,000
"	28	Paid rent	500
"	30	Paid telephone bill by cheque	200
"	31	Deposited into bank	1,000

(Answer: Cash Balance Rs. 780; Bank Overdraft Rs. 1,200; Discount Allowed Rs. 20)

5 The cash book of a trader showed a bank balance of Rs. 7,500 on December 31,1987. On going through the cash book it was found that: (i) two cheques for Rs. 500 and

Rs. 700 deposited on December 28 were credited in the pass book on January 4, 1988; (ii) Three cheques for Rs. 500, Rs. 900 and Rs. 1,200 issued on December 29, 1987 were presented to the bank for payment on January 7, 1988; (iii) Bank had credited the trader for Rs. 125 as interest and had debited him for Rs. 10 as bank charges for which there were no corresponding entries in the cash book.

Prepare a Bank Reconciliation Statement as on December 31, 1987.

(Answer: Balance as per Pass Book Rs. 9,015)

6 Prepare a Bank Reconciliation Statement on December 31, 1987 from the following particulars.

		Ks.
1	Overdraft as per cash book	10,210
2	Interest and bank charges appeared in pass book only	305
3	A cheque debited in cash book but not credited by bank	300
4	Cheques issued but not cashed by customers up to December 31, 1987	2,320
5	Cheques paid into bank but not yet cleared	1,550
6	A Bill Receivable discounted with the bank on November, 1987, dishonoured on December 30, 1987. No entry was made in the cash book.	800

(Answer: Overdraft as per Pass Book Rs. 10,845)

7 When Madhav & Co. Ltd. received its bank statement for the period ending on June 30, 1987, the balance therein did not agree with tlie balance as per cash book. The Bank statement showed a balance of Rs. 12,000. The following discrepancies were noticed,

1 A cheque for Rs. 400 paid on June 30 was not credited by the bank until July 2,

2 Bank charges amounting to Rs. 20 were not entered in the cash book.

3 A debit of Rs. 70 appeared in the cash book in respect of a cheque which had been returned by the bank marked 'out of date'. The cheque was revalidated by the customer and received by Madhav & Co. Ltd. in July. It was deposited into the bank again on July 6.

4 A standing instruction for payment of annual subscription amounting to Rs. 40 was not entered in the cash book.

5 On June 26, the Managing Director gave the cashier a cheque for Rs. 800 to pay into his petsonal account at the bank. The cashier paid it into the company's account by mistake.

6 On June 29, two customers paid Rs. 700 and Rs. 800 directly into the company's bank account. The concerned advices had not been received by the company until July 3.

7 Rs. 250 paid into the bank was entered twice in the cash book.

8 Cheques amounting to Rs. 3,500 were issued but not yet presented for payment.

9 A customer of the company who received a cash discount of 1.5% on his account of Rs. 1,000 paid the company by cheque on June 10. The cashier by mistake entered the gross amount in the bank column of the cash hook.

Prepare the Bank Reconciliation Statement.

(Answer: Balance as per Cash Book Rs. 6,995)

8 On June 26,1988, I had an overdraft of Rs. 7,500 as shown by my pass book. Cheques amounting to Rs. 1,000 had been paid into the bank on June 24, but of these only Rs. 750 was credited in the pass book. I had also issued cheques amounting to Rs. 2,500 of which Rs. 2,000 worth only have been presented. There is a debit in my pass book of Rs. 75 for interest. I also find that a cheque for Rs. 60 which I had debited to Bank Account in my pass books has been omitted to be banked. An entry of Rs. 300 of a payment by a customer direct into the bank appears in the pass book only.

Prepare a Reconciliation Statement as on June 30, 1988.

(**Answer:** Overdraft as per Cash Book Rs. 7,915)

9 Prepare a Bank Reconciliation Statement from the following particulars and find out the balance as per pass book on December 31,1987. The bank balance as per cash book was Rs. **5,600.**

1 Cheques Received from the following persons were paid into the bank in December 1987 but were credited by the bank in January 1988.

Shekhar Rs. 2,500
Madan Rs. 3,200
Rakesh Rs. **4,480**

2 Cheques issued by the firm in December 1987, were cashed in January 1988.

Ahmed Rs. 700
David Rs. 900
Siva Rs. 550

3 The pass book showed a credit of Rs. 100 for interest.

4 'A debit of Rs. 20 for bank charges appeared twice in the pass book. However, it did not appear in cash book at all.

5 Jagdeep, a customer, deposited a cheque of Rs. 100 directly into firm's bank account for which there was no entry in the cash book.

6 A cheque for Rs. 100 received from Pradeep and deposited into the bank was returned dishonoured.

7 A cheque received from Anil for Rs. 690 was entered twice in the cash book.

(Answer: Overdraft as per Pass Book Rs. 3,060)

10 Compile a Petty Cash book on the Imprest System from the following particulars.

1988			Rs.
Feb.	1	Received a cheque for petty cash	200.00
"	2	Bought postage stamps	4.70
"	4	Paid for stationery	10.00
"	6	Paid for tonga hire	5.00
"	8	Paid cartage	10.00
"	9	Paid for two telegrams	15.20
"	12	Coolie charges	5.00
"	15	Paid for tea far customers	5.50
"	17	Paid for minor repairs	12.00
"	18	Bus fare	4.50
"	19	Purchased ink and pencils	7.50
"	20	Purchased soap	5.50
"	21	Paid to sweeper	5.00
"	22	Paid taxi fare	45.50
"	23	Cold drinks for customers	7.50
"	25	Paid travelling expenses	20.00
"	26	Bought Air mail letters	17.50
"	28	Purchased order books	12.00

(**Answer: On March** 1, 1988, petty cashier will be given a cheque for Rs. 192.40)

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 4 OTHER SUBSIDIARY BOOKS

Structure

4.8 OBJECTIVES

After studying this unit you should be able to:

- prepare purchases and purchases returns journals and post them into ledger
- prepare sales and sales returns journals and post them into ledger
- identify transactions to be recorded in journal proper and explain the journal entries to be passed

4.1 INTRODUCTION

In Unit 3 you learnt why journal is sub-divided and which subsidiary books are generally used in business. You also learnt about the preparation of different types of cash books and their posting into ledger. In this unit we intend to discuss most of the remaining subsidiary books including Journal Proper. The Bills Receivable Book and Bills Payable Book will be taken up in Unit 5 where bills of exchange transactions have been discussed in detail.

4.2 SPECIAL PURPOSE SUBSIDIARY BOOKS

You have learnt that in any business the number of cash and bank transactions is quite large. Hence, the firms always maintain a separate book called Cash Book to record them. Similarly, the transactions relating to purchase and sale of goods are also large in number and they take place too frequently. It is, therefore, considered desirable to maintain separate books for purchases and sales of goods also. But you know cash purchases and cash sales of goods are recorded in the Cash Book. Therefore, separate books will be needed only for recording credit purchases and credit sales of goods. The firms generally maintain four separate books to record credit transactions relating to goods. These are: (i) Purchases journal, (ii) Purchases Returns Journal, (iii) Sales Journal, and (iv) Sales Returns Journal. Let us now discuss them one by one,

4.2.1 Purchases Journal

The Purchases Journal (also called Purchases Book) Is used for recording credit purchases of goods and raw-materials. Note that the credit purchases of fixed assets like furniture, vehicles, etc. are not recorded in this book. They are to be recorded in Journal Proper about which you will learn later in this unit. The Purchases Journal is also called 'Purchases Book', 'Purchases Day Book:, and 'Invoice Book'. The proforma of Purchases Journal is given in Figure 4.1.

Prepare a Reconciliation Statement as on June 30, 1988.

(Answer: Overdraft as per Cash Book Rs. 7,915)

9 Prepare a Bank Reconciliation Statement from the following particulars and find out the balance as per pass book on December 31, 1987. The bank balance as per cash book was Rs. 5,600.

1 Cheques Received from the following persons were paid into the bank in December 1987 but were credited by the bank in January 1988.

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Madan Rs. 3,200
Rakesh Rs. 4,480

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David Rs. 900
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3 The pass book showed a credit of Rs. 100 for interest.

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"	6	Paid for tonga hire	5.00
"	8	Paid cartage	10.00
"	9	Paid for two telegrams	15.20
"	12	Coolie charges	5.00
"	15	Paid for tea for customers	5.50
"	17	Paid for minor repairs	12.00
"	18	Bus fare	4.50
"	19	Purchased ink and pencils	7.50
"	20	Purchased soap	5.50
"	21	Paid to sweeper	5.00
"	22	Paid taxi fare	45.50
"	23	Cold drinks for customers	7.50
"	25	Paid travelling expenses	20.00
"	26	Bought Air mail letters	17.50
"	28	Purchased order books	12.00

(Answer: On March 1, 1988, petty cashier will be given a cheque for Rs. 192.40)

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 4 OTHER SUBSIDIARY BOOKS

Structure

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- prepare sales and sales returns journals and post them into ledger
- identify transactions to be recorded in journal proper and explain the journal entries to be passed

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4.2.1 Purchases Journal

The Purchases Journal (also called Purchases Book) is used for recording credit purchases of goods and raw-materials. Note that the credit purchases of fixed assets like furniture, vehicles, etc. are not recorded in this book. They are to be recorded in Journal Proper about which you will learn later in this unit. The Purchases Journal is also called 'Purchases Book', 'Purchases Day Book:, and 'Invoice Book'. The proforma of Purchases Journal is given in Figure 4.1.

Figure 4.1: Purchases Journal

Date	Name of the Supplier	Invoice No.	L. F.	Amount	Remarks

When goods are purchased on credit you will receive a bill from the seller. Such a bill is called 'Invoice'. It contains the details pertaining to the quantity, description, price, trade discount, total amount, etc. It is generally prepared in duplicate. The original is given to the buyer and the duplicate is retained by the seller. The entries in the Purchase Journal are made on the basis of the purchase invoices received. Although the invoices bear a number but the buyer accords his own serial number to all inward invoices for easy reference. It is this serial number which will be entered in the invoice number column of the Purchases Journal.

The transactions recorded in the Purchases Journal are to be posted to their respective personal accounts in the ledger. When a purchase is made on credit, the supplier becomes the creditor for the firm. Hence, every credit purchase recorded in the Purchases Journal is posted on the credit side of the personal account of the supplier by writing 'By Purchases A/c' in particulars column. The Purchases Journal is totalled periodically, say, weekly or monthly. This total is posted to the debit side of Purchases Account in the ledger by writing 'To Sundries—as per Purchases Journal'. Thus, you observe that posting of Purchases Journal involves two steps: (i) posting each purchase to the credit of the respective personal accounts of suppliers, and (ii) posting the total purchases to the debit of the Purchases Account. With this, the double entry for credit purchases is complete.

4.2.2 Purchases Returns Journal

In any business, sometimes goods purchased may have to be returned to the supplier either partly or fully. This may become necessary when they are found to be defective, damaged in transit, inferior quality, short weight, received too late, or not in conformity with the order given. If the number of such returns is small they can be recorded in the journal itself. But, if it is large, a separate book called 'Purchases Returns Journal' should be used for recording these transactions. This book is also called 'Returns Outwards Journal' or 'Purchases Returns Book'. The proforma of a Purchases Returns Journal is given in Figure 4.2.

Figure 4.2: Purchases Returns Journal

Date	Name of the Supplier	Debit Note No.	L. F.	Amount	Remnrks

When goods are returned to the supplier, a statement called 'Debit Note' is sent to him intimating that his account has been debited on account of the goods returned. The debit note also contains particulars and the value of goods returned. It is also prepared in duplicate. The original is sent to the supplier and the duplicate is retained by the firm. The entries in the Purchases Returns Journal are made on the basis of the copies of debit notes issued, The debit notes bear a serial number which is duly recorded in the third column of the Purchases Returns Journal. While recording the amount of purchases returns, you must remember that if the original purchases involve some trade discount, it is also adjusted in the value of goods returned. The transactions recorded in the Purchases Returns Journal are to be posted to their respective personal accounts in the ledger. Separate account in the name of each supplier already exists in the ledger (opened at the time of purchase). The entries made in the Purchases Returns Journal will be posted to the debit of each supplier's account by writing 'To Purchases Returns A/c'. The total of the Purchases Returns Journal is posted to the credit side of the 'Purchases Returns Account' in the ledger by writing 'By Sundries—as per Purchases Returns Journal'.

4.2.3 Sales Journal

The Sales Journal is used for recording the credit sales of goods only. The credit sale of items which do not constitute goods are not to be recorded in this book. The Sales Journal is also called 'Sales Book' or 'Sales Day Book'.

The ruling of the Sales Journal is similar to that of the Purchases Journal. The difference is only with regard to the second column. In Purchases Journal the second column is used for recording the name of the supplier. But, in case of the Sales Journal, it is used for writing the name of the customer.

You know when goods are sold on credit, an invoice is given to the buyer. The seller generally has a bound invoice book which contains consecutively numbered invoices in duplicate. While the original copy is given to the buyer, the duplicate remains in the book itself. The entries in the Sales Journal are made with the help of the duplicate copies of the invoices issued.

The customer to whom the goods are sold on credit becomes debtor to the firm. Hence, each sale recorded in the Sales Journal is posted to the debit of the personal account of the customer concerned by writing 'To Sales A/c' in particulars column. The total of the Sales Journal is posted on the credit side of the Sales Account by writing 'By Sundries—as per Sales Book'.

4.2.4 Sales Returns Journal

When customers return goods to the business, it is normally recorded in a separate book called 'Sales Returns Journal'. If, however, the number of such returns are small, they can be recorded in the Journal itself. The Sales Returns Journal is also called 'Returns Inwards Journal' or 'Sales Returns Book'. Its ruling is more or less similar to that of Purchases Returns Journal. The second column of the Sales Returns Journal is used for recording the name of the customer and the third column for credit note number, while in Purchases Returns Journal they are used for recording the name of the supplier and debit note number respectively.

When a customer returns goods to the business, a statement called 'Credit Note' is issued to him. It contains particulars and the value of goods returned by him. The entries in Sales Returns Journal are made with the help of credit notes issued. While recording the account of sales returns, you must remember that if the original sales involve some trade discount, it is also adjusted in the value of goods returned. The transactions recorded in the Sales Returns Journal are posted to the respective personal accounts in the ledger. Separate accounts in the name of each customer already exists in the ledger (opened at the time of sale). Credit the customers' accounts individually by writing 'By Sales Returns A/c' and then post the total of the Sales Returns Journal to the debit side of the Sales Returns A/c by writing 'To Sundries—as per Sales Returns Journal'.

Look at Illustration 1 and study how credit transactions relating to goods are recorded in various special purpose subsidiary books and postings made in the ledger.

Illustration 1

Enter the following transactions in proper subsidiary books of Chekra Enterprises and show their postings into ledger.

1987			Rs.
Aug.	1	Sold goods to Ram Singh	2,550
"	2	Bought goods from Dhillon	1,200
"	3	Sold goods to Gopinath	2,500
"	4	Purchased goods from Habeeb	3,600
"	5	Ram Singh returned goods	350
"	6	Goods returned to Dhillon	200
"	9	Gopinath returned goods	150
"	10	Returned goods to Habeeb	260
"	12	Bought goods from Sanyal	4,750
"	13	Sold goods to Sailo	6,200

1987		Rs.
Aug. 14	Sold goods to Michael	4,850
" 15	Purchased goods from Anthony	3,940
" 18	Returned goods to Sanyal	320
" 19	Sailo returned goods	230
" 22	Michael returned goods	150
" 25	Returned goods to Anthony	250
" 27	Sold goods to Solanki	5,340
" 28	Purchased goods from Gopalan	4,670
" 29	Sold goods to Harbinder Singh subject to a trade discount of 5%	2,000
" 30	Purchased goods from Bhandari subject to a trade discount of 10%	1,000

Solution:

PURCHASES JOURNAL

Date	Name of the Supplier	Invoice No.	L. F.	Amount	Remarks
1987				Rs.	
Aug. 2	Dhillon			1,200	
" 4	Habeeb			3,600	
" 12	Sanyal			4,750	
" 15	Anthony			3,940	
" 28	Gopalan			4,670	
" 30	Bhandari			900	
" 31	Total			19,060	

PURCHASES RETURNS JOURNAL

Date	Name of the Supplier	Debit Note No.	L. F.	Amount	Remarks
1987				Rs.	
Aug. 6	Dhillon			200	
" 10	Habeeb			260	
" 18	Sanyal			320	
" 25	Anthony			250	
" 31	Total			1,030	

SALES JOURNAL

Date	Name of the Customer	Invoice No.	L. F.	Amount	Remarks
1987				Rs.	
Aug. 1	Ram Singh			2,550	
" 3	Gopinath			2,500	
" 13	Sailo			6.200	
" 14	Michael			4,850	
" 27	Solanki			5.340	
" 29	Harbinder Singh			1,900	
" 31	Total			23,340	

SALES RETURNS JOURNAL

Date	Name of the Customer	Credit Note No.	L. F.	Amount	Remarks
1987				Rs.	
Aug. 5	Ram Singh			350	
" 9	Gopinath			150	
" 19	Sailo			230	
" 22	Michael			150	
" 31.	Total			880	

Purchases Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1987		Rs.			
Aug. 31	To Sundries—as per Purchases Journal	19,060			

Dhillon's Account

1987		Rs.	1987		Rs.
Aug. 6	To Purchases Returns A/c	200	Aug. 2	By Purchases A/c	1,200

Habeeb's Account

1987		Rs.	1987		Rs.
Aug. 10	To Purchases Returns A/c	260	Aug. 4	By Purchases A/c	3,600

Sanyal's Account

1987		Rs.	1987		Rs.
Aug. 18	To Purchases Returns A/c	320	Aug. 12	By Purchases A/c	4,750

Anthony's Account

1987		Rs.	1987		Rs.
Aug. 25	To Purchases Returns A/c	250	Aug. 15	By Purchases A/c	3,940

Gopalan's Account

			1987		Rs.
			Aug. 28	By Purchases A/c	4,670

Bhandari's Account

			1987		Rs.
			Aug. 30	By Purchases A/c	900

Purchases Returns Account :

			1987		Rs.
			Aug. 31	By Sundries-as per Purchases Returns Journal	1,030

Sales Account

Dr.					Cr.
			1987		Rs.
			Aug. 31	By Sundries—as per Sales Journal	23,340

Ram Singh's Account

1987		Rs.	1987		Rs.
Aug. 1	To Sales A/c	2,550	Aug. 5	By Sales Returns A/c	350

Gopinath's Account

1987		Rs.	1987		Rs.
Aug. 3	To Sales A/c	2,500	Aug. 9	By Sales Returns A/c	150

Sailo's Account.

1987		Rs.	1987		Rs.
Aug. 13	To Sales A/c	6,200	Aug. 19	By Sales Returns A/c	230

Michael's Account

1987		Rs.	1987		Rs.
Aug. 14	To Sales A/c	4,850	Aug. 22	By Sales Returns A/c	150

Solanki's Account

1987		Rs.			
Aug. 27	To Sales A/c	5,340			

Harbinder Singh's Account

1987		Rs.			
Aug. 29	To Sales A/c	1,900			

Sales Returns Account

1987		Rs.			
Aug. 31	To Sundries—as per Sales Returns Journal	880			

Check Your Progress A

1 What is an invoice?

....

....

....

....

2 What.is a debit note?

....

....

....

....

3 What is a credit note?

....

....

....

....

4 Fill in the blanks.

i) Purchases Journal records credit purchases of .... only.

ii) Sales Journal records all .... sales of goods.

iii) A .... is sent to a customer when he returns the goods.

iv) Total purchases are posted to ....Account at the end of every month.

v) Total of Sales Journal is posted on the ....side of Sales Account at the end of every month.

vi) Sales Returns are also called.......................

vii) Purchases Returns are also called........................

viii) Debit Note is sent to the supplier when the goods are ....to him.

4.3 JOURNAL PROPER

You have learnt that certain types of transactions which are repetitive and large in number are recorded in special journals called subsidiary books. The remaining transactions are to be recorded in the journal itself which is now called the Journal Proper. As a matter of fact, all events and transactions for which the firm does not maintain a special journal shall be recorded in the Journal Proper. The following are the examples of transactions which shall usually be recorded in Journal Proper.

1 Opening Entry
2 Closing Entries
3 Transfer Entries
4 Adjustment Entries
5 Rectification Entries
6 Miscellaneous Entries

Let us now briefly discuss them one by one.

1 Opening Entry: An opening entry is passed in the journal for opening a new set of accounts. This may be needed at the time of commencement of business or at the commencement of new accounting year. If a person commences business only with cash, there is no need to pass a journal entry. The cash brought in is simply entered in the Cash Book, But, if he also brings some other assets, an opening entry will have to be recorded in the journal. You will debit the concerned assets accounts and credit the Capital Account. In case of a running business, an opening entry is passed at the commencement of the new accounting year to incorporate the balances of various assets and liabilities brought forward from the previous year into the current year's books. You have already learnt about it in Unit 2.

2 Closing Entries: At the end of each accounting year, when final accounts are prepared, the nominal accounts are closed by transferring them to Trading Account or Profit and Loss Account. The journal entries passed for this purpose are called 'Closing Entries'. These entries are explained later in Unit 7.

3 Transfer Entries: When an amount is to be transferred from one account to another, you have to pass an entry in the Journal Proper in order to effect the transfer. Such entries are called 'Transfer Entries', Suppose, you want to transfer proprietor's total drawings made during the year to his Capital Accouqt. Total drawings appear in Drawings Account which shows a debit balance. You will transfer this balance to Capital Account by passing the following entry in the Journal Proper:

Capital Account Dr.
To Drawings Account
(Being Transfer entry)

4 Adjustment Entries: At the time of preparing the final accounts, it becomes necessary to bring into books of account certain unrecorded items like closing stock, depreciation on fixed assets, interest on capital, expenses incurred but not yet paid, income earned but not yet received, etc. Entries passed in the Journal Proper to record such items are called 'Adjustment Entries'. These entries are explained in detail later in Unit 8.

5 Rectification Entries: You may commit errors while recording transactions in various books or while posting, totalling, balancing, etc. Such errors are generally corrected through entries in Journal Proper and are known as 'Rectification Entries'. Errors and their rectifications will be dealt with in Unit 9.

6 Miscellaneous Entries: If, in addition to the entries mentioned above, there is any transaction which cannot be recorded in any of the special journals, it will be entered in the Journal Proper. Examples of such transactions are:

i) Credit purchases of fixed assets, investments, etc.
ii) Credit sales of fixed assets, investments, etc.
iii) Withdrawal of goods from the business by the owner for his personal use.
iv) Loss of goods by theft, accident, fire, etc.
v) Special allowances received from suppliers or given to customers.
vi) Endorsement or dishonour of bills.
vii) Writing off bad debts.

Look at the Illustration 2 for entries of such transactions in the Journal Proper.

Illustration 2

Enter the following transactions in Journal Proper of Kansal Enterprises.

1988

May 3 Sold office van for Rs.15,000 to Ahmed Ali.
" 8 The proprietor took away goods worth Rs. 1,000 for personal use.
" 15 Fire broke out in the premises and goods worth Rs. 5,000 were destroyed.
" 21 Purchased furniture on credit for Rs. 2,000 from Singh & Co. for the office.
" 25 Amount'of Rs. 500 due from Shyam is irrecoverable, as he became insolvent.
" 28 Misra, a customer, informed that some goods were damaged in transit. An allowance of Rs. 50 was granted to him for repairs

Solution:

JOURNAL PROPER

Date	Particulars	L. F.	Debit Amount	Credit Amount
1988			Rs.	Rs.
May 3	Ahmed Ali Dr. To Office Van A/c (Being the credit sale of office van to Ali)		15,000	15,000
" 8	Drawings A/c Dr. To Purchases A/c (Being the withdrawal of goods by the owner for his domestic use)		1,000	1,000
" 15	Loss by Fire A/c Dr. To Purchases A/c (Being loss of goods by fire accident)		5,000	5,000
" 21	Furniture A/c Dr. To Singh & Co. (Being the furniture bought from Singh)		2,000	2,000

"	25	Bad Debts A/c Dr. To Shyam (Being the amount irrecoverable from Shyam)			500	500
"	28	Allowances A/c Dr. To Misra (Being an allowance granted for repairs of goods damaged in transit)			50	50

Check Your Progress B

1 List five transactions which are to be recorded in the Journal Proper.

....

....

....

....

2 State whether each of the following statements is True or False.

i) Closing entries are passed for transferring the amount of one account to another. ....

ii) Rectification entries are passed for correction of errors in books of account. ....

iii) Credit purchases of fixed assets will be recorded in the Purchases Book. ....

iv) Special allowance granted to a customer is recorded in Sales Returns Book. ....

v) Journal Proper is meant for recording all such transactions which cannot be recorded in any special journal. ....

vi) Cash sale of fixed asset will be recorded in Journal Proper. ....

4.4 A COMPREHENSIVE ILLUSTRATION

You have learnt the method of recording transactions In journal and its sub-divisions. You have also learnt their posting into the concerned accounts in the ledger and the preparation of a Trial Balance to check the arithmetical accuracy of the books of account: Let us now take a comprehensive example covering all types of transactions, record them in appropriate books, post them into ledger, and prepare a Trial Balance.

Illustration 3

On January 1, 1988 the balances of Tenali Traders stood as follows :

Cash in hand Rs. 2,000; Cash at bank Rs. 12,300; Stock in trade Rs. 51,700; Furniture Rs. 8,200; Debtors Rs. 6,600 (Shyam Rs. 3,500, Shanker Rs, 2,600, Laxman Rs. 500); Creditors Rs. 7,100 (Reddy & Co. Rs. 3,020, Kishore Rs. 4,080); Capital Rs. 73,700.

Their Transactions during the month of January were as follows:

1988			Rs.
Jan.	1	Borrowed from Globe Finance Co.	10,000
"	2	Bought goods for cash	2,300
"	2	Purchased from Reddy & Co.	5,500
"	3	Paid into Bank	9,000
"	5	Received Cheque from Shyam	3,500
"	6	Sold goods for cash	1,200
"	7	Sold to Shanker	8,700
"	8	Paid Kishore by cheque	2,000
		Discount received	100

Jan.	9	Received Cheque from Shanker on account	5,000
"	9	Sold to Reddy & Co.	380
"	10	Sold goods to Thomas	10,000
"	10	Drew cash from bank	1,000
"	12	Purchased postage stamps	300
"	14	Bought goods from Bose & Sons	9,300
"	16	Paid Globe Finance & Co. by cheque in part payment of loan	5,000
"	17	Received cash from Laxman	500
"	21	Paid Reddy & Co. by cheque	6,000
"	23	Carriage paid	100
"	24	Withdrew cash for private expenses	1,500
"	28	Paid salaries in cash	800
"	30	Rent due to landlord	500
"	31	Purchased furniture on credit from Joseph	600
"	31	Paid interest to Globe Finance Co.	100

Enter the above transactions in the appropriate books, post them into ledger, and prepare a Trial balance.

Solution:

Books of Tanali Traders

CASH BOOK

Dr. **Cr.**

Date	Particulars	L.F.	Discount	Cash	Bank	Date	Particulars	L.F.	Discount	Cash	Bank
1988			Rs.	Rs.	Rs.	1988			Rs.	Rs.	Rs.
Jan. 1	To Balance b/d			2,000	12,300	Jan. 2	By Purchases A/c			2,300	
" 1	To Globe Finance Co. Loan A/c			10,000		Jan. 3	By Bank A/c	C		9,000	
" 3	*To* Cash A/c	C			9,000	Jan. 8	By Kishore		100		2,000
" 5	*To* Shyam				3,500	Jan. 10	By Cash A/c	C			1,000
" 6	*To* Sales A/c			1,200		Jan. 12	*By* Postage A/c			300	
" 9	To Shanker				5,000	Jan. 16	By Globe Finance Co. Loan A/c				5,000
" 10	*To* Bank A/c	C		1,000		Jan. 21	By Reddy & Co.				6,000
" 17	To Laxman			500		Jan. 23	By Carriage A/c			100	
						Jan. 24	By Drawings A/c			1,500	
						Jan. 28	By Salaries A/c			800	
						Jan. 31	By Interest A/c			100	
				14,700	29,800	Jan. 31	By Balance c/d			600	15,800
Feb. 1	To Balance b/d			600	15,800				100	14,700	29,800

.PURCHASES JOURNAL

Date	Name of the Supplier	Invoice No.	L.F.	Amount	Remarks
1988				Rs.	
Jan. 2	Reddy & Co.			5,500	
" 14	Bose & Sons			9,300	
" 31	Total			14.800	

SALES JOURNAL

Date	Name of the Customer	Invoice No.	L.F.	Amount	Remark~
1988				Rs.	
Jan. 7	Shanker			8,700	
" 9	Rcddy & Co.			380	
" 10	Thomas			10,000	
" 31	Total			19,080	

JOURNAL

Date	Particulars		L. F.	Dr. Amount	Cr. Amount
1988				Rr.	Rs.
Jan. 1	Cash A/c	Dr.		2,000	
	Bank A/c	Dr.		12,300	
	Stock A/c	Dr.		51,700	
	Furniture A/c	Dr.		8,200	
	Shyam	Dr.		3,500	
	Shanker	Dr.		2,600	
	Laxman	Dr.		500	
	To Reddy & Co.				3,020
	To Kishore				4,080
	To Capital A/c				73,700
	(Being an opening entry)				
" 30	Rent A/c	Dr.		500	
	To Rent Outstanding A/c				500
	(Being rent due to landlord)				
" 31	Furniture A/c	Dr.		600	
	To Joseph				600
	(Being furniture bought on credit from Joseph)				
" 31	Total			81,900	81,900

LEDGER

Globe Finance Co's, Loan Account

Dr. **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
1988		Rs.	1988		Rs.
Jan. 16	To Bank A/c	5,000	Jan. 1	By Cash A/c	10,000
31	To Balance c/d	5,000			
		10,000			10,000
			Feb. 1	By Balance b/d	5,000

Shyam's Account

1988		Rs.	1988		Rs.
Jan. 1	To Balance b/d	3,500	Jan. 5	By Bank A/c	3,500

Sales Account

1988		Rs.	1988		Rs.
Jan. 31	To Balance c/d	20,280	Jan. 6	By Cash A/c	1,200
			" 31	By Sundries—ns per Sales Journal	19,080
					20,280
		20,280	Feb. 1	By Balance b/d	20,280

Shanker's Account

1988		Rs.	1988		Rs.
Jan. 1	To Balance b/d	2,600	Jan. 9	By Bank A/c	5,000
" 7	To Sales A/c	8,700	" 31	By Balance c/d	6,300
		11,300			11,300
Feb. 1	To Balance bld	6,300			

Laxman's Account

1988		Rs.	1988		Rs.
Jan. 1	To Balance b/d	500	Jan. 17	By Cash A/c	500

Purchnscs Account

1988		Rs.	1988		Rs.
Jan. 2	To Cash A/c	2,300	Jan. 31	By Balance c/d	17,100
" 31	To Sundries—as per Purchases Journal	14,800			
		17,100			17,100
Feb. 1	To Balance b/d	17,100			

Kishore's Account

1988		Rs.	1988		Rs.
Jan. 8	To Bank A/c	2,000	Jan. 1	By Balance b/d	4,080
" 10	To Discount Received A/c	100			
" 31	To Balance c/d	1,980			
		4,080			4,080
			Feb. 1	By Balance b/d	1,980

Discount Received Account

1988		Rs.	1988		Rs.
Jan. 31	To Balance c/d	100	Jan. 8	By Kishore	100
			Feb. 1	By Balance b/d	100

Postage Account

1988		Rs.	1988		Rs.
Jan. 12	To Cash A/c	300	Jan. 31	By Balance c/d	300
Feb. 1	To Balance b/d	300			

Reddy & Co's. Account

1988			Rs.	1988			Rs.
Jan.	9	To Sales A/c	380	Jan.	1	By Balance b/d	3,020
	21	To Bank A/c	6,000	"	2	By Purchases A/c	5,500
"	31	To Balance c/d	2,140				
			8,520				8,520
				Feb.	1	By Balance b/d	2,140

Carriage Account

1988			Rs.	1988			Rs.
Jan.	23	To Cash A/c	100	Jan.	31	By Balance c/d	100
Feb.	1	To Balance b/d	100				

Drawings Account

1988			Rs.	1988			Rs.
Jan.	24	To Cash A/c	1,500	Jan.	31	By Balance cld	1,500
Feb.	1	To Balance b/d	1,500				

Salaries Account

1988			Rs.	1988			Rs.
Jan.	28	To Cash A/c	800	Jan.	31	By Balance c/d	800
Feb.	1	To Balance b/d	800				

Interest Paid Account

1988			Rs.	1988			Rs.
Jan.	31	To Cash A/c	100	Jan.	31	By Balance c/d	100
Feb.	1	To Balance b/d	100				

Stock Account

1988			Rs.	1988			Rs.
Jan.	1	To Balance b/d	51,700	Jan.	31	By Balance c/d	51,700
Feb.	1	To Balance b/d	51,700				

Furniture Account

1988			Rs.	1988			Rs.
Jan.	1	To Balance b/d	8,200	Jan.	31	By Balance c/d	8,800
"	31	To Joseph	600				
			8,800				8,800
Feb.	1	To Balance b/d	8,800				

Capital Account

1988			Rs.	1988			Rs.
Jan.	31	To Balance c/d	73,700	Jan.	1	By Balance b/d	73,700
				Feb.	1	By Balance b/d	73.700

Rent Account

1988		Rs.	1988		Rs.
Jan. 30	To Rent Outstanding A/c	500	Jan. 31	By Balance c/d	500
Feb. 1	To Balance b/d	500			

Rent Outstanding Account

					Rs.
Jan.	To Balance c/d		Jan. 30	By Rent A/c	500
			Feb. 1	By Balance bid	500

Joseph's Account

1988		Rs.	1988		Rs
Jan. 31	To Balance c/d	600	Jan. 31	By Furniture A/c	600
			Feb. 1	By Balance b/d	600

Dose & Son's Account

1988		Rs.	1988		Rs.
Jan. 31	To Balance c/d	9,300	Jan. 14	By Purchases A/c	9,300
			Feb. 1	By Balance b/d	9,300

Thomas's Account

1988		Rs.	1988		Rs.
Jan. 10	To Sales A/c .		Jan. 31	By Balance c/d	10,000
Feb. 1	To Balance b/d	10,000			
		10,000			

TRIAL BALANCE
as on January 31, 1988

Name of Account	L. F.	Dr. Balances	Cr. Balances
		Rs.	Rs.
Cash in hand		600	
Cash at bank		15,800	
Globe Finance Co's. Loan A/c			5,000
Sales A/c			20,280
Shanker		6,300	
Purchases A/c		17,100	
Kishore			1,980
Discount Received A/c			100
Postage A/c		300	
Reddy & Co.			2,140
Carriage A/c		100	
Drawings A/c			1,500
Salaries A/c		800	
Interest Paid A/c			100
Stock A/c		51,700	
Furniture A/c		8,800	
Capital A/c			73,700
Rent A/c		500	
Rent Outstanding A/c			500
Joseph		600	
Bose & Sons			9,300
Thomas		10,000	
Total		1,13,600	1,13,600

4.5 LET US SUM UP

In addition to Cash Book, the firms maintain some other special purpose subsidiary books to record credit transactions relating to goods. They are: (i) Purchases Journal, (ii) Purchases Returns Journal, (iii) Sales Journal, and (iv) Sales Returns Journal. The Purchases Journal is meant for recording all credit purchases of goods and the Sales Journal for credit sales of goods. The goods returned to suppliers is recorded in Purchases Returns Journal and the goods returned by customers in Sales Returns Journal. The transactions recorded in these books are posted individually to the concerned personal accounts in ledger. The postings into Purchases Account, Purchases Returns Account, Sales Account and Sales Returns Account are made only for the totals of respective books periodically.

All transactions which cannot be recorded in any of the special journals will be recorded in the Journal Proper. Some examples of such transactions are: opening entry, closing entries, transfer entries, adjustment entries, rectification enmes, credit purchases and credit sales of fixed assets.

4.6 KEY WORDS

Adjustment Entry: An entry passed to bring into account unrecorded items like closing stock, outstanding expenses, outstanding incomes, etc. at the time of preparing final accounts.

Closing **Entries:** Entries passed at the end of each accounting year to close the nominal accounts by transferring them to the Trading and Profit and Loss Account.

Credit Note: A statement sent by the seller to his customer intimating that his account has been credited with the amount of goods returned by him or any other allowance granted to him.

Debit Note: A statement sent by the buyer to his supplier intimating that his account has been debited with the amount of goods returned to him.

Invoice: A bill or a statement issued by the seller to the buyer giving details of goods sold.

Opening Entry: An entry passed to open a new set of accounts.

Rectification Entry: An entry passed to rectify an error.

Transfer Entry: An entry passed to transfer an amount from one account to another account.

4.7 SOME USEFUL BOOKS

1 Maheshwari S.N., 1986. ***Introduction to Accounting,*** Vikas Publishing House, New Delhi. (Chapter 5)

2 Patil, V.A. and J.S. Korlahalli, 1986. ***Principles and Practice of Accounting,*** R. Chand & Co., New Delhi. (Chapters 6, 14) ,

3 Gupta R. L. and M. Radhaswamy, 1986. ***Advanced Accountancy,*** Sultan Chand & Sons, New Delhi. (Chapter 3)

4.8 ANSWERS TO CHECK YOUR PROGRESS

A 4 (i) goods (ii) credit (iii) credit note (iv) purchases (v) credit (vi) returns inwards (vii) returns outwards (viii) returned

B 2 (i) False (ii) True (iii) False (iv) False (v) True (vi) False

4.9 TERMINAL QUESTIONS/EXERCISES

Questions

1 Give the proforma of Purchases Journal. Explain the method of recording the transactions in Purchases Joumal and its posting into ledger.

2 What is Joumal Proper? What entries are usually recorded in the Journal Proper?

3 Discuss briefly the utility of debit note, credit note and invoice.

Exercises

1 From the following particulars, prepare the Purchases and Purchases Returns Journals. Also show their postings into ledger.

1987		
Nov.	6	Purchased from Mohan Brothers, Delhi 100 metres silk @ Rs. 15 per meter 60 metres Valvet @ Rs. 10 per metre Less 10% trade discount
Nov.	18	Purchased from Ram Kishan, Bombay 70 shirts @ Rs. 60 per shirt 40 sarees @ Rs. 50 per saree Less 5% trade discount
"	19	Returned to Ram Kishan, Bombay 10 shirts @ Rs. 60 per shirt Less 5% trade discount
"	21	Bought of Jankidas, Kanpur 100 meters longcloth @ Rs. 10 per meter 200 meters voil @ Rs.15 per meter Less 15% trade discount
"	28	Returned to Jankidas, Kanpur 20 meters voil @ Rs.15 per meter Less 15% trade discount

(Answer: Purchases Book Total Rs.11,180; Purchases Returns Book Total Rs. 825)

2 Enter the following transactions in Sales Journal and Post them into ledger.

1988		
Jan.	5	Sold to Raj Kumar of Delhi 50 meters coating @ Rs.110 per meter 200 meters poplin @ Rs.7 per meter Less 5% trade discount
"	18	Returned by Raj Kumar of Delhi 40 meters poplin @ Rs. 7 per meter Less 5% trade discount
"	20	Sold to Gopal Brothers, Lucknow 100 meters shirting @ Rs.15 per meter 60 sarees @ Rs. 70 per saree Less 10% trade discount
"	25	Sold to Mohan & Co., Sonepat 100 meters artificial silk @ Rs.12 per meter 75 meters voil @ Rs.18 per meter Less 10% trade discount
"	30	Returned by Mohan & Co., Sonepat 20 meters artificial silk @ Rs.12 per meter Less 10% trade discount

(Answer: Sales Book Total Rs. 13,980; Sales Returns Book Total Rs. 482)

3 From *the* following transactions of Shankar, write up Journal Proper and the other subsidiary books involved. Show their postings into ledger and prepare a Trial Balance.

1987			Rs.
Mar.	1	Assets:	
		Cash in hand	1,000
		Cash at bank	34,000
		Stock of goods	20,000
		Machinery	50,000
		Furniture	5,000
		Sudhir owes	5,000
		Naveen owes	12,500

		Liabilities:	
		Loan	20,0.00
		Sum owing to Samuel	10,000
Mar.	2	Bought goods on credit from Naresh	5,000
"	3	Cnshsales	2,000
"	4	Sold goods to Raman	5,000
"	5	Received from Sudhir in settlement of his account	5,000
"	6	Payment made to Samuel by cheque, in full settlement	9,950
"	9	Old furniture sold for cash	5,00
"	10	Cash purchases	4,000
"	11	Naveen pays by cheque which was deposited into bank	12,500
"	11	Paid for repairs to machinery	500
"	13	Purchased goods from Shyam	5,000
"	13	Paid carriage on these goods	250
"	16	Received cheque from Raman	5,000
"	17	Paid to Shyam by cheque	5,000
"	18	Bank intimates that cheque of Raman has been returned unpaid	
"	19	Cash sales	3,000
"	21	Cash deposited into bank	2,500
"	25	Paid municipal taxes In cash	500
"	26	Old newspaper sold	50
"	28	Paid for advertisements	500
"	31	Paid rent by cheque	600

(**Answer:** Cash in hand Rs. 2,800; Cash at bank Rs. 33,450; Total of Trial Balance Rs. 1,32,600.)

Hint: Find out the opening capital before working on the problem.

Note : These questions will help you lo understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 5 BILLS OF EXCHANGE

Structure

5.0 OBJECTIVES

After studying this unit, you should be able to:

- identify various instruments of credit
- define bill of exchange
- define promissory note
- distinguish between bill of exchange and promissory note
- record transactions relating to bills in the journal of drawer, drawee and endorsee
- explain the nature of accommodation bills and their accounting treatment
- prepare bills receivable and bills payable journals

5.1 INTRODUCTION

In Unit 4 you have learnt about various subsidiary books commonly used in the business for recording certain transactions. The businessman can also maintain separate subsidiary books for the transactions relating to bills of exchange. But the number of such transactions is usually small and therefore one may prefer to record them in the Journal itself. In this unit we shall first discuss the nature of various instruments of credit including bills of exchange and promissory notes, identify the type of transactions which usually take place in connection with bills and study how they are to be recorded in the books of various parties. We shall also discuss the preparation of Bills Receivable and Bills Payable Books and study how various details relating to bills are recorded in these books and how postings are done.

5.2 TYPES OF INSTRUMENTS OF CREDIT

Selling goods on credit has become a very common phenomenon in business. The producer takes raw material on credit and supplies the finished goods to the wholesalers on credit. The wholesalers in turn provide the credit facilities to the retailers. The retailers also sell on

		Liabilities:	
		Loan	20,0.00
		Sum owing to Samuel	10,000
Mar.	2	Bought goods on credit from Naresh	5,000
"	3	Cash sales	2,000
"	4	Sold goods to Raman	5,000
"	5	Received from Sudhir in settlement of his account	5,000
"	6	Payment made to Samuel by cheque, in full settlement	9,950
"	9	Old furniture sold for cash	5,00
"	10	Cash purchases	4,000
"	11	Naveen pays by cheque which was deposited into bank	12,500
"	11	Paid for repairs to machinery	500
"	13	Purchased goods from Shyam	5,000
"	13	Paid carriage on these goods	250
"	16	Received cheque from Raman	5,000
"	17	Paid to Shyam by cheque	5,000
"	18	Bank intimates that cheque of Raman has been returned unpaid	
"	19	Cash sales	3,000
"	21	Cnsh deposited into bank	2,500
"	25	Paid municipal taxes in cash	500
"	26	Old newspaper sold	50
"	28	Paid for advertisements	500
"	31	Paid rent by cheque	600

(Answer: Cash in hand Rs. 2,800; Cash at bank Rs. 33,450; Total of Trial Balance Rs. 1,32,600.)

Hint: Find out the opening capital before working on the problem.

Note : These questions will help you to understand the unit better, Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 5 BILLS OF EXCHANGE

Structure

5.0 OBJECTIVES

After studying this unit, you should be able to:

- identify various instruments of credit
- define bill of exchange
- define promissory note
- distinguish between bill of exchange and promissory note
- record transactions relating to bills in the journal of drawer, drawee and endorsee
- explain the nature of accommodation bills and their accounting treatment
- prepare bills receivable and bills payable journals

5.1 INTRODUCTION

In Unit 4 you have learnt about various subsidiary books commonly used in the business for recording certain transactions. The businessman can also maintain separate subsidiary books for the transactions relating to bills of exchange. But the number of such transactions is usually small and therefore one may prefer to record them in the Journal itself. In this unit we shall first discuss the nature of various instruments of credit including bills of exchange and promissory notes, identify the type of transactions which usually take place in connection with bills and study how they are to be recorded in the books of various parties. We shall also discuss the preparation of Bills Receivable and Bills Payable Books and study how various details relating to bills are recorded in these books and how postings are done.

5.2 TYPES OF INSTRUMENTS OF CREDIT

Selling goods on credit has become a very common phenomenon in business. The producer takes raw material on credit and supplies the finished goods to the wholesalers on credit. The wholesalers in turn provide the credit facilities to the retailers. The retailers also sell on credit to some of the ultimate consumers. Credit may also be granted by a moneylender, a bank or a financial institution. Credit is generally provided by obtaining a written document called 'Instrument of Credit'. They serve as a proof for existence of credit. The most commonly used instruments of credit are :

i) Bills of Exchange,

ii) Promissory Notes, and

iii) Hundies.

5.2.1 Bill of Exchange

When a seller grants credit to his customers, he would like to have some written commitment from the buyer to pay the amount on a specified date, otherwise the payment may not be made on time. Such a written undertaking generally takes the form of a bill of exchange or a promissory note. A bill of exchange is drawn by the seller (a creditor) on the buyer (a debtor) asking him to pay the specified amount after a specified period to him, or his order, or to a person named in the bill. According to the Negotiable Instruments Act 1881, a bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a 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.

The above definition makes it clear that there are three parties to a bill of exchange. They are :

i) Drawer: a person who draws the bill

ii) Drawee: a person who accepts the bill

iii) Payee: a person who is to receive the payment.

Suppose A sells goods to B and draws on him a bill for Rs. 1,000 for two months payable to C. In this example 'A' is the drawer, 'B' is the drawee and 'C' is the payee. In most of the cases, however, the drawer himself is the payee.

Look at Figure 5.1 for the specimen of a bill of exchange. In this case Mukesh draws a bill on Nagesh for 2 months for Rs. 1,000, payable to himself.

Figure 5.1: Bill of Exchange

Hyderabad
August 1, 1987

Rs. *2,000*

Revenue
Stamp

Two months after date pay to me or my order, the sum of rupees two thousands only, for value received.

To
Nagesh
T. Nagar
Madras.

A. Mukesh
Signature

When the bill of exchange is drawn it is sent to the drawee for his acceptancc. The drawee has to affix his signatures across the bill as a mark of his acceptance and return it to the drawer.

Thus, a bill of exchange has the following features :

i) It must be in writing.

ii) It must contain an order.

iii) The order must be unconditional.

iv) It must be signed by the maker of the instrument.

v) It is made by the creditor.

vi) It must be for a specified amount and specified period.

vii) It should be duly accepted by the debtor.

5.2.2 Promissory Note

As stated earlier a written undertaking by the buyer to make payment on a specified data can take the form of a bill of exchange or as promissory note. You have learnt that a bill of exchange is drawn by the seller and accepted by the buyer. A promissory note, on the other hand, is written by the buyer promising the seller to pay a specified amount after a specified period to him, or his order. It can be defined as *"an instrument* in *writing (not being a hank note or a currency note) containing an unconditional undertaking, signed by the maker to pay a certain sum of money to, or to the order of a certain person, or to the bearer of the instrument".*

In case of a promissory note there are only two parties. They are:

i) Maker: A person who makes the note and promises to pay the amount.

ii) Payee: A person who is to receive the amount.

Suppose A sells the goods to B and B writes a promissory note in favour of A. In this example B is the maker and A is the payee. You should note that no acceptance is required in case of a promissory note because it is made by the person who has to make the payment. Look at Figure 5.2 for the specimen of a promissory note. In this case Nagesh promises to pay Rs. 1,000 to Mukesh.

Figure 5.2: Promissory Note

Rs. 2.000

Madras
August 1,1987

Revenue Stamp

Two months after date I promise to pay Mukesh or order, the sum of rupees two thousands only, for value received.

To
Mukesh
Hyderabad.

Nagesh
Signature

Thus, a promissory note has the following features:

i) It must be in writing.

ii) It must be an undertaking to pay,

iii) The undertaking must be unconditional.

iv) It must be signed by the maker of the instrument.

v) It is made by the debtor.

vi) It must be for a specified amount and period.

5.2.3 Distinction between Bill of Exchange and Promissory Note

Keeping in view the features of a bill of exchange and a promissory note, following distinctions can be made between the two:

Bill of Exchange	Promissory Note
1) It is an unconditional order to pay	1) It is an unconditional promise to pay
2) It is made by the creditor	2) It is made by the debtor
3) Acceptance by the debtor is necessary	3) No acceptance is required
4) There are three parties to a hill of exchange	4) There arc only two parties to a promissory note
5) When the bill is dishonoured it is better to get it noted by the notary public.	5) Noting is not necessary

A bill of exchange is a bill receivable (B/R) for the drawer or the payee and a bill payable (B/P) for the drawee.-Similarly, a promissory note is a bill receivable for the payee and a bill payable for the maker. A bill receivable is an asset for the business whereas a bill payable is a liability. For **accounting purposes, no distinction is made between bill** of **exchange and** the **promissory note.**

5.3 TERM AND DUE DATE OF A BILL

A bill is generally written for a fixed period of time, say, two months *(60* days), three months (90 days), etc. The period of a bill is called 'Term' or 'Tenor' of the bill. The date on which the bill falls due is called the 'due date' or the 'date of maturity'. The due date is calculated by adding three days of grace to the actual period of the bill. For example, a bill drawn on April 1 for a period of three months will become due for payment on July 4 (add three months and three days of grace to April 1, you arrive at July 4).

If the due dare is a public holiday, the bill becomes due on the previous working day. In the above example, if July 4 were to be a public holiday, July 3 would be treated as the due date.

Check Your Progress A

1 *State* **whether each** of the following **statements** is True or False.

i) Bill of Exchange-is drawn only when money is lent by moneylender, a banker, or a financial institution. ....

ii) Negotiable Instruments can be easily transferred to the third party. ....

iii) In case of a public holiday the due date of the hill falls on the next working day. ....

iv) Bill of Exchange is an unconditional promise to pay. ....

v) For a bill drawn on April 1 for two months, the due date falls on June 4. ....

vi) Acceptance is necessary in case of a promissory note. ....

2 **On January 1, Laxman** draws on Ram a bill for three months for Ks. 500 payable to Bharat. It is duly accepted by Ram and sent to Laxman. State the names of the drawer, the drawee and the payee.

....

....

....

3 State whether each the following is a B/R or a B/P for Bhushan.

i) On February 1. he drew a bill on Vinod for Rs. 800 for one month which is duly accepted by him. ....

ii) On March 1, he received an acceptance from Sam for Rs. 1,600. ....

iii) On April I, Bhushan wrote a promissory note for Rs. 600 in favour of Alok payable two months after date. ....

iv) On April 10, he gave his acceptance to a bill drawn on him by Shyam for Rs. 900. ....

v) On April 25, he received a **promissory note from Ram for Rs. 600.** ....

5.4 TREATMENT OF BILL BY THE HOLDER AND ITS ACCOUNTING

As pointed out earlier no distinction is made between a bill of exchange and a promissory note for accounting purposes. When a bill or a promissory note is received by the person who is entitled to receive its payment, he becomes a holder of the bill. It is a bill receivable for **him.** He will pass the following journal entry in his books at the time of receiving the bill or the promissory note drawn in his favour.

Bills Receivable A/c Dr.
To Drawee
(Being acceptance received from the drawee)

The holder of the bill can deal with it in the following three ways :

i) He may retain it till the date of maturity.

ii) He may discount it with his banker and receive the amount less discount, immediately.

iii) He may endorse it in favour of his own creditor.

Let us now study what journal entries are to be passed in each case.

5.4.1 Retaining the Bill

When the holder of the bill decides to retain the bill till the date of maturity no further entry is required till that date. If on the date of maturity the bill is honoured he will pass the following entry.

Bank A/c Dr.
To Bills Receivable A/c
(Being payment received)

5.4.2 Discounting the Bill

If the holder of the bill needs funds he can approach the bank for encashment of the bill before due date. The bank will make the payment of the bill after deducting some interest. The process of encashing the bill with the bank before the date of maturity is called 'discounting a bill' and the interest charged by bank is called 'discount'.

'hen a bill is discounted the holder of the bill (drawer) will pass the following journal entry in his books.

Bank A/c Dr.
Discount A/c Dr.
To Bills Receivable A/c
(Being bill discounted)

On the date of maturity, payment of a discounted bill will be received by the bank and not by the drawer.

Hence, at the time of payment, the drawer will not pass any entry in his books.

5.4.3 Endorsing the Bill

When the holder of the bill endorses the bill to a third party, the bill is said to be endorsed. He is called the endorser and the party to whom it is endorsed is called endorsee. At the time of endorsement, the following journal entries will be passed in the books of the endorser and the endorsee.

Books of Drawer (Endorser)		Books of Endorsee	
Endorsee (creditor)	Dr.	Bills Receivable A/c	Dr.
To Bills Receivable A/c		To Endorser (Drawer)	
(Being bill endorsed)		(Being bill received)	

On the date of maturity, the payment will be received by the endorsee. Hence, at the time of payment, the endorser will not pass any entry in his books. However endorsee will pass the following entry in his books.

Bank A/c Dr.
To Bills Receivable A/c
Being payment received)

5.5 TREATMENT OF BILL BY THE ACCEPTOR AND ITS ACCOUNTING

For the person who accepts a bill of exchange or makes a promissory note, it is a bill payable. He will pass the following journal entry in his books when he accepts a bill or makes a promissory note.

Drawer (Creditor) Dr.
To Bills Payable A/c
(Being bill accepted)

When a bill is discounted or endorsed by the holder of the bill, the drawee is not required to pass any entry in his books. He comes into picture only when the bill becomes due for payment. When he makes the payment on due date, he will pass the following journal entry in his books irrespective of the fact whether the bill is retained, discounted or endorsed:

Bills Payable A/c Dr.
To Bank A/c
(Being bill paid)

Look at Illustration 1 and study how journal entries are passed in the books of various parties concerned with the bill.

Illustration 1

On January 1,1987 A sold to B goods worth Rs. 1,500. On the same date he drew on B three bills for Rs. 600, Rs. 500 and Rs. 400 for one month, two months and three months respectively. B accepted all the three bills and sent them back to A. A retained the first bill, discounted the second bill with the bank for Rs. 495 on January 5, and endorsed the third bill to C on January 6. On the due date B met his acceptances. Record the above transactions in the books of A, B and C.

Solution:

BOOKS OF A (DRAWER)
Journal

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
1987				Rs.	Rs.
Jan, 1	B	Dr.		1,500	
	To Sales A/c				1,500
	(Being goods sold to B)				
" 1	Bills Receivable A/c	Dr.		600	
	To B				600
	(Being first bill received for one month)				
" 1	Bills Receivable A/c	Dr.		500	
	To B				500
	(Being second bill received for two months)				
" 1	Bills Receivable A/c	Dr.		400	
	To B				400
	(Being third bill received for three months)				
" 5	Bank A/c	Dr.		495	
	Discount A/c	Dr.		5	
	To Bills Receivable A/c				
	(Being second bill discounted)				500

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
			Rs.	Rs.
Jan 6	C Dr. To Bills Receivable A/c (Being third bill endorsed to C)		400	400
Feb 4	Bank A/c Dr. To Bills Receivable A/c (Being first bill honoured on due)		600	600

BOOKS OF B (DRAWEE)
Journal

Date	Particulars	L. F.	Dr. Amount	Cr. Amount
1987			Rs.	Rs.
Jan. 1	Purchases A/c Dr. To A (Being goods purchased on credit)		1,500	1,500
" 1	A Dr. To Bills Payable A/c (Being first bill accepted for one month)		600	600
" 1	A Dr. To Bills Payable A/c (Being second bill accepted for two months)		500	500
" 1	A Dr. To Bills Payable A/c (Being third bill accepted for three months)		400	400
Feb. 4	Bills Payable A/c Dr. To Bank A/c (Being first bill honoured)		600	600
Mar. 4	Bills Payable A/c Dr. To Bank A/c (Being second bill honoured)		500	500
Apr. 4	Bills Payable A/c Dr. To Bank A/c (Being third bill honoured)		400	400

BOOKS OF C (ENDORSEE)
Journal

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1987			Rs.	Rs.
Jan. 6	Bills Receivable A/c Dr. To A (Being a bill received from A)		400	400
Apr. 4	Bank A/c Dr. To Bills Receivable A/c (Being bill honoured)		400	400

5.5.1 Dishonouring the Bill

When due to some reason the drawee (the person who has to make the payment) is not in a position to make the payment of the bill on the due date, the bill is said to be dishonoured. In such a situation the holder of the bill gets an endorsement from the Notary Public. The purpose of such notation is to establish the facts of presentation and of dishonour. The endorsement is done either on the bill or on a separate paper attached to the bill called 'allonge'. The holder of the bill has to pay a small charge for service of the Notary Public. It is called 'Noting charges'. These noting charges are to be borne ultimately by the drawee. The journal entries for the dishonour of the bill and noting charges in the books of the drawer, the drawee and the endorsee are as follows :

Books of Drawer	Books of Drawee	Books of Endorsee
i) If the bill is retained Drawee Dr. To Bills Receivable A/c To Cash A/c (Being bill dishonoured and noting charges paid)	The drawee passes the following entry in his books irrespective of the fact whether the bill is retained, discounted or endorsed.	—
ii) If the bill is discounted Drawee Dr. To Bank A/c (Being discounted bill dishonoured) (Note: The amount will be inclusive of noting charges)	Bills Payable A/c Dr. Noting charges A/c Dr. To Drawer (Being bill accepted dishonoured, noting charges involved)	—
iii) If the bill is endorsed Drawee Dr. To Endorsee (Being endorsed bill dishonoured) (Note: The amount will be inclusive of noting charges.)		Endorser Dr. To Bills Receivable A/c To Cash A/c (Being bill dishonoured and noting charges paid)

If the drawee is declared insolvent on or before the due date, the bill is deemed to have been dishonoured and all entries for dishonour will have to be passed in the books of the concerned parties as given above.

Look at Illustration 2 and see how dishonour entries are recorded in the books of various parties.

Illustration 2

On January 1, 1988 Q owes to P Rs. 2,400 and accepts three bills as per the following details.

i) for Rs. 1,000 for 2 months, it is retained by P

ii) for Rs. 800 for 3 months, it is endorsed to R

iii) for Rs. 600 for 4 months, it is discounted with the bank for Rs. 580.

What will be the entries in the books of P, Q and R if the bills are dishonoured on due dates and noting charges Rs. 8 are paid in all the three cases.

BOOKS OF P (DRAWER)
Journal

Date 1986		Particulars		L.F.	Dr. Amount	Cr. Amount
					Rs.	Rs.
Jan.	1	Bills Receivable A/c	Dr.		1,000	
		To Q				1,000
		(Being first bill Received for two months)				

Jan. 1	Bills Receivable **A/c** Dr.		800	
	To Q			800
	(Being second bill received for three months)			
" 1	Bills Receivable **A/c** Dr.		600	
	To Q			600
	(Being third bill received for four months)			
" 1	**R** **Dr.**		800	
	To Bills Receivable **A/c**			800
	(Being second bill **endorsed** to **R)**			
" 1	**Bank A/c** **Dr.**		580	
	Discount **A/c** **Dr.**		20	
	To Bills Receivable **A/c**			600
	(Being third bill discounted with the bank for Rs. 580)			
Mar. 4	**Q** **Dr.**		1,008	
	To Bills **Receivable** A/c			1,000
	To **Cash** A/c			8
	(Being first bill **dishonoured,** noting charges paid Rs. 8)			
Apr. 4	**Q** **Dr.**		808	
	To R			808
	(Being endorsed bill **dishonoured,** noting charges involved Rs. 8)			
May 4	**Q** Dr.		608	
	To Bank A/c			608
	(Being **discounted** bill dishonoured, noting charges involved **Rs.** 8)			

Books of *Q* (Drawee)
Journal

Date	**Particulars**	**L.F.**	**Dr. Amount**	**Cr. Amount**
1986			**Rs.**	**Rs.**
Jan. 1	P Dr.		1,000	
	To Bills Payable A/c			1,000
	(Being **first** bill accepted for two months)			
" 1	**P** **Dr.**		800	
	To Bills Payable **A/c**			800
	(Being second **bill accepted** for three months)			
	P **Dr.**		600	
	To Bills Payable **A/c**			600
	(Being third bill accepted for four **months)**			
Mar. 4	**Bills** Payable **A/c** Dr.		1,000	
	Dr.		8	
				1,008
	(Being **first** bill **dishonoured** *and* noting **charges** involved Rs. 8)			

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
				Rs.	Rs.
Apr. 4	Bills Payable A/c	Dr.		800	
	Noting charges A/c	Dr.		8	
	To P				808
	(Being second bill dishonoured, noting charges involved Rs. 8)				
May 4	Bills Payable A/c	Dr.		600	
	Noting charges A/c	Dr.		8	
	To P				608
	(Being third bill dishonoured, noting charges involved Rs. 8)				

BOOKS OF R (ENDORSEE)
Journal

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
1986				Rs	Rs.
Jan. 1	Bills Receivable A/c	Dr.		800	
	To P				800
	(Being bill received from P)				
Apr. 4	P	Dr.		808	
	To Bills Receivable A/c				800
	To Cash A/c				8
	(Being bill dishonoured and noting charges paid)				

Check Your Progress B

1 What do you mean by discounting of a bill?

....

....

....

....

....

2 Fill in the blanks

i) No distinction is made between a bill of exchange and a promissory note for.......... purposes:'

ii) The holder of a bill can deal with the bill in any of the ....ways.

iii) When bill is drawn.......... Account is debited in the books of the drawer.

iv) Bill payable is a .... for the drawee.

v) When bill is endorsed or discounted, no entry is passed in the books of the..........

vi) When an endorsed or discounted bill is honoured, no entry is passed in the books of the..........

3 On January 1,1988 a bill is drawn on Jack for Rs 2,000 payable after one month. State the journal entries to be passed in the books of the drawer if :

i) the bill is retained

ii) the bill is discounted with the bank for Rs.1,975

iii) the bill is endorsed to Jill

4 State whether each of the following statements is True or False.

i) When the bill is honoured on the due date the drawee credits Bills Payable A/c in his books. ....

ii) When the bill is discounted or endorsed no entry for payment of the bill is passed in the books of the drawer. ....

iii) In case of the dishonour of a bill noting charges are initially paid by the drawee. ....

iv) The bill is treated as dishonoured in case of insolvency of the drawee. ....

v) When the bill is dishonoured, the drawee will be debited in books of drawer whether the bill is retained, endorsed or discounted. ....

5 On March 1, Alok drew a bill on Arun for Rs. 2,800 for three months. The bill was discounted by Alok for Rs. 2,750. The bill was dishonoured on the due date, noting charges of Rs.10 were paid by the bank. What will be the entries in the books of Drawer and Drawee for dishonour of the bill ?

5.5.2 Renewal of the Bill

There are certain instances when the drawee is in a position to foresee that he would not be able to honour the bill on the due date. In such a situation the drawee can request the drawer for extension of time. If the drawer agrees to such a request the old hill is mated as dishonoured and a new bill is drawn in Lieu thereof. This process is called 'Renewal of Bill'. In case of renewal, the drawer will charge some interest for the period of the new bill. This interest may be paid in cash or included in the amount of the new bill. There is no need for getting the bill noted since the drawee himself makes a request for cancellation of the bill. The journal entries passed at the time of renewal of the bill are as follows :

	Books of Drawer			Books of Drawee	
i)	For dishonour of the bill Drawee To B/R A/C Bank A/c Endorsee A/c	 Dr.	i)	Bills Ryable A/c To Drawer	Dr.
ii)	For Interest due Drawee To Interest A/c	 Dr.	ii)	Interest A/c To Drawer	Dr.
iii)	For drawing new bill Bills Receivable A/c To Drawee	 Dr.	iii)	For accepting new bill Drawer To Bills Payable A/c	 Dr.

Note: Dishonour entry is passed keeping in view whether the bill is retained, discounted or endorsed.

Look at Illustrations 3, 4 and 5 and see how the journal entries are recorded in the books of various parties when the bill is renewed.

Illustration 3

Ram drew a bill on Shyam for Rs. 1,000 on April 1,1988 for two months. On May 15 Shyam requested Ram to renew the bill for two months. Ram agreed to renew the bill and Charged interest @ 6% p.a. A new bill was drawn for Rs. 1,010 including interest. The bill was honoured on the due date. Record all this in the books of Ram and Shyam.

Ram's Journal

Date		Particulars		L.F.	Dr. Amount	Cr. Amount
1988					Rs.	Rs.
Apr.	1	Bills Receivable A/c	Dr.		1,000	
		To Shyam				1,000
		(Being bill received)				
May	15	Shyam	Dr.		1,000	
		To Bills Receivable A/c				1,000
		(Being bill dishonoured on account of renewal)				
"	15	Shyam	Dr.		10	
		To Interest A/c				10
		(Being interest due for two months)				
"	15	Bills Receivable A/c	Dr.		1,010	
		To Shyam				1,010
		(Being a new bill received inclusive of interest)				
July	18	Bank A/c	Dr.		1,010	
		To Bills Receivable A/c				1,010
		[Being bill honoured on due date)				

Shyam's Journal

Date		Particulars		L.F	Dr. Amount	Cr. Amount
1988					Rs.	Rs.
Apr.	1	Ram	Dr.		1,000	
		To Bills payable A/c				1,000
		(Being bill accepted]				
May	15	Bills Payable A/c	Dr.		1,000	
		To Ram				1,000
		(Being bill dishonoured on account of renewal)				
"	15	Interest A/c	Dr.		10	
		To Ram				10
		(Being interest due to Ram for two months)				
"	15	Ram	Dr.		1,010	
		To Bills Payable A/c				1,010
		(Being new bill accepted together with interest)				
July	18	Bills Payable A/c	Dr.		1,010	
		To Bank A/c				1,010
		(Being bill honoured on due date)				

illustration 4

Sohan drew on Mohan a bill for Rs. 1,500 for 3 months on June 1, 1987. The bill was endorsed to Rohan. On July 15, Mohan approaches Sohan to renew the bill for a period of three months and charges Rs. 25 as interest. Sohan agress to renew the bill. Mohan pays the amount of interest in cash and accepts a new bill for Rs. 1,500. The bill is honoured on the due date. Record these transactions in the books of various parties.

Solution:

Sohan's Journal

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1987			Rs.	Rs.
June 1	Bills Receivable A/c Dr. To Mohan (Being bill received for three months)		1,500	1,500
" 1	Rohan Dr. To Bills Receivable A/c (Being bill endorsed to Rohan)		1,500	1,500
July 15	Mohan Dr, To Rohan (Being bill dishonoured on account of renewal)		1,500	1,500
" 15	Mohan Dr. To Interest A/c (Being interest due from Mohan)		25	25
" 15	Cash A/c Dr. To Mohan (Being cash received from Mohan for interest)		25	25
" 15	Bills Receivable A/c Dr. To Mohan (Being bill renewed for three months)		1,500	1,500
Oct. 18	Bank A/c Dr. To Bills Receivable A/c (Being bill honoured on due date)		1,500	1,500

Mohan's Journal

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1987			Rs.	Rs.
June 1	Sohan Dr. To Bills Payable A/c (Being bill accepted for three months)		1,500	1,500
July 15	Bills Payable A/c Dr. To Sohan [Being bill dishonoured on account of renewal)		1,500	1,500
" 15	Interest A/c Dr. To Sohan (Being interest due to Sohan)		25	25

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
				Rs.	Rs.
July 15	Sohan	Dr.		25	
	To Cash A/c				25
	(Being cash paid for interest)				
" 15	Sohan	Dr.		1,500	
	To Bills Paynble A/c				1,500
	(Being new bill accepted for three months)				
Oct. 18	Bills Payable A/c	Dr.		1,500	
	To Bank A/c				1,500
	(Being bilis payable honoured)				

Rohan's Journal

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
1987				Rs.	Rs.
June 1	Bills Receivable A/c	Dr.		1,500	
	To Sohan				1,500
	(Being bill received from Sohan)				
July 1	Sohan	Dr.		1,500	
	To Bills Receivable A/c				1,500
	(Being bill dishonoured)				

Illustration 5

On January 1,1988 B owes to A Rs. 1,000. A draws on him a bill for Rs. 1,000 for three months, The bill is discounted for Rs. 980. On the date of maturity B requests A for renewal of the bill. A agrees to his request and the following arrangement is made.

B pays Rs. 400 in cash and requests for the renewal of the balance for two months, charging interest @ 6% p.a. to be included in the new bill.

B becomes insolvent on June 2, 1988 and only one third of the amount could be recovered from his estate.

Record the above transactions in the books of A and B.

Solution :

A's Journal

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
1988				Rs.	Rs.
Jan. 1	Bills Receivable A/c	Dr.		1,000	
	To B				1,000
	(Being bill received)				
" 1	Bank A/c	Dr.		980	
	Discount A/c	Dr.		20	
	To Bills Receivable A/c				1,000
	(Being bill discounted)				
Apr. 4	B	Dr.		1,000	
	To Bank A/c				1,000
	(Being bill cancelled)				
Apr. 4	B	Dr.		6	
	To Interest A/c				6
	(Being interest due from B)				

			Rs.	Rs.
" 4	Cash A/c Dr. To B (Being part payment received in respect of the cancelled bill)		400	400
" 4	Bills Receivable A/c Dr. To B (Being renewal of the bill for three months)		606	606
June 2	B Dr. To Bills Receivable A/c (Being B became insolvent and bill treated as dishonoured)		606	606
" 2	Cash A/c Dr. Bad Debts A/c Dr. To B (Being recovery of one third of the amount due)		202 404	606

B's Journal

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1988			Rs.	Rs.
J . I	A Dr. To Bills Payable A/c (Being bill accepted)		1,000	1,000
Apr. 4	Bills Payable A/c Dr. To A (Being bill cancelled)		1,000	1,000
" 4	A Dr. To Cash A/c (Being part payment made in respect of cancelled bill)		400	400
" 4	Interest A/c Dr. To A (Being interest due @ 6%p.a. on Rs. 600)		6	6
" 4	A Dr. To Bills Payable A/c (Being acceptance for the renewed bill tor three months)		606	606
June 2	Bills Payable A/c Dr. To A (Being bill treated as dishonoured at the time of Insolvency)		606	606
" 2	A Dr. To Cash A/c To Deficiency A/c (Being 1/3rd payment made for the amount due)		606	202 404

5.5.3 Retiring The Bill

You have already learnt that the drawee can approach the drawer before the due date for the renewal of the bill. Sometimes he may offer the payment before the due date, In that case the bill is said to have been retired. The drawee is allowed some discount on account of early payment. Such a discount is termed as 'rebate'. Rebate is nothing but interest for unexpired period of the bill. The following entries are passed in the books of concerned parties in case of retiring the bill.

Books of Drawer		Books of Drawee	Books of Endorsee
i)	When the bill is retained: Bank A/c Dr. Rebate A/c Dr. To Bills Receivable A/c	The following entry is made irrespective of the fact whether the bill is retained, discounted or endorsed Bills Payable A/c Dr. To Bank A/c To Rebate A/c	
ii)	When the bill is discounted No entry		Bank A/c Dr. Rebate A/c Dr. To Bills Receivable A/c
iii)	When the bill is endorsed: No entry		

Look at Illustration 6 and see how entries are passed in case the bill is retired.

Illustration 6

On April 1, 1987 Y owes to X Rs. 1,200, On the same date X drew two bills for Rs. 800 and Rs. 400 for two months and three months respectively. The first bill was endorsed to Z on April 5 and the second bill was retained. Both the bills were retired. On May 1,1987, Y got a rebate of 6% p.a. on both the bills. Record the above transactions in the books of X,Y and Z.

Solution:

X's Journal

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1987			Rs.	Rs.
Apr. 1	Bills Receivable A/c Dr. To Y (Being first bill received for two months)		800	800
" 1	Bills Receivable A/c Dr. To Y (Being second bill received for three months)		400	400
" 5	Z Dr. To Bills Receivable A/c (Being first bill endorsed to Z)		800	800
May 1	Bank A/c Dr. Rebate A/c Dr. To Bills Receivable A/c (Being second bill retired before due date)		396 4	400

Y's Journal

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1987			Rs.	Rs.
Apr. 1	X Dr. To Bills Payable A/c (Being first bill accepted for two months)		800	800
" 1	X Dr. To Bills Payable A/c (Being second bill accepted for three months)		400	400
May 1	Bills Payable A/c Dr. To Bank A/c To Rebate A/c (Being first bill retired one month before due date)		800	796 4
	Bills Payable A/c Dr. To Bank A/c To Rebate A/c (Being second bill retired two months before due date)		400	396 4

Z's Journal

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
1987				Rs.	Rs.
Apr. 1	Bills Receivable A/c	Dr.		800	
	To X				800
	(Being bill received from X)				
May 1	Bank A/c	Dr.		796	
	Rebate A/c	Dr.		4	
	To Bills Receivable A/c				800
	(Being payment receivect before due date)				

Note: Rebate is calculated as **follows:**

First bill was paid one month before due date -

$\frac{6}{100} \times \frac{1}{12} \times 800 = \text{Rs. } 4$

Second hill was paid two months before due date -

$\frac{6}{100} \times \frac{2}{12} \times 400 = \text{Rs. } 4$

5.6 ACCOMMODATION BILLS

Normally a bill is drawn by tile seller on the buyer or by the lender on the borrower. In other words, a bill is drawn for some debt. Sometimes, a bill is drawn even when no debt is involved. This is done primarily to help or accommodate a fellow businessman and is called an 'accommodation bill'. When such a bill is drawn and accepted, the drawer discounts it with the bank and the money so raised is either fully utilised by him or shared with the drawee. Before or on the due date, the drawer remits the ainount utilised by him to the drawee and the drawee then meets the acceptance on the due date by making payment to the bank with which the bill had been discounted. The parties can also draw separate bills on each other. In such a situation, each party discounts his own bill with the bank and utilises the amount. When the bills become due for payment they meet their acceptances and settle their accounts. From the above discussion it is clear that there can be three types of arrangements in case of accommodation bill. They are as follows:

i) A bill is drawn for accominodation of the drawer only.

ii) A bill is drawn and the proceeds are shared by drawer and drawee.

iii) Qne bill each is drawn by both the parties on each other i.e. two bills are drawn.

The accounting treatment of accommodation bill is similar to the treatment of normal bills. However, in case of accommodation bills you should remember that if the amount of the bills is shared by both the parties, the amount of discount charged by the bank is to be borne by both the parties. It is shared in the same proportion as the amount utilised by each party. A suitable entry for proportionate amount of discount shall also be pssed in the journals of both the parties. Look at Illustrations 7 and 8 and see how entries are passed when the bill is drawn and accepted for mutual accommodation.

Illustration 7

On January 1,3988 Woolmer draws a bill on Steele for Rs. 600 for three months. Steele accepts the bill and returns it to Woolmer who discounts it for Rs. 585 and remits one third of the proceeds to Steele. On March 30 Woolmer sends the requisite amount to Steele who meets the bill, on the due date. Pass the necessary journal entries in the books of Woolmer and Steele.

Solution:

Woolmer's Journal

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
1988				Rs.	Rs.
Jan. 1	Bills Receivable A/c	Dr.		600	
	To Steele				600
	(Being bills received)				
Jan 1	Bank A/c	Dr.		585	
	Discount A/c	Dr.		15	
	To Bills Receivable A/c				600
	(Being bill discounted with the bank)				
" 1	Steele	Dr.		200	
	To Bank A/c				195
	To Discount A/c				5
	(Being one third amount remitted to Steele)				
Mar. 30	Steele	Dr.		400	
	To Bank A/c				400
	(Being amount utilised, remitted to Steele)				

Steele's Journal

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
1988				Rs.	Rs.
Jan. 1	Woolmer	Dr.		600	
	To Bills Payable A/c				600
	(Being bill accepted)				
" 1	Bank A/c	Dr.		195	
	Discount A/c	Dr.		5	
	To Woolmer				200
	(Being one third of the proceeds received)				
Mar. 30	Bank A/c	Dr.		400	
	To Woolmer				400
	(Being money received from Woolmer)				
Apr. 4	Bills Payable A/c	Dr.		600	
	To Bank A/c				600
	(Being bill met on maturity)				

Illustration 8.

A drew on B a bill for Rs. 1,000 on January 1,1988 for four months for mutual accommodation. After receiving B's acceptance the same day. A discounted it with the bank @ 5% p.a. and remitted half the proceeds to B. On February 1, 1988, B drew a bill on A for Rs. 1,500 for three months and after obtaining A's acceptance, he discounted it @ 8% p.a. and remitted me-third of the proceeds to 4. On April 30,1988 B became insolvent and only 50% was received from his estate. Write journal entries and prepare A's A/c in B's books and B's A/c in A's Books.

Solution:

Books of A

Journal

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
1988				Rs.	Rs.
Jan. 1	Bills Receivable A/c	Dr.		1,000	
	To B				1,000
	(Being bill received from B)				
" 4	Bank A/c	Dr.		980	
	Discount A/c	Dr.		20	
	To Bills Receivable A/c				1,000
	(Being bill discounted with the bank)				
	B	Dr.		500	
	To Bank A/c				490
	To Discount A/c				10
	(Being 50% of the proceeds remitted to B)				
Feb. 1	B	Dr.		1,500	
	To Bills Payable A/c				1,500
	(Being bill accepted)				
" 4	Bank A/c	Dr.		490	
	Discount A/c	Dr.		10	
	To B				500
	(Being one-third of the proceeds received from B)				
Apr. 30	B	Dr.		1,000	
	To Bank A/c				1,000
	(Being bill receivable dishonoured, as B became insolvent)				
May 4	Bills Payable A/c	Dr.		1,500	
	To Bank A/c				1,500
	(Being bill met on maturity)				
" 4	Bank A/c	Dr.		750	
	Bad Debts A/c	Dr.		750	
	To B				1,500
	(Being 50% of amount due received from B's estate)				

B's Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1988		Rs.	1988		Rs.
Jan. 4	To Bank A/c	490	Jan. 1	By B/R A/c	1,000
4	To Discount A/c	10	Feb. 4	By Bank A/c	490
Feb. 1	To B/P A/c	1,500	" 4		10
Apr. 30	To Bank A/c	1,000	May 4		750
			" 4	By Bad Debts A/c	750
		3,000			3,000

Books of B

Journal

Date		Particulars		L.F.	Dr. Amount	Cr. Amount
1988					Rs.	Rs.
Jan.	1	A	Dr.		1,000	
		To Bills Payable A/c				1,000
		(Being bill accepted)				
"	4	Bank A/c	Dr.		490	
		Discount A/c	Dr.		10	
		To A				500
		(Being half of the proceeds received from A)				
Feb.	1	Bills Receivable A/c	Dr.		1,500	
		To A				1,500
		(Being bill received from A)				
"	4	Bank A/c	Dr.		1,470	
		Discount A/c	Dr.		30	
		To Bills Receivable A/c				1,500
		(Being bill discounted @5% p.a. with the bank)				
"	4	A	Dr.		500	
		To Bank A/c				490
		To Discount A/c				10
		(Being one-third of proceeds remitted to A)				
Apr.	30	Bills Payable A/c	Dr.		1,000	
		To A				1,000
		(Being bill dishonoured due to insolvency)				
May	4	A	Dr.		1,500	
		To Bank A/c				750
		To Deficiency A/c				750
		(Being payment of 50% of the amount due to A)				

A's Account

Dr. Cr.

Date		Particulars	Amount	Date		Particulars	Amount
1988			Rs.	1988			Rs.
Jan.	1	To B/P A/c	1,000	Jan.	4	By Bank A/c	490
Feb.	4	To Bank A/c	490	"	4	By Discount A/c	10
"	4	To Discount A/c	10	Feb.	1	By B/R A/c	1,500
May	4	To Bank A/c	750	Apr.	30	By B/P A/c	1,000
"	4	To Deficiency A/c	750				
			3,000				3,000

Note: Amount due from B is calculated by preparing B's Account in A's books

5.7 BILLS SENT FOR COLLECTION

When bill becomes due for payment, the holder of the bill usually presents it to the drawee through the bank. In other words the bills are sent for collection to the bank as and wheh they fall due. The bank will credit the account of the drawer when it receives the payment of the bill. Generally, no entries are passed when bills are sent for collection. An entry is made in the Cash Book when an intimation about the payment is received from the bank. But, some accountants prefer to record the entries even when the bills are sent for collection, In that case the following entry will have to be made in the journal of the holder for the bill sent for collection.

1 Bills Sent for Collection A/c Dr.
To Bills Receivable A/c
(Being bill sent for collection)

2 On receipt of intimation from the bank that the payment has been received against the bill, the journal will be:

Bank A/c Dr.
To Bills Sent for Collection A/c
(Being bill sent for collection honoured)

3 If the bill is dishonoured, the journal entry will be:

i) Bills Receivable A/c Dr.
To Bills Sent for Collection A/c
(Being bill sent for collection dishonoured)

ii) Drawee Dr.
To Bills Receivable A/c
(Being bill dishonoured)

Note that no entry is passed in the books of the drawee fur bills sent to bank for collection, He will make the *entries* in his books in the usual *manner* **when he makes the payment.**

5.8 BILE BOOKS

You have learnt how transactions relating to bills can be recorded In the Journal. Rut, if the dealings in bills are numerous, it is better to maintain separate books both for bills receivable and bills payable. A book in which we record all bills receivable by the firm is called 'Bills Receivable Journal' and the books in which we record all bills accepted and payable by the firm is called 'Bills Payable Journal'. Look at Figures 5.3 and 5.4 for rulings of these two books.

Figure 5.3 : Bills Receivable Journal

Sl. No.	Date of receipt	From whom received	Acceptor	Date of bill	Term	Due date	Where Payable	Amount	L.F.	How disposed of	Remarks
								Rs.			

Figure 5.4 : Rills Payable Journal

Sl. No.	Date of acceptance	Drawn by	Payee	Date of bill	Term	Due date	Where payable	Amount	L.F.	Remarks
								Rs.		

5.8.1 Recording in Bills Receivable Journal and its Posting

As and when promissory notes or bills of exchange are received, the particulars are noted in the Rills Receivable Journal as per the columns given in Figure 5.3. Note that entries in Bills Receivable Journal are made only at the time of receiving the bills from the drawee. The entries for their realisation and discounting are made in the Cash Book. Similarly the entries for endorsement and dishonour of bills are made in Journal Proper. However, if a discounted bill is dishonoured, the entry for dishonour will be made in the Cash Book, not in the Journal Proper.

All entries made in Bills Receivable Journal are posted to the credit side of the individual accounts of the parties from whom the bills were received. Periodic total of the Bills Receivable Journal is posted to the debit of Bills Receivable Account by writing 'To Sundries — as per B/R Journal'.

5.8.2 Recording in Bills Payable Journal and its Posting

As and when the firm accepts the bills, they are entered in the Bills Payable Joumal as per columns given in Figure 5.4. Note that entries for the payment of these bills are made in the Cash Book and those for dishonour in the Journal Proper.

All entries made in the Bills Payable Journal are posted to the debit side of the individual accounts of the parties at whose request the acceptances have been given. Periodical total of the Bills Payable Journal is posted to the credit side of the Bill Payable Account by writing 'By Sundries—as per B/P Journal'.

Look at Illustration 9 and study how transactions are recorded in Bills Receivable Journal and Bills Payable Journal, and how they have been posted into ledger.

Illustration 9

The following are the bill transactions of Saptagiri Agencies, Hyderabad. All bills accepted by Saptagiri Agencies are payable at the Andhra Bank, Hyderabad. Prepare Bills Receivable and Bills Payable Journals and post them into ledger.

1987

Aug. 3 A bill is drawn on Ram Narayan of Hyderabad, payable after three months for Rs. 5,000. It was duly accepted by him on the same day, payable at State Bank of India, Hyderabad.

" 5 Accepted a bill dated August 1,1987 drawn by B Agarwal of Lucknow, payable after 60 days for Rs. 3,000.

" 8 Drew. a bill on Manohar Singh of Chandigarh for Rs. 4,000 payable after two months at Punjab National Bank, Chandigarh. The bill is received on August 16, duly accepted.

" 12 Accepted a bill dated August 6,1987 drawn by Ghanshyam Oza of Rajkot, payable after one month for Rs. 2,500.

" 18 Received an acceptance dated August 12, 1987 from N. Mirdha of Jaipur, payable at State Bank of Bikaner, Jaipur, 90 days after date for Rs. 6,000. It was endorsed to S. Saklecha of Bhopal on the same day.

" 22 Accepted the bill dated July 14, 1987 drawn by P. Obul Reddy, Tirupathi, for Rs. 3,500, payable after 2 months.

" 23 A bill is drawn on S. Mukherjee of Calcutta for Rs. 9,000 payable at Allahabad Bank, Calcutta, 90 days after date, The bill was received duly accepted on August 28,1987 and was discounted with Andhra Bank on the same day.

" 30 Accepted tbe bill dated August 25,1987 by Palerio of Panaji, for Rs. 2,800, payable after 30 days.

Solution:

Bills Receivable Journal

Sl. No.	Date of receipt	From whom received	Acceptor	Date of bill	Term	Due date	Where payable	Amount	L. F.	How disposed of	Remarks
	1987							Rs.			
1	Aug. 3	Ram Narayan Hyderabad	Ram Narayan Hyderabad	Aug. 3	3 months	Nov. 6	State Bank of India, Hyderabad	5,000			
2	" 16	Manohar Singh Chandigarh	Manohar Singh Chandigarh	" 8	2 months	Oct.11	Punjab National Bank, Chandigarh	4,000			
3	" 18	N. Mirdha Jaipur	N. Mirdha, Jaipur	" 12	3 months	Nov. 15	State Bank of Bikaner, Jaipur	6,000		Endorsed to S. Saklecha	
4	" 28	S. Mukherjee Calcutta	S. Mukherjee, Calcutta	" 23	3 months	" 36	Allahabad Bank, Calcutta	9,000		Discount-ed	
						Total		24,000			

Bills Payable Journal

Sl. No.	Date of Accept-ance	Drawn by	Payee	Date of Bill	Term	Due date	Where payable	Amount	L. F.	Remarks
	1987							Rs.		
1	Aug. 5	B. Agarwal Lucknow	B. Agarwal Lucknow	Aug. 1	2 months	Oct. 4	Andhra Bank, Hyderabad	3,000		
2	" 12	Ghanshyam Oza Rajkot	Ghanshyam Oza Rajkot	" 6	1 month	Sept. 9	—do—	2,500		
3	" 22	P. Obul Reddy Tirupathi	P. Obul Reddy Tirupathi	Jul.14	2 months	" 17	—do—	3,500		
4	" 30	Palerio Panaji	Palerio Panaji	Aug. 25	1 month	" 28	—do—	2,800		
						Total		11,800		

LEDGER

Ram Narayan's Account

Dr. Cr.

Date		Particulars	Rs.	Date	Particulars	Rs.
1987			Rs.	1987		Rs.
Aug.	1	To Balance b/d	5,000	Aug. 3	By Bills Receivable A/c	5,000

Manohar Singh's Account

Date		Particulars	Rs.	Date	Particulars	Rs.
1987			Rs.	1687		Rs.
Aug.	1	To Balance b/d	4,000	Aug. 16	By Bills Receivable A/c	4,000

N. Mirdhn's Account

1987		Rs.	1987		Rs.
Aug. 1	To Balance b/d	6,000	Aug. 18	By Bills Receivable A/c	6,000

S. Mukherjec's Account

1987		Rs.	1987		Rs.
Aug. 1	To Balance b/d	9,000	Aug. 28	By Bills Receivable A/c	9,000

Bills Receivable Account

1987		Rs.			
Aug. 31	To Sundries—as per B/R Journal	24,000			

B. Agarwal's Account

1987		Rs.	1987		Rs.
Aug. 5	To Bills Payable A/c	3,000	Aug. 1	By Balance b/d	3,000

Ghnnshynm Oza's Account

1987		Rs.	1987		Rs.
Aug. 12	To Bills Payable A/c	2,500	Aug. 1	By Balance b/d	2,500

P. Obul Reddy's Account

1987		Rs.	1987		Rs.
Aug. 22	To Bills Payable A/c	3,500	Aug. I	By Balance b/d	3,500

Palerio's Account

1987		Rs.	1987		Rs.
Aug. 30	To Bills Payable A/c	2,800	Aug. I	By Balance b/d	2,800

Bills Payable Account

			1987		Rs.
			Aug. 31	By Sundries—as per B/P Journal	11,800

Check Your Progress C

1 What is an Accommodation Bill?

2 What do you understand by Bills Sent for Collection?

3 State whether each of the following statements is True or False.

i) When the hilt is drawn for mutual help it is called accommodation bill. ....

ii) For drawing an accommodation bill some valuable consideration must pass between the two parties. ....

iii) When an accommodation bill is discounted and the amount received is shared by the two parties, discount is borne by the drawer only. ....

iv) Total of Bills Receivable Journal is posted to the debit of Bills Receivable A/c. ....

v) All the entries from Bills Payable Journal are to be individually recorded in Bills Payable A/c. ....

4 An accommodation bill of Rs. 1,500 is discounted for Rs. 1,470. One-third of the proceeds of the bill are sent to the drawee. State the amount of discount which will be borne by the drawer.

5.9 LET US SUM UP

Credit transactions are very common in business. The seller or the lender likes to have some written undertaking from the debtor to pay the amount on a specified date. This may take the form of a bill of exchange or a promissory note. A bill of exchange is drawn by a creditor on tbe debtor. The debtor accepts it by putting his signatures across the bill. A promissory note is written by a debtor in favour of the creditor. It is a promise by the debtor to pay a certain sum on a certain date. There is no need for acceptance of a promissory note. A bill is a bills receivable for the drawer and the payee and a bills payable for the drawee. Similarly, the promissory note is a bills payable for the maker and a bills receivable for the payee,

For accounting purposes no distinction is made between the bill of exchange and a promissory note. When the businessman receives a promissory note or an acceptance to a bill he may deal with it in three ways. He may retain it, discount it with the bank, or endorse it to his own creditor, When a bill or a promissory becomes due for payment, the drawee of a bill or the maker of a promissory note may deal with it in four ways: he may honour it, dishonour it, renew it or retire it. All transactions with regard to bills and promissory notes are recorded in the journal. The journal entries to be made by various parties are shown in Chart 5.1.

CHART 5.1

Journal Entries in Books of Various Parties

TRANSACTION	DRAWER'S BOOKS	DRAWEE'S BOOKS	ENDORSEE'S BOOKS
When the bill is drawn and accepted	Bills Receivable A/c Dr. To Drawee	Drawer Dr. To Bills Payable A/c	No Entry
i) If retained	No entry	No entry	No entry
ii) If discounted	Bank A/c Dr. Discount A/c Dr. To Bills Receivable A/c	No entry	No entry
iii) If endorsed	Endorsee Dr. To Bills Receivable A/c	No entry	Bills Receivable A/c Dr. To Drawer (Endorser)
Honouring the Bill			
i) If retained	Bank A/c Dr. To Bills Receivable A/c	Bills Payable A/c Dr. To Bank A/c	No entry
ii) If discounted	No entry	Bills Payable A/c Dr. To Bank A/c	No entry
iii) If endorsed	No entry	Bills Payable A/c Dr. To Bank A/c	Bank A/c Dr. To Bills Receivable A/c

	TRANSACTION	DRAWER'S BOOKS	DRAWEE'S BOOKS	ENDORSEE'S BOOKS
4	**Dishonouring the Bill**			
	i) If retained	Drawee Dr. To Bills Receivable A/c To Cash A/c (N. charges)	Bills Payable A/c Dr. Noting Charges Aic Dr. To Drawer	No entry
	ii) If discounted	Drawee Dr. To Bank A/c (Amount of the bill plus N. charges)	Bills Payable A/c Dr. Noting Charges A/c Dr. To Drawer	No entry
	iii) If endorsed	Drawee Dr. To Endorsee (Amount of the bill plus N. charges)	Bills Payable A/c Dr. Noting charges A/c Dr. To Drawer Dr.	Drawer (Endorser) Dr. To Bills Receivable A/c To Cash A/c (Noting charges)
5	**Renewing the Bill**			
	i) Dishonouring the Bill	Pass dishonour entry keeping in view whether the bill is retained, endorsed or discounted	Pass dishonour entry	Pass dishonour entry only if the bill had been endorsed
	ii) For interest	Drawee Dr. To Interest A/c	Interest A/c Dr. To Drawer	No entry
	iii) For new bill drawn and accepted	Bills Receivable A/c Dr. To Drawee	Drawer Dr. To Bills Payable A/c	No entry
	Amount for the new bill will **depend** on **whether interest and noting charges have been paid in cash**			
6	**Retiring the Bill**			
	i) If retained	Bank A/c Dr. Rebate A/c Dr. To Bills Receivable A/c	Bills Payable A/c Dr. To Bank A/c To Rebate A/c	No entry
	ii) If discounted	No entry	Bills Payable A/c Dr. To Bank A/c To Rebate A/c	No entry
	iii) If endorsed	No entry	Bills Payable A/c Dr. To Bank A/c To Rebate A/c	Bank A/c Dr. Rebate A/c Dr. To Bills Receivable A/c

Accommodation bills are drawn when no valuable consideration has passed between the two parties. It is done for mutual help. Accommodation bill can be used fully by the drawer, or its proceeds may be shared both by the drawer and the drawee. They can also draw separate bills on each other. The accounting treatment for accommodation bills is similar to that of the normal bills.

If the number of transactions relating to bills is large, separate bill books can be maintained. In that case, all bills and promissory notes received by the firm are recorded in the 'Bills Receivable Journal' and all bills accepted and promissory note written by the firm are recorded in the 'Bills Payable Journal',

5.10 KEY WORDS

Acceptance: A signing across the bill by the drawee to show that the terms of the bill are accepted.

Accommodation Bill: Bills drawn to accommodate or help a fellow businessman.

Allonge: A separate paper attached to the bill for noting by the Notary Public.

Bills of Exchange: An instrument in writing containing an unconditional order, directing a certain person to pay a certain sum of money on demand or after a specified period to a certain person or his order,

Bills Payable: A bill of exchange or a promissory note payable by the bysiness.

Bills Receivable: A bill of exchange or a promissory note receivable by the business.

Date of Maturity: The date on which bill is due for payment.

Days of Grace: Three days to be added to the actual period of the bill to arrive at the due date.

Discounting of Bill: Encashrnent of bill with the bank before due date.

Drawer: One who draws the bill, usually a creditor.

Drawee: A person on whom the bill is drawn, usually a debtor.

Endorser: A person who transfers a bill receivable to his own creditor in full or part payment of his debt.

Endorsee: A person in whose favour the bills receivable is transferred.

Holder: A person who is entitled to the possession of the bill and is to receive its payment.

Hundi: It is an Indian name for the bill of exchange.

Instrument of Credit: A written document used for the purpose of settlement of mutual indebtedness arising from commercial transactions.

Negotiable Instruments: A written document the title of which can be transferred to the third party for valuable consideration.

Notary Public: A person authorised by the Government for recording the fact of dishonour (noting) in respect of the bill.

Payee;: A person who has the right to receive the payment against the bill.

Rebate: The discount allowed to the drawee for early payment of the bill.

Tenor: The period for which the bill is drawn and accepted.

5.11 SOME USEFUL BOOKS

I Maheshwari, S.N., 1986. *Introduction to Accounting*, Vikas Publishing House, New Delhi. (Chapter 6)

2 Patil, V.A. and J.S. Korlahalli, 1986, *Principles* and *Practice of Accounting*, R. Chand & Co., New Delhi. (Chapter 12)

3 William Pickles, 1982, *Accountancy*, E.L.B.S. and Pitman, London. (Chapter 6)

4 Gupta, R.L. and M. Radhaswamy, 1986. *Advanced Accountancy*, Sultan Chand & Sons, New Delhi. (Chapter 12)

5.12 ANSWERS TO CHECK YOUR PROGRESS

A 1 (i) False (ii) True (iii) False (iv) False (v) True (vi) False

2 Laxman: Drawer; Ram: Drawee; Bharat: Payee

3 (i) B/R (ii) B/R (iii) B/P (iv) B/P (v) B/R

B. 2 (i) accounting (ii) three (iii) Bills Receivable (iv) liability (v) drawee (vi) drawer

3 (i) No entry

(ii)	Bank A/c	Dr.	1975
	Discount A/c	Dr.	25
	To Bills Receivable	A/c	2,000
(iii)	Jill	Dr.	2,000
	To Bills Receivable A/c		2,000

4 (i) False (ii) True (iii) False (iv) True (v) True

5 Alok's Books

Arun	Dr.	2,810	
To Bank A/c			°10

Arun's Books

Bills Payable A/c	Dr.	2,800	
Noting Charges A/c	Dr.	10	
. To Alok			2,810

C 3 (i) True (ii) False (iii) False (iv) True (v) False

4 Rs. 20

5.13 TERMINAL QUESTIONS/EXERCISES

Questions

1 Differentiate between a Bill of Exchange and a Promissory Note? State their importance for the modem business?

2 What is the purpose of noting on the bill? Is it necessary in case of a promissory note?

3 Why do you maintain bill books? State the transactions recorded in Bills Receivable and Bills Payable Journals.

Exercises

1 Three bills for Rs. 2,400, Rs. 2,500 and Rs. 2,600 were drawn for two months, three months and four months respectively. First bill was discounted with the bank for Rs. 2,300. The second bill was endorsed to a creditor in settlement of a debt and the third bill was retained by the drawer. What will be the journal entries in the books of drawer, drawee and endorsee if :

i)' the bills is honoured on the due date;

ii) the bill is dishonoured on the due date and noting charges Rs. 20 are paid in all the three cases by the holder of the bill.

2 Raman owes to Suman Rs. 4,800. The debt is discharged by Raman on January 1,1988 by accepting three bills of Rs. 1,600 for two months, Rs. 1,400 for three months, and Rs. 1,800 for four months. First bill is endorsed to Aman, the second bill is retained whereas the thud bill is discounted for Rs. 1,350 with the bank. On the due date all the bills were dishonoured. The noting charges paid in each case were Rs. 15. On May 15, Raman accepted another bill for three months for the total amount including interest @ 15% p.a. The new bill was duly honoured on the due date. Record the above transactions in the books of Raman, Suman and Aman.

3 Krishna owed to Govinda Rs. 2,400. On January 1, 1988 he accepted two bills of Rs. 1,200 each for one month and two months respectively. First bill was retained whereas the second was endorsed to Karim in settlement of a debt. Both the bills were dis-honoured on the due date and noting charges Rs. 10 were paid in each case. A new bill for the full amount was drawn for 4 months and was accepted including interest @ 6% p.a. Before the due date of the renewed bill Krishna was declared insolvent and only 50 paise in a rupee was received from his estate.. Journalise the above hansactions in the books of Krishna, Govinda and Karim.

4 On April 1,1988 Pradeep drew on Sandeep two bills for Rs. 900 and Rs. 800 for two months and three months respectively. Second bill was discounted with the Bank @ 6% p.a. On May 1 Sandeep approached Pradeep and made the payment for the first bill before the due date at a discount of 6% p.a. On the same date Sandeep asked to renew the second bill for a further period of 2 mopths. Pradeep agreed and drew a new bill for the amount. Interest @ 6% p.a. was paid in cash. Record the above transactions in the books of Pradeep and Sandeep.

5 On October 1,1987 Shashi owed to Rishi Rs. 1,500. Rishi draws on Shashi two bills for Rs. 900 and Rs. 600 for 3 months. The fust bill is retained and the second bill is discounted with the bank for Rs. 585.

On the due date Shashi approaches Rishi for renewal of both the bilk. Rishi agrees to the arrangement and for the first bill he draws a new bill for a period of three months including interest @ 6% p.a. In respect of the second bill Shashi pays Rs. 303 in cash including Rs. 3 for interest, accepts a new bill for the balance for two months. Shashi meets the bill due on February 7,1988. He became insolvent on February 20 and only two-third of the amount could be received from his estate. Record the above transactions in the books of Rishi and Shashi.

6 On January 1, 1988 Rajiv drew on Sanjeev, a bill for three months for Rs. 1,000 for mutual and temporary accommodation. Sanjeev sent his acceptance to Rajiv who discounted the bill with the bank for Rs. 960 and remitted half the proceeds to Sanjeev. On the same date, Sanjeev drew a bill for 3 months for Rs. 900 for similar purpose. He discounted the bill forks. 870 with the bank and remitted half the proceeds to Rajiv. Sanjeev became insolvent on March 31, 1988 and failed to meet his acceptance. On June 30 twenty-five paise in a rupee was received from his estate. Joumalise the above transactions in the books of Rajiv and Sanjeev.

7 On Nov 1, 1987 the debtors and creditors of a firm were as follows :

Debtors	Rs.	Creditors	Rs.
Amita	5,000	Asha	6,000
Sunita	10,000	Usha	8,000
Kavita	13.000	Varsha	7,000

During November, the following transactions relating to bills of exchange took place.

Nov. 6 Received a bill dated November 1, duly accepted by Amita of Bangalore, payable at Karnataka Bank, Bangalore, after three months for Rs. 5,000.

" 9 Accepted a bill dated November 3 of Asha of Ghaziabad, payable at State Bank of Hyderabad, Hyderabad, after one month for Rs. 6,000.

" 11 Drew a bill on Sunita of Jaipur for Rs. 10,000, payable after 90 days. The bill was duly accepted. It is payable at Bank of Baroda, Jaipur. Bill was discounted with State Bank of Hyderabad on the same date.

" 15 Sent our acceptance to Usha on November 10, payable at State Bank of Hyderabad, Hyderabad, two months after date for Rs. 8,000.

" 21 Accepted a bill for Rs. 7,000 drawn by Varsha of Chandigarh dated November 12, payable after 3 months at State Bank of Hyderabad, Hyderabad.

" 25 Drew a bill on Kavita for Rs. 13,000, payable after 2 months, The bill was returned duly accepted on November 30, payable at Allahabad Bank, Chandigarh. It was endorsed to Sohan & Sons, Ambala.

Prepare Bills Receivable and Bills Payable Journals and show their posting into ledgers.

Note: These questions will help you to understand the unit better. **Try** to write **answers** for them. But do not submit your answers to the University. These are for your practice only.

UNIT 6 CONCEPTS RELATING TO FINAL ACCOUNTS

Structure

6.0 OBJECTIVES

After studying this unit you should be able to:

- explain the concepts underlying the preparation of final accounts
- describe various bases of accounting
- explain the importance of distinction between capital and revenue
- identify correctly whether an expenditure/receipt is of a capital or revenue nature.

6.1 INTRODUCTION

You have learnt about the procedure of recording and posting various business transactions in the appropriate books of account and testing the arithmetical accuracy of these records with the help of a Trial Balance. Having recorded the transactions and tested the accuracy of books of account,' we prepare a summary at the end of the accounting period to ascertain (i) the profit or loss, and (ii) the financial position of the business. The summary is prepared in the form of a Profit and Loss Account (also called Income Statement) and a Balance Sheet (also called Position Statement). These two financial statements are termed as the 'Final Accounts',

Before you can prepare the final accounts properly, it is necessary to understand the basic concepts which guide their preparation, In this unit, you will learn about these concepts and study how each concept influences the measurement of income and the financial position of the business, Clarity on the distinction between capital and revenue is equally relevant for the correct ascertainment of profit or loss and the financial position of the business. Hence, it is important to know whether a particular expenditure or receipt is of a capital nature or of a revenue nature.

6.2 BASIC CONCEPTS RELATING TO FINAL ACCOUNTS

You know that accounting concepts are broad working rules adopted by the accounting profession as guides for recording and reporting the affairs and activities of the business. In Unit 1 you learnt about the concepts to be observed at the recording stage. Let us now discuss the concepts which are to be observed at the reporting stage i.e., at the time of preparing the final accounts. These concepts are:

1 Going Concern Concept
2 Accounting Period Concept
3 Matching Concept
4 Conservatism Concept
5 Consistency Concept
6 Full Disclosure Concept
7 Materiality Concept

Let us take them up one by one.

6.2.1 Going Concern Concept

Normally the business is started with the intention of continuing it indefinitely or at least for the foreseeable future. The investors lend money and the creditors supply goods and services with the expectation that the enterprise would continue for long. Unless there is a strong evidence to the contrary, the enterprise is normally viewed as a going (continuing) concern. Hence, financial statements are prepared on a going concern basis and not on liquidation (closure) basis.

Certain expenses like rent, repairs, etc., give benefit for a short period, say less than one year. But the benefit of some other expenditure like purchase of a building, machinery etc. is spread over a longer period. If the benefit of an expenditure is limited to one accounting year it is fully charged to the Profit and Loss Account of that year. But, if the benefit of an expenditure is available for a number of accounting years, it must be spread over a number of years. Hence, only a portion of such expenditure is charged to the Profit and Loss Account every year. The balance is shown in the Balance Sheet as an asset. Let us take an example, Suppose a firm purchased a delivery van for Rs. 60,000 and its expected life is 10 years. It means the business will use the van for a period of 10 years. So, the accountant has to spread the cost of the van over 10 years. He would charge Rs. 6,000 (1110 of its cost) every year to the Profit and Loss Account in the form of depreciation, and show the balance in the Balance Sheet as an asset. This is based on the assumption that the business will continue for an indefinite period and the asset will be used for its expected life. Thus this concept is regarded as the basic assumption in accounting according to which the fixed assets are valued at historical cost less depreciation and not at its realisable value.

6.2.2 Accounting Period Concept

You know the going concern concept assumes that the business will continue for a long period, almost indefinitely. But, the businessmen cannot postpone the preparation of financial statements indefinitely. Therefore, he prepares them periodically to find out the profit or loss and financial position of the business. This will also enable other interested parties such as owners, investors, creditors, tax authorities to make periodic assessment of its performance. So, the life of the business enterprise is divided into what are called 'accounting periods', Profit and loss and the financial position at the end of each such accounting period is regularly assessed. Conventionally, duration of the accounting period is twelve months. It is called an 'accounting year'. Accounting year cap be a calendar year i.e., January 1 to December 31 or any other period of twelve months, say, April 1 to March 31 or Dewali to Dewali.

Normally, the final accounts are prepared at the end of each accounting year. The

Profit and Loss Account is prepared for the year so as to ascertain the profit earned or loss incurred during that year, and the Balance Sheet is prepared as on that date. However, for internal management purposes, accounts can be prepared even for shorter periods, say monthly, quarterly or half yearly.

6.2.3 Matching Concept

This is called 'Matching of Costs against Revenues Concept'. To work out profit or loss of an accounting year, it is necessary to bring together all revenues and costs pertaining to that accounting year. In other words, expenses incurred in an accounting year should be matched with the revenues earned during that year. The crux of the problem, therefore, is that appropriate costs must be matched against appropriate revenues. For this purpose, first we have to recognise the inflows (revenues) during an accounting period and the costs incurred in securing those inflows. Then, the sum of the costs should be deducted from the sum of the revenues to arrive at the net result of that period. Let us now understand how to recognise the revenues and costs in relation to an accounting period. For this purpose, the following rules are followed.

The Timing of Revenue Recognition

Revenue is recognised in the period in which it is earned or realised. The revenue recognition is primarily based on realisation principle which clearly states that in identifying revenues with a specific period one must look to the time of various transactions rather than cash inflow. Thus,

i) In case of the sale of goods (or services) revenue is regarded as realised when sales actually take place and not when cash is received. In other words, credit sales are treated as revenue when sales are made and not when money is received from the debtors
ii) Income such as rent, interest, commission, etc. are recognised on a time basis. The revenue from such items is taken to the Profit and Loss Account of the year during which it is earned. Let us assume that the business purchased some government securities on October 1,1987 for Rs. 20,000 carrying interest at 12 per cent. The interest is payable half yearly on April 1 and October 1 every year. The first instalment of interest (Rs. 1,200) is received on April 1,1988. The Profit and Loss Account is being prepared for the year 1987 (January 1,1987 to December 31, 1987). The interest amounting to Rs. 600 earned during October 1 to December 31 must be shown as the income from interest on investments in the Profit and Loss Account for 1987 though the amount has not been received in 1987.

The Timing of Cost Recognition

The matching principle holds that the expenses should be recognised in the same period as the associated revenues. Thus,

i) Cost of goods have to be matched with their sales revenue. This means that while preparing the Profit and Loss Account for a particular year, you should not take the cost of goods produced during that year but consider only the cost of goods that have actually been sold during that year. The cost of goods sold is arrived at by deducting the cost of closing stock from the cost of goods produced. You will learn about it in detail in Unit 7.
ii) Expenses such as salaries, wages, interest, rent, insurance, etc., are recognised on time basis. In other words, they are related to the year in which the service is obtained or the expense is incurred, whether paid immediately or payable at a later date.
iii) Costs like depreciation on fixed assets are also allocated over the periods during which the benefit is derived.

Thus, all revenues earned during an accounting year, whether received or not, and all costs incurred, whether paid or not have to be taken into account while preparing the Profit and Loss Account for the year. Similarly, any amount received or paid during the current year which actually relates to the previous year or the following accounting year, must be eliminated from the current year's revenues and costs. This gives rise to another aspect viz., the accrual basis of accounting about which you will learn later in this unit.

The Matching Concept thus has the following implications for ascertaining of profit or loss during a particular period.

1 We should ensure that costs should relate to the same accounting period as the revenues. For example, when we prepare the Profit and Loss Account for 1986, we shall take into account all those incomes that were earned during 1986, and similarly consider only those costs which were incurred in 1986 only. Any costs or incomes which relate to 1985 or 1987 shall be excluded.
2 We should ensure that all costs incurred during the accounting period (whether paid or not) and all revenues earned during that year (whether received or not) are bully taken into account.
3 We should consider only those costs which relate to the revenue taken into account. That is why we consider only the cost of goods sold, and not the cost of goods produced during that period.

6.2.4 Conservatism Concept

This is also known as Prudence Concept. This concept tries to ensure that all uncertainties and risks inherent in business are adequately provided for, Accountants generally prefer understatement of assets or revenues, and overstatement of liabilities or costs. This is in accordance with the traditional view which states anticipate no profits but anticipate all losses. In other words, you should account for profits only when they are actually realised. But in case of losses, you should take into account even those losses which may be a remote possibility. That is why the closing stock is valued at cost price or market price whichever is lower. Provision for doubtful debts and provision for discounts on debtors are also made according to this concept. This reflects a generally pessimistic attitude of the accountants but it is regarded as the best way of dealing with uncertainty and protecting creditors against an unwarranted distribution of the firm's assets as dividends.

6.2.5 Consistency Concept

The principle of consistency means conformity from period to period with unchanging policies and procedures. It means that accounting method adopted should not be changed from year to year. For example, the principle of valuing closing stock at cost price or market price whichever is lower should be followed year after year. Similarly, if depreciation on fixed assets is provided on straight line basis, it should be followed consistently year after year. Consistency eliminates personal bias and helps in achieving comparable results.

If this principle of consistency is not followed, the accounting information about an enterprise cannot be usefully compared with similar information about other enterprises and so also within the same enterprise for some other period. Consistent use of the same methods and bases from one period to another, enhances the utility of the financial statements.

However, consistency does not prohibit change. Desirable changes are always welcome. But such changes should be completely disclosed while presenting the financial statements.

6.2.6 Full Disclosure Concept

You know the financial statements are the basic means of communicating financial information to all interested parties. These statements are the only source for assessing the performance of the enterprise for investors, lenders, suppliers, and others. Therefore, financial statements and their accompanying footnotes should completely disclose all relevant information of a material nature which relate to the profit and loss and the financial position of the business. This enables the users of the financial statements to make correct assessment about the profitability and financial soundness of the enterprise. It is therefore necessary that the disclosure should be full, fair and adequate.

6.2.7 Materiality Concept

This concept is closely related to the Full Disclosure Concept. Full disclosure does not mean that every thing should be disclosed. It only means that all relevant and material information must be disclosed. Materiality primarily relates to the relevance and reliability of information. An item is considered material if there is a reasonable expectation that the knowledge of it would influence the decision of the users of the financial statements. All such material information should be disclosed through the financial statements and the accompanying notes. For example, commission paid to sole selling agents, if any, should be disclosed separately in the Profit and Loss Account. Similarly, if there is a change in the method or rate of depreciation, this fact must be duly reported in the financial statements.

A strict adherence to accounting principles is not required for items of little significance or of non-material nature. For example, erasers, pencils, scales, etc., are used for a long period, but they are not treated as assets. They are treated as expenses. This does not affect the amount of profit or loss materially.

Similarly, while showing the amounts of various items in the financial statements, they can be **approximated up** to paise. Even if they are shown to the nearest rupee or hundreds, there may not be any material effect. For example, if an amount of **Rs. *1,45,923.28*** is shown as Rs. **1,45,923** or Rs. **1,45,900** *it* does not make much difference for assessment of the performance of the enterprise.

However, there are no specific rules for ascertaining material or non-material items. It is **just** a matter of personal judgment.

Check Your Progress A

1 What is the assumption under Going Concern Concept?

....

....

....

2 What is the significance of an Accounting Period?

....

....

....

3 Name three items of costs.

....

....

....

4 Name three items of revenue.

....

....

....

5 Fill in the blanks.

i) Profit is the excess of revenue over ....
ii) Cost of goods .... is matched with their sales revenue.
iii) Conservatism concept is also known as .... Concept.
iv) Consistency enhances the .... of financial statements.
v) An item is **considered** .... if its **knowledge influences** the **decision** of the users of the financial statements.
vi) Revenue **realisation does** not mean that revenue is **realised** in ....

6.3 BASES OF ACCOUNTING

The accounts are prepared by the business either on cash **basis** or **on** accrual basis. In the **Cash System** accounting entries are made on the basis of dash received or cash paid. In other words, no entry is made when an income is earned or an expenditure is incurred. It will be recorded in books only when the amount involved is actually received or paid. Thus, the incomes earned but not yet received (accrued income) or the expenses incurred but not yet paid (outstanding expenses) are completely ignored while preparing the final accounts. For example, rent for the month of December, 1987 paid in January 1988 will be taken to the Profit and Loss Account of 1988 even though the expenditure relates to 1987. This leads to incorrect ascertainment of profit or loss of the business. But it is not true of the accounts maintained on accrual basis, Under the Accrual System (also called Mercantile System of Accounting) the financial effect of transactions is recorded in the books as and when they occur and not when the amount involved is received or paid by the business. This system attempts to relate the revenues and expenses to the accounting period during which they are actually earned or incurred. Thus, rent for the month of December, 1987 paid in January, 1988 will be taken into the Profit and Loss Account of 1987 and not of 1988. This is more logical because the benefit of expenditure is enjoyed in the year 1987 and not in 1988.

The main difference between accrual basis of accounting and cash basis of accounting is the timing of recognition of revenues, gains, expenses and losses. The objective of accrual accounting is to account for the effect of transaclions and events to the extent their financial effect are recognisable and measurable in the periods in whcih they occur. The adjustments made in the final accounts in respect of outstanding expenses, prepaid expenses, income received in advance, income earned but not yet received, etc. are in fact based on accrual accounting. You will learn about these adjustments in Unit 8.

Sometimes the businessman adopts a combination of both the above systems. In that case it is called Mixed or Hybrid System. For example, he may consider incomes on cash basis and expenses on accrual basis. This is considered most conservative. In practice most enterprises adopt the accrual basis of accounting.

6.4 DISTINCTION BETWEEN CAPITAL AND REVENUE

You know that a firm prepares Profit and Loss Account for ascertaining the net result of business operations and the Balance Sheet for determining the financial position of the business. These are prepared with the help of Trial Balance which shows the final position of all ledger accounts'. All items appearing in the Trial Balance are transferred either to the Profit and Loss Account or to the Balance Sheet. As per rules, the items of revenue nature are taken to the Profit and Loss Account and the items of capital nature are shown in the Balance Sheet. In other words whether an item appearing in the Trial Balance is to be taken to the Profit and Loss Account or the Balance Sheet depends upon the capital and revenue nature of the item. If any item is wrongly classified i.e., if an item of revenue nature is treated as a capital item or vice versa, the Profit and Loss Account will not reveal the correct amount of profit and the Balance Sheet will not reflect the true and fair view of the affairs of the business. It is therefore necessary to determine correctly whether an item is of capital nature or of a revenue nature and record it in the books accordingly. There are certain rules governing the allocation of expenditures and receipts between capital and revenue which should be clearly understood..

6.4.1 Capital and Revenue Expenditures

You incur expenditure on various items every day. You buy food items, stationery, cosmetics; utensils, furniture, etc. Some of them are consumables and some are durables. The benefit of expenditure on consumables like stationery, cosmetics, etc. is derived over a short period. But in case of durables like furniture, utensils, etc., the benefit spreads over a number of years. Same is true of business also. In business you incur expenditure on two types of items: (i) routine items like stationery, and (ii) fixed assets like machinery, building, furniture, etc., whose benefit is available over a number of years. In accounting terminology the first category of expenditure is called revenue expenditure and the second one is called capital expenditure.

Let us now study the exact nature of capital and revenue expenditures.

Capital Expenditure: As stated above, when the benefit of an expenditure is not exhausted in the year in which it is incurred but is available over a number of years it is considered as capital expenditure. The following expenditures are usually treated as capital expenditures.

1 Any expenditure which results in the acquisition of fixed assets such as land, buildings, plant and machinery, furniture and fixtures, office equipment, copyright, etc. You should note that such capital expenditure includes not only the purchase price of the fixed asset but also the expenses incurred in connection with their acquisition. Thus, the brokerage or commission paid in connection with the acquisition of an asset, the freight and cartage paid for transportation of machinery, the expenses incurred on its installation, the legal fees and registration charges incurred in connection with purchase of land and buildings are also treated as capital expenditure.

2 Any expenditure incurred on a fixed asset which results in (a) its expansion, (b) substantial increase in its life, or (c) improvement in its revenue earning capacity. Improvement in the revenue earning capacity can be in the form of (i) increased production capacity, (ii) reduced cost of production, or (iii) increased sales of the firm. Thus, cost of making additions to buildings and the amount spent on renovation of the old machinery are also regarded as capital expenditures. If you buy a second hand machinery and incur heavy expenditure on reconditioning it, such expenditure is also to be treated as capital expenditure. Similarly, expenditure on structural improvements or alterations to existing fixed assets whereby their revenue earning capacity is increased, is also treated as capital expenditure.

3 Expenditure incurred, during the early years, on development of mines and land for plantations till they become operational.

4 Cost of experiments which ultimately result in the acquisition of a patent. The cost of experiments which are not successful is not to be treated as capital expenditure. It is treated as a deferred revenue expenditure which is written off within two to three years.

5 Legal charges incurred in connection with acquiring or defending suits for protecting fixed assets, rights, etc.

Revenue Expenditure: When the benefit of an expenditure is not likely to be available for more than one year, it is treated as revenue expenditure. So all expenses which are incurred during the regular course of business are regarded as revenue expenditures. The examples of such expenses are:

1 Expenses incurred in day-to-day conduct of the business such as wages, salaries, rent, postage, stationery, insurance, electricity, etc.

2 Expenditure incurred for buying goods for resale or raw materials for manufacturing.

3 Expenditure incurred for maintaining the fixed assets such as repairs and renewals of building, machinery, eta.

4 Depreciation on fixed assets. This can also be termed as revenue loss.

5 Interest on loans borrowed for running the business. You should note that any interest on loan paid during the initial period before production commences, is not treated as revenue expenditure. It is treated as capital expenditure.

6 Legal charges incurred during the regular course of business such as legal expenses incurred on collection from debtors, legal charges incurred on defending a suit for damages, etc.

6.4.2 Deferred Revenue Expenditure

'Sometimes, certain expenditure which is normally treated as revenue may be unusually heavy and its benefit is likely to be available for more than one year. In such a situation, it is considered appropriate to spread the cost of the expenditure over a number of accounting years. Hence, it is capitalised and only a portion of the total amount spent is charged to the Profit and Loss Account of the current year. The balance is shown as an asset which will be written off during the subsequent accounting years. Such expenditure is called a Deferred Revenue Expenditure because its charge to Profit and Loss Account has been deferred to future years. Some examples of such expenditure are:

1 Expenditure incurred on advertising campaign to introduce a new product in the market.
2 Expenditure incurred on formation of a new company (preliminary expenses)
3 Brokerage charges, underwriting commission paid and other expenses incurred in connection with the issue of shares and debentures.
4 Cost of shifting the plant and machinery to a new site which may involve dismantling, removing and re-erection of the plant and machinery.

Let us take the case of expenditure on advertising campaign. It is not a routine advertisement and the amount involved is unusually heavy. Its benefit will not completely exhaust in one accounting year but will continue over two to three years. Hence, it is not proper to charge such expenditure to the Profit and Loss Account of one year. It is better to distribute it carefully over three years. So, in the first year we may charge one-third of the amount spent to the Profit and Loss Account and show the balance in the Balance Sheet as an asset. In the second year again we may charge a similar amount to the Profit and Loss Account and show the balance as an asset. In the third year, we may charge this balance to the Profit and Loss Account. Every expenditure which is regarded as deferred revenue is treated in this way in the final accounts.

Look at Illustration 1 and note how each expenditure has been treated and why.

Illustration 1

State whether the following items of expenditure would be treated as (a) capital expenditure, (b) revenue expenditure, or (c) deferred revenue expenditure:

i) Carriage on goods purchased Rs. 25
ii) Rs. 2,000 spent on repairs of machinery
iii) Rs. 5,000 spent on white washing
iv) Rs. 8,000 paid for import duty and cartage on the purchase of machinery from West Germany
v) Rs. 25,000 spent on issue of equity shares
vi) Rs. 14,000 spent on spreading new tiles on factory floors
vii) Rs. 4,000 spent on dismantling, transportation and reinstalling plant and machinery to new site
viii) Rs. 60,000 spent on construction of railway siding
ix) Rs. 20,000 spent on some major alterations to a theatre which made it more comfortable and attractive.
x) A second hand machine was bought for Rs. 10,000 and an amount of Rs. 6,000 was spent on its overhauling.

Solution:

i) It is a revenue expenditure as it relates to the goods for resale.
ii) It is a revenue expenditure as it relates to the maintenance of a fixed asset.
iii) Same as no. (ii).
iv) It is a capital expenditure as it is spent in connection with the purchase of a fixed assets.
v) It would be treated as deferred revenue expenditure. It is a heavy amount incurred in connection with raising of capital for the company and so capitalised. Even under the Indian Companies Act and the Indian Income Tax Act this expenditure is allowed to be written off over a number of years.
vi) It is a revenue expenditure so it is treated as a sort of repairs not leading to any increase in the earning capacity of a fixed asset.
vii) Normally expenditure on transportation etc. is revenue in nature. But this expenditure has been incurred on shifting to new site which is non-recurring in nature and involves a heavy amount. Hence it shall be treated as a deferred revenue expenditure.
viii) It is a capital expenditure as it is incurred on the construction of railway siding, a fixed asset.
ix) It is a capital expenditure as the alterations made the theatre more comfortable and attractive which is likely to increase its collections.

x) It is a capital expenditure as it is incurred on making the newly bought second hand machinery operational.

6.4.3 Capital and Revenue Receipts

Receipts refer to amounts received by a business i.e., cash inflows. Receipts may be classified as Capital Receipts and Revenue Receipts. It is necessary to note this distinction clearly because only the revenue receipts are taken to the Profit and Loss Account and not the capital receipts.

Capital Receipts: Capital receipts are the amounts received in the form of (a) additional capital introduced in the business, (b) loans received, and (c) sale proceeds of fixed assets. You are aware that a loan taken by the business is repayable sooner or later. Similarly, additional capital received represents an increase in the proprietor's claim over the business assets. Thus these two items represent increase in liabilities of the business and obviously are not incomes or revenues. These are capital receipts and should be treated as such. The sale proceeds of a fixed asset are also treated as a capital receipt because the amount received is not revenue earned in the normal course of business. The capital receipts increase the liabilities or reduce the assets. They do not affect the profit or loss.

Revenue Receipts: Revenue receipts are the amounts received in the normal and regular course of business. They take the form of (a) sale proceeds of goods, and (b) incomes such as interest earned, commission earned, rent received, etc. These receipts are on account of goods sold or some services rendered by the business and as such they are not repayable. All revenue receipts are treated as incomes and shown on the credit side of the Profit and Loss Account.

Check Your Progress B

1 Choose one of the alternatives given within brackets and fill in the blanks.

i) Proper allocation of expenditure between capital and revenue is necessary for the ascertainment of .... (Profit or Loss/Cash in hand)
ii) All items of revenue nature are shown in the .... (Profit and Lass Account/Balance Sheet)
iii) Any expenditure where the benefit is spread over a number of years is .... expenditure (capital/deferred revenue)
iv) When a revenue expenditure is capitalised, it is called .... expenditure (capital/deferred revenue)
v) Any expenditure incurred in acquiring a right like goodwill or patent is treated as .... expenditure (capital/revenue)

2 State whether the following statements are True or False

i) Every expenditure of large amount is capital expenditure. ....
ii) An expenditure incurred on acquisition of a fixed asset is a capital expenditure. ....
iii) Cartage paid on the new machine is a revenue expenditure. ....
iv) Depreciation on fixed assets is a capital expenditure. ....
v) Cost of goods purchased for resale is a revenue expenditure. ....
vi) Heavy expenditure on advertising campaign is a deferred revenue expenditure. ....
vii) Money received from the sale of goods is a capital receipt. ....
viii) Expenditure is not the same thing as payment. ....

6.5 LET US SUM UP

Summary is prepared at the end of an accounting period in the form of Profit and Loss Account and Balance Sheet to ascertain the profit or loss and the financial position of the business. These are called final accounts. There are seven accounting concepts which are to be observed while preparing the final accounts. The going concern concept implies that the firm is a continuing unit. Hence expenditure on long term assets could be spread over a number of years. According to the Matching Concept, appropriate costs have to be matched against the appropriate revenues for the accounting period. The concept of conservatism implies that while calculating the profit of an accounting period, all possible losses should be taken into account while only those incomes should be included which have actually arisen and not just expected. According to consistency concept the accounting methods followed from period to period should be the same so as to ensure meaningful comparisons. The full disclosure and the materiality concepts signify that the financial statements should disclose all material infofmation so that the users can draw rational conclusions about the enterprise.

There are two bases of accounting viz., cash basis and accrual basis. The accrual basis is considered more logical because it takes into account all expenses incurred (whether paid or not) and all incomes earned (whether received or not) during the accounting period and thus ensures correct ascertainment of profit or loss.

It is also important to distinguish between capital and revenue otherwise the ascertainment of profit or loss and the financial position of the business will be incorrect. There are certain rules which guide us to determine whether a particular expenditure or receipt is of a capital nature or of a revenue nature.

6.6 KEY WORDS

Accrual Accounting: Accounting based on accrual system which takes into account all expenses incurred (whether paid or not) and all incomes earned (whether received or not) during an accounting period.

Accounting Year: A period of twelve months at the end of which the financial results are generally ascertained.

Balance Sheet: A statement prepared for ascertaining the financial position of the business as at the end of the accounting period.

Capital Expenditure: An expenditure which results in the acquisition of a fixed asset, or addition to a fixed asset, or an improvement in the earning capacity of the business.

Capital Receipt: Receipt in the form of additions to capital, liabilities or sale prqceeds of a fixed asset.

Deferred Revenue **Expenditure: A** revenue expenditure which involves a heavy amount and the benefit of which is likely to spread over two-three years.

Final Accounts: Financial statements prepared at the end of the accounting period for ascertaining the profit or loss and the financial position of the business. They include Profit and Loss Account and the Balance Sheet.

Revenue Expenditure: An expenditure the benefit of which is limited to one year.

Revenue Receipt: Receipts on account of goods sold or services provided.

6.7 SOME USEFUL BOOKS

Maheshwari, S.N., 1986. ***Introduction to Accounting,*** Vikas Publishing House: New Delhi. (Chapters 8,9,12).

Patil, V.A. and J.S. Korlahalli, 1986. ***Principles and Practice of Accounting***, R.R. Chand & Co.: New Delhi. (Chapter 2).

William Pickles, 1982. ***Accountancy,*** E.L.B.S. and Pitman: London. (Chapter 8).

Gupta, R.L. and M. Radhaswamy, 1986. ***Advanced Accountancy,*** Sultan Chand & Sons: New Delhi. (Chapters 2,11).

Shukla, M.C. and T.S. Grewal, 1987. ***Advanced Accounts,*** S. Chand & Company: New Delhi. (Chapter 2).

6.8 ANSWERS TO CHECK YOUR PROGRESS

A 5 i) costs ii) sold iii) prudence iv) utility v) material vi) cash
B 1 i) profit or loss ii) Profit and Loss Account iii) capital iv) deferred revenue v) capital
2 i) False ii) True iii) False iv) False v) True vi) True vii) False viii) True

6.9 TERMINAL QUESTIONS/EXERCISES

Questions

1 What do you understand by matching costs against revenue? Explain the main implications of the Matching Concept.
2 Distinguish between cash basis and accrual basis of accounting. Why do you consider accrual basis more rational?
3 Write notes on the following concepts
   i) Going Concern Concept
   ii) Conservatism
   iii) Consistency
   iv) Full Disclosure
   v) Materiality
4 Why is distinction between capital and revenue important? Give examples to show how wrong classification can affect the ascertainment of profit.
5 What is deferred revenue expenditure? Give three examples.

Exercises

1 Ascertain the profit to the business for the month of June, 1988 for which the following information is available.

	Rs.
Sales	80,000
Cost of goods produced	70,000
Cost of goods sold	60,000
Salaries for June	10,000
Rent for June paid in July	1,000
Sundry Expenses	600

Hint: Match costs against revenues
(Answer: Rs. 8,400)

2 State with reasons whether the following expenditure is of capital or revenue nature
   i) Rs. 3,00,000 spent on constructing an additional hall.
   ii) Rs. 600 spent on carriage of goods.
   iii) A second hand machine was bought for Rs. 10,000 and Rs. 900 were spent on its carriage and installation.
   iv) Rs. 800 were paid as wages to own workers for manufacturing loose tools for use in the factory.
   v) A sum of Rs. 800 spent on legal charges for recovering dues from debtors.
   vi) Rs. 2,000 were paid to an architect for drawing up the plans for the proposed building.

(Answer: i) capital ii) revenue iii) capital (including carriage, etc.) iv) capital v) revenue vi) capital).

3 State whether the following expenditures are capital or revenue. Give reasons in each case.
   i) Rs. 15,000 paid as brokerage in connection with the purchase of land.
   ii) Rs. 60,000 spent on uniforms to staff

iii) Rs. 2,00,000 incurred in developing a new area for tea plantation
iv) Rs. 600 spent on transportation of stock to new site
v) Rs. 20,000 spent on experimenting a new product which was not **successful**
vi) A sum of Rs. 25,000 spent on overhauling the machinery. It increased the life of the machinery by three years

(Answer: i) capital ii) revenue iii) capital iv) deferred revenue v) deferred revenue vi) capital

Note: These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University. These are for your practice only.

UNIT 7 FINAL ACCOUNTS I

Structure

7.0 OBJECTIVES

After studying this unit you will be able *to:*

- explain the purpose of preparing final accounts
- prepare a trial balance from a given list of balances
- prepare trading and profit and loss account
- prepare balance sheet
- prepare manufacturing account and calculate cost of goods produced
- prevent the final accounts in vertical form.

7.1 INTRODUCTION

In Unit 6 you have learnt about the concepts which guide the preparation of final accounts. You know that the final accounts are primarily prepared for ascertaining the operational result and the financial position of the business. They consist of (i) Profit and Loss Account, and (ii) Balance Sheet. The Profit and Loss Account reveals the profit earned or loss incurred (operational result) during the accounting year and the Balance Sheet indicates the financial position as at the end of the year. In this unit you will learn about the basic framework of final accounts including their presentation in vertical form.

7.2 FINAL ACCOUNTS AND TRIAL BALANCE

You how final accounts are prepared with the help of a Trial Balance which shows all the ledger balances as at the end of an accounting period. Generally, when you are asked to prepare final accounts you are given a properly prepared Trial Balance and you have no difficulty in identifying the items of incomes, expenses, assets, and liabilities. But, sometimes you may not be given a proper Trial Balance, You may simply be asked to prepare the final accounts from the list of closing balances extracted from the books of some firm. In such a situation, it will be helpful if you first prepare the Trial Balance and then the final accounts. Hence it is important that you should know how to prepare the Trial Balance from a given list of balances.

Normally when a Trial Balance is to be prepared, you have full details of ledger accounts with you. You can easily ascertain whether a particular account has a debit

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iv) Rs. 600 spent on transportation of stock to new site
v) Rs. 20,000 spent on experimentinga new product which was not **successful**
vi) **A** sum of Rs. 25,000 spent on overhauling the machinery. It increased the life of the machinery by three years

(Answer: i) **capital** ii) revenue **iii)** capital iv) deferred revenue v) deferred revenue vi) capital

Note: These questions will help you to understand the unit better. Try **to** write answers for them. But, do not submit your answers to the University. These are for your practice only.

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Normally when a Trial Balance is to be prepared, you have full details of ledger accounts with you. You can easily ascertain whether a particular account has a debit balance or a credit balance, and prepare the Trial Balance without any difficulty. The problem arises when you are given a list of balances but it is not indicated whether the account has a debit balance or a credit balance. Under such a situation you will have to determine the nature of each balance before you can prepare the Trial Balance. In this exercise your knowledge of rules of debit and credit will help you. For example you know that in case of nominal accounts all expenses and losses are debited and all incomes and gains are credited. Similarly, you know the rules for real and personal accounts according to which the account of assets like cash, machinery debtors, etc. will show debit balances while accounts like capital, creditors, etc, will show credit balances. For convenience however, a few guidelines should help you. They are

a) All accounts of expenses (including purchases) and losses will be debit balances.
b) All accounts of income (including sales) and gains will be credit balances.
c) All accounts of assets will be debit balances.
d) All accounts of liabilities will be credit balances.
e) Capital Account will normally be a credit balance.
f) Drawings Account will be a debit balance.

However, the problem may arise with regard to some item like rent, discount, commission and interest as they can be expenses as well as incomes. In such cases, the nature of the balance is usually indicated by mentioning (Dr.) or (Cr.) against each item, or the word 'received' or 'paid' is written after each item. This helps you to treat the item correctly. But, if there is only one item for which no such indication is given you can proceed with the preparation of Trial Balance and work out the totals of both the columns. You will find that the total of one column will be less than the other. This means that the unidentified balance pertains to the column which is short. For example, here is an item of commission of Rs. 300 appearing in the list of balances and it is not indicated whether it is paid or received. When you prepare the Trial Balance you will find that the debit total is short by Rs. 300. This would mean that the Commission Account has a debit balance. Now if you show it as such in the Trial Balance, it will tally.

Look at Illustration 1 and see how the Trial Balance has been prepared from a given list of balances where the nature of each balance has not been indicated.

Illustration 1

Prepare a Trial Balance from the following balances extracted from the books of Sudhakar as on March 31, 1987.

	Rs.		Rs.
Opening Stock	40,000	Drawings	10,000
Purchases	4,10,000	Wages	7,300
Sales	4,29,000	Salaries	11,000
Purchases Returns	1,250	Outstanding Expenses	1,000
Sales Returns	2,500	Prepaid Expenses	750
Carriage Inwards	1,500	Postage	900
Carriage Outwards	2,500	Discount Received	375
Bank Overdraft	21,000	Discount Allowed	1,000
Cash	4,000	Bad Debts	750
Capital	1,27,750	Sundry Debtors	1,00,000
Sundry Creditors	37,500	Interest	3,500
Loans	41,375	Interest Received	300
Investments	10,000	Provision for Bad Debts	1,750
Accrued Income	600	Furniture & Fixture	7,500
Machinery	47,500		

Solution:

Trial Balance of Sudhakar as on March 31, 1987

Particulars	Dr. Balances	Cr. Balances
	Rs.	Rs.
Opening Stock	40,000	
Purchases	4,10,000	
Sales		4,29,000
Purchases Returns		1,250
Sales Returns	2,500	
Carriage Inwards	1,500	
Carriage Outwards	2,500	
Bank Overdraft		21,000
Cash	4,000	
Capital		1,27,750
Sundry Creditors		37,500
Loans		41,375
Investments	10,000	
Accrued Income	600	
Machinery	47,500	
Drawings	10,000	
Wages	7,300	
Salaries	11,000	
Outstanding Expenses		1,000
Prepaid Expenses	750	
Postage	900	
Discount Received		375
Discount Allowed	1,000	
Bed Debts	750	
Sundry Debtors	1,00,000	
Interest	3,500	
Interest Received		300
Provision for Bad Debts		1,750
Furniture & Fixture	7,500	
Total	6,61,300	6,61,300

In Illustration 1 the Trial Balance has tallied **i.e,** the total of debit balances column is equal to the total of cre'dit balances column. This would mean that each balance has been entered in the appropriate amount column of the Trial Balance. **This** is not always true. It is quite possible that even when the Trial Balance has tallied, some balances may not have been entered in the correct columns. Look at Illustration 2. You will find that the Trial Balance has tallied (the totals of both Dr. balances and Cr. balances is the same **i.e.,** Rs. 91,650 but there are a number of items which have been shown in the wrong columns. For example, bank overdraft which should have been shown in the Cr. balances column has been included in the Dr. balances column and Furniture which should have appeared in Dr. balances column has been shown in the **Cr.** balances column. So, the Trial Balance has been rewritten and all items shown correctly. Such situation arises on account of the compensating effect of the errors which is very rare.

Illustration 2

An inexperienced accountant provides you **with** the following Trial Balance. In case you find it to be incorrect prepare it again so as to remove its defects.

Trial Balance as on June 30, 1987

Name of Account	L.F.	Dr. Balances	Cr. Balances
		Rs.	Rs.
Stock (Opening)		10,500	
Buildings		31,500	
Bills Payable		1,800	
Bank Overdraft		1,500	
Capital			45,000
Furniture			12,000
Discount Allowed		90	
Sales		39,000	
Loan from Suresh		2,400	
Carriage Inwards		270	
Bills Receivable			3,000
Purchases			24,000
Salaries			3,300
Investments		3,000	
Interest on Investments			1,650
Returns Inwards		900	
Returns Outwards		300	
Insurance Premium		360	
Interest on Loan		30	
Advertisement			1,200
Drawings			1,500
Total		91,650	91,650

Solution:

Revised Trial Balance as on June 30, 1987

Name of Account	L.F.	Dr. Balances	Cr. Balances
		Rs.	Rs.
Stock (opening)		10,500	
Buildings		31,500	
Bills Payable			1,800
Bank Overdraft			1,500
Capital			45,000
Furniture		12,000	
Discount Allowed		90	
Sales			39,000
Loan from Suresh			2,400
Carriage Inwards		270	
Bills Receivable		3,000	
Purchases		24,000	
Salaries		3,300	
Investments		3,000	
Interest on Investments			1,650
Returns Inwards		900	
Returns Outwards			300
Insurance Premium		360	
Interest on Loan		30	
Advertisement		1,200	
Drawings		1,500	
Total		91,650	91,650

Check Your Progress A

Mention against each item whether it will generally show a debit balance or a credit balance.

Items	Nature of Balance Debit or Credit
i) Sales Returns	....
ii) Carriage Inwards	....
iii) Carriage Outwards	....
iv) Capital	....
v) Loss by fire	....
vi) Overdraft	....
vii) Drawings	....
viii) Returns Outwards	....
ix) Bills Receivable	....
x) Goodwill	....
xi) Rent Paid	....
xii) Commission Received in Advance	....

7.3 TRADING AND PROFIT AND LOSS ACCOUNT

You know the Profit and Loss Account is prepared for ascertaining the profit or loss of the business. This is worked out in two stages. In the first stage we work out the gross profit or gross loss and in the second stage, the net profit or net loss. Hence, the profit and Loss Account is divided into two sections, The first section is called Trading Account. It reveals the gross profit or gross loss. The second section is called Profit and Loss Account which shows the net profit or net loss.

7.3.1 Trading Account

As stated above, the Trading Account is prepared for ascertaining the gross profit or gross loss. The gross profit is defined as the excess of sales revenue over cost of goods sold, This can be presented in the form of an equation as follows.

Gross Profit = Net Sales – Cost of Goods sold
Where i) Net Sales = Total sales – Sales Returns
ii) Cost of Goods Sold = Opening stock + Net Purchases + Direct Expenses – Closing stock

You know the terms 'Opening Stock' and 'Closing Stock' refer to the value of unsold goods as at the beginning of the year and at the end of the year respectively. Such stock may also include the semi-finished goods and raw materials. In order to arrive at the cost of goods sold the opening stock is added to the net purchases while the closing stock is deducted. The term 'Direct Expenses' refer to those expenses which are incurred on the goods purchased till they are brought to the place of business for sale. These include expenses such as freight, insurance, import duty, dock dues, clearing charges, octroi duty, carriage, cartage, etc. The administrative expenses, selling and distribution expenses, interest paid, etc. are termed as indirect expenses and, therefore, are excluded from the cost of goods sold.

Look at Illustrations 3 and 4 and study how Cost of Goods Sold and the Gross Profit are-computed.

Illustration 3

The following figures have been extracted from the books of a firm. Calculate the Cost of Goods Sold.

	Rs.
Stock as on 1.1.1987	1,00,000
Purchases for 1987	15,00,000
Purchases Returns	40,000
Carriage Inwards	20,000
Octroi	80,000
Freight	15,000
Stock as on 31.12.87	1,70,000

Solution:

Opening Stock	1,00,000
Add Net Purchases	
(Purchases Rs. 15,00,000	
Purchases Returns Rs. 40,000)	14,60,000
Carriage Inwards	20,000
Octroi	80,000
Freight	15,000
	16,75,000
Less Closing Stock	1,70,000
Cost of Goods Sold	15 05,000

Illustration 4

On January 1,1987 a firm had stock of goods valued at Rs. 20,000. During the year the following transactions took place.

	Rs.
Sales	5,00,000
Purchases	3,00,000
Carriage Inwards	3,000
Freight Inwards	5,000
Sales Returns	10,000
Clearing charges	22,000
Purchases Returns	5,000

The closing stock of goods on December 31,1987 is Rs. 40,000.

Solution:

	Rs.	Rs.
Sales	5,00,000	
Less Sales Returns	10,000	
Net Sales		4,90,000
Less Cost of Goods Sold:		
Opening Stock	20,000	
Add Purchases	3,00,000	
	3,20,000	
Less Purchases Returns	5,000	
	3,15,000	
Add Carriage Inwards	3,000	
Freight Inwards	5,000	
Clearing Charges	22,000	
	3,45,000	
Less Closing Stock	40,000	3,05,000
Gross Profit		1,85,000

Form of Trading Account: The Equation for Gross Profit is also known as Trading Account Equation. This equation forms the basis of preparing the Trading Account. The Trading Account, like any other account in the ledger, has two sides—debit and credit. The opening stock, purchases (less returns) and all direct expenses are shown on the debit side of the Trading Account while sales (less returns) and the closing stock on the credit side. The gross profit appears as the last item on the debit side which, in fact is the excess of the total of credit side over the total of debit side. If however, the total of the debit side exceeds the total of the credit side, it will be treated as gross loss. This is shown as the last item on the debit side of the Trading Account. The gross profit/gross loss thus worked out is transferred to the Profit and Loss Account. Look at the Figure 7.1 for the form of Trading Account.

Figure 7.1
Form of Trading Account
Trading Account of ....
(Day, Month and Year)

Dr. Cr.

Particulars	hunt	Amount	Particulars	Amount	Amount
	Rs.	Rs.		Rs.	Rs.
To Opening Stock		...	By Sales	...	
To Purchases	...		Less Sales		
Less Purchases			Returns	...	
Returns	...				...
		...	By Closing		
To Direct Expenses			Stock		...
(specify individually)		...			
To Gross Profit					
(transferred to Profit					
and Loss Account)		...			
		...			...

Based on the data given in Illustration 4, the Trading Account will be prepared as follows.

Trading Account of ....
for the year ending December 31, 1987

Dr. Cr.

Particulars		Amount	Particulars		Amount
		Rs.			Rs.
To Opening Stock		20,000	By Sales	5,00,000	
To Purchases	3.00,000		Less Returns	10,000	
Less Returns	5,000				4,90,000
		2,95,000			
To Carriage Inwards		3,000	By Closing Stock		40,000
To Freight		5,000			
To Clearing Charges		22,000			
To Gross Profit (transferred to (P&L A/c)		1,85,000			
		5,30,000			5,30,000

Some Important Points

1 Purchases: This item refers to the goods pu chased for resale and includes both cash and credit purchases. The purchases of assets which are meant for permanent use in business such as machinery furniture, etc., are not included in the purchases, The amount taken to Trading Account will be the net amount of purchases (after deducting purchase returns/returns outwards.) If the proprietor has taken away some goods from the business for his personal use, the same should also be deducted from the total purchases.

2 Sales: It includes both cash and credit sales of goods and refers to the net amount of sales (after deducting sales returns-returns inwards). Sales of old furniture, car, machinery, etc. are not included in the sales. Similarly, sales of old newspapers etc. are also excluded from sales. Such items are shown as miscellaneous income in the Profit and Loss Account.

3 Wages: Wages are usually treated as a direct expense and so shown in the Trading Account. The difficulty arises when wages are clubbed with salaries (an indirect expense) and the Trial Balance includes a single amount for 'Wages and Salaries'. In such a situation, the amount may be shown in the Trading Account. It is based on the assumption that the item includes the salaries of the supervisory staff in the factory itself. But, if the item in the Trial Balance reads 'Salaries and Wages' it will be taken to the Profit and Loss Account on the assumption that the item includes wages of the office staff only. It should be noted that wages paid in connection with the purchases of fixed assets or the construction of building should not be charged to Trading Account. They are to be included in the cost of the concerned fixed asset. There is another important aspect in relation to wages which must be clarified. If a Manufacturing Account is prepared the wages paid to the factory labour is debited to Manufacturing Account about which you will learn later in this unit.

4 Freight, Carriage and Cartage: When paid in connection with purchases of goods, they are shown in the Trading Account. Such freight and carriage are also termed as 'Freight Inwards' and 'Carriage Inwards' respectively. 'Freight Outwards' and 'Carriage Outwards' relate to sales and therefore taken to the debit of Profit and Loss Account,

5 Royalties: Royalties refer to the payments made for the use of copyright or a patent. The amount of royalty is generally based on the quantity produced. It is, therefore, treated as a direct expense and charged to Trading Account. But if it is calculated on the basis of quantity sold as in case of books, it is shown in the Profit and Loss Account. Royalties are also paid to the Government for extraction of minerals such as coal, diamond, gold, etc. These are charged to the Profit and Loss Account of the mining companies, You will learn about the accounting of such royalties later under a separate course.

7.3.2 Profit and Loss Account

After ascertaining the gross profit by preparing the Trading Account, the businessman proceeds to prepare the Profit and Loss Account in order to work out the net profit/net loss. You know the net profit is the excess of gross profit and other incomes over the indirect expenses and losses. So, while preparing the Profit and Loss Account we show gross profit and other incomes such as rent received, discount received, commission received, interest and dividends etc. on the credit side, and all indirect expenses and losses on the debit side. Indirect expenses include all administrative, selling and distribution expenses such as salaries, rent and taxes,-postage and stationery, insurance, depreciation, interest paid, office lighting, advertising, packing carriage outwards, etc., while losses refer to items like loss by fire, loss by theft etc. The difference between the two sides of the Profit and Loss Account represent either the net profit or net loss. If the total of the credit side is higher than the total of the debit side, the difference is called net profit and if the debit side total exceeds the credit side total, the difference is called net loss. The net profit/net loss belongs to the proprietor and it is therefore transferred to his Capital Account. Look at figure 7.2. It shows various expenses. losses, incomes, etc. which usually appear in the Profit and Loss Account.

Figure 7.2
Profit and Loss Account..............
for the period ended..............

Dr. **Cr.**

Particulars	Amount	**Particulars**	**Amount**
	Rs.		**Rs.**
To Gross Loss, if any, (transferred from Trading Account)		By Gross Profit (transferred from Trading Account)	
To Salaries		By Interest Received	
To Rent, Rates and Taxes		By Discount Received	
To Postage and Telegrams		By Rent Received	
To Telephone Charges		By Commission Received	
To Printing and Stationery		By Dividend Received	
To Legal Expenses		By Other Incomes and Gains	
To Insurance		By Net Loss (transferred to Capital Account)	
To Office Lighting			
To Bad Debts			
To Depreciation			
To Advertising			
To Travelling Expenses			
To Carriage Outwards			
To Trade Expenses			
To Discount Allowed			
To Interest Paid			
To Repairs and Renewals			
To Loss by Fire			
To Loss by Theft			
To Other Expenses and Losses, if any			
To Net Profit (transferred to Capital Account)			

Notes:

1 The heading for the Profit and Loss Account, as in the case of the Trading Account, indicates the name of the business or proprietor and the period for which it is being prepared.

2 In addition to the items shown in the above form, there are certain items such as depreciation, bad debts, provision for doubtful debts, interest on capital, interest on drawings, etc., which appear in the Profit and Loss Account as a result of the adjustment entries. We shall discuss them in Unit 8.

Some Important Points

1 Rent, Rates and **Taxes:** These are charges levied by the municipal bodies on the house property. It is a common item of indirect expenses debited to the Profit and Loss Account.

2 Insurance: Generally, assets are insured to cover the risk of loss, say, by fire. Premium paid to the insurance company should be treated as a business expense. When assets such as factory building, factory machinery, etc. are insured, the insurance premium should be debited to Trading Account. If on the other hand, the premium is paid for insurance of assets in the office building, office furniture, etc., it should be charged to Profit and Loss Account.

3 Bad **Debts:** Bad debts denote the amount which could-not be recovered from the debtors to whom the goods were sold on credit. It is a loss and so debited to the Profit and Loss Account. You will learn more about their treatment in Unit 8.

4 Depreciation: Depreciation means decrease in the, value of fixed assets due to normal wear and tear. You. know that every fixed asset such as machinery, furniture, vehicle, etc. depreciates in value on account of its constant use. Such

reduction in their value is a loss to the business and so charged to the Profit and Loss Account. If, however, a Manufacturing Account is ako prepared, depreciation on machinery and factory building is charged to the Manufacturing Account, while depreciation on office building, office furniture, office equipment, etc. is charged to the Profit and Loss Account.

5 Trade Expenses: This item represents various small expenses incurred in the business. They are also called General Expenses, Sundry Expenses or miscellaneous Expenses.

6 Packing: The cost of packing materials such as polythene bags, wrapping materials, etc. for delivery is a distribution expense and hence charged to Profit and Loss Account. Where packing is essential to make the products fit for sale, in the market as in the case of cigarettes, biscuits, medicines, oil, etc. it is called 'packaging' and such expenditure is charged to the Trading Account.

7 Samples: Generally, samples of goods are distributed free of charge to increase sales. The cost of such samples should be treated as a selling expense and so debited to Profit and Loss Account.

8 Income Tax: It is the tax payable by a person on his income. In the case of a sole trading concern, the tax paid by the proprietor on the profits of the business is treated as a personal expense. Hence, it should be added to drawings or directly deducted from capital.

Illustration 5

Prepare Profit and Loss Account from the following balances extracted from the books of a business for the year 1987.

	Rs.
Gross Profit	1,85,000
Salaries	20,000
Rent and Rates	5,000
Stationery	1,000
Postage	500
Insurance	2,000
Repairs	1,500
Depreciation	5,000
Advertisement	5,000
Discount (Dr.)	500
Commission of Salesmen	5,000
Bad Debts	2,000
Loss by Fire	2,000
Interest on Investments	2,500
Profit on sale of Investments	2,000

Solution:

Roflt and Loss Account of... ....
tor the year ending December 31, 1987

Dr.			Cr.
Particulars	**Amount**	**Particulars**	**Amount**
	Rs.		Rs.
To Salaries	20,000	By Gross Profit (transferred from Trading A/c)	1,85,000
To Rent and Rates	5,000		
To Stationery	1,000		
To Postage	500	By Interest on Investments	2,500
To Insurance	2,000	By Profit on Sale of Investments	2,000
To Repairs	1,500		
To Depreciation	5,000		
To Advertisement	5,000		
To Discount	500		
To Commission to Salesmen	5,000		
To Bad Debts	2,000		
To Loss by fire	2,000		
To Net Profit (transferred to Capital Account)	1,40,000		
	1,89,500		1,89,500

In Practice the Trading Account and the Profit and Loss Account are combined and one account called 'Trading and Profit and Loss Account' is prepared. This account is divided into two parts. The first part shows the Gross Profit and the second part shows the Net Profit.

Look at Illustration 6 and see how combined Trading and Profit and Loss Account will be prepared.

Illustration 6

From the following figures prepare Trading and Profit and Loss Account of Lakshmi & Co. for the year ended December 31, 1987.

	Rs.
Stock on January 1,1987	40,000
Purchases	98,000
Commission Received	650
Rent, Rates and Taxes	8,600
Salaries & Wages	12,000
Sales	1,62,100
Returns Inwards	2,400
Returns Outwards	3,000
Sundry Expenses	2,500
Bank Charges	50
Discount Received	750
Carriage on Purchases	2,000
Discount Allowed	530
Carriage on Sales	1,700
Lighting and Heating	2,200
Postage	300
Income from Investments	500
Commission Paid	1,000
Interest paid on a bank loan	550

The stock on December 31,1987 was valued at Rs. 26,000

Solution:

Trading and Profit & Loss Account of Lakshmi & Co.
for the year ended December 31, 1987

Dr. Cr.

Particulars		Amount	Particulars		Amount
		Rs.			Rs.
To Opening Stock		40,000	By Sales	1,62,100	
To Purchases	98,000		Less Returns	2,400	
Less Returns	3,000				
		95,000			1,59,700
To Carriage on Purchase		2,000	By Closing Stock		26,000
To Gross Profit c/d		48,700			
		1,85,700			1,85,700
To Rent, Rates and Taxes		8,600	By Gross Profit b/d		48,700
To Salaries & Wages		12,000	By Commission Received		650
To Sundry Expenses		2,500	By Discount received		750
To Bank Charges		50	By Income from Investments		500
To Discount Allowed		530			
To Carriage on Sales		1,700			
To Postage		300			
To Commission Paid		1,000			
To Interest paid on bank loan		550			
To Lighting & Heating		2,200			
To Net Profit		21,170			
		50,600			50,600

7.3.3 Closing Entries

You learnt in Unit 2 that all nominal accounts which represent items of expenses and incomes are closed at the end of the accounting year by transfer to either the Trading Account or the Profit and Loss Account. The journal entries passed for such transfer are called closing entries. You also know that accounts relating to expenses and losses always show debit balances while those representing incomes show credit balances. In order to close an account which shows a debit balance and is to be transferred to the Trading Account we credit the account concerned with an amount equal to its balance and debit the Trading Account. For example, the Carriage Inwards Account Shows a debit balance of Rs. 6,000. The closing entry for this will be as follows:

		Rs.	Rs.
Trading A/c	Dr.	6,000	
To Carriage Inwards A/c			6,000

Similarly, an account which shows a credit balance, will be closed by debiting it with an amount equal to the balance and crediting the Trading Account or Profit and Loss Account, as the case may be. The closing entries are passed in the Journal Proper and it is necessary to pass such entries for preparing the Trading and Profit and Loss Account. The entries required for the items which are to be transferred to the Trading Account are as follows:

1 Trading Account Dr.
To Stock Account (opening)
To Purchases Account
To Sales Returns Account
To Direct Expenses Accounts
(to be credited individually) .

2 Sales Account Dr.
Purchases Returns Account Dr.
Stock Account (closing) Dr.
To Trading Account .

3 Trading Account Dr.
To Profit and Loss Account
(For gross profit)

Note: If there is gross loss, the closing entry will be just the reverse of the above.

When the closing entry is passed for gross profit or gross loss the Trading Account stands closed. The entries required for items to be transferred to the Profit and Loss Account are as follows:

1 Profit and Loss Account Dr.
To Expenses/Losses Accounts
(to be credited individually)

2 Incomes/Gains Accounts Dr.
(to be debited individually)
To Profit and Loss Account

3 Profit and Loss Account **Dr.**
To Capital Account
(for Net Profit)

Note: If there is net loss, the closing entry will be just the reverse of the above.

Let us see how closing entries for the items given in Illustration 4 will be passed. These are as follows:

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Date	Particulars		L.F.	Dr. Amount	Cr. Amount
				Rs.	Rs.
1987 Dec 31	Trading A/c	Dr.		1,42,400	
	To Opening Stock A/c				40,000
	To Purchase A/c				98,000
	To Sales Returns A/c				2,400
	To Carriage Inwards A/c				2,000
	(Being closing Entry)				
" 31	Sales A/c	Dr.		1,62,100	
	Purchases Returns A/c	Dr.		3,000	
	Closing Stock A/c			26,000	
	To Trading A/c	Dr.			1,91,100
	(Being closing entry)				
" 31	Trading A/c	Dr.		48,700	
	To Profit and Loss A/c				
	(Being transfer of gross profit)				48,700
31	Profit and Loss A/c	Dr.		29,430	
	To Rent, Rates & Taxes A/c				8,600
	To Salaries & Wages A/c				12,000
	To Sundry Expenses A/c				2,500
	To Bank Charges A/c				50
	To Discount Allowed A/c				530
	To Carriage Outwards A/c				1,700
	To Postage A/c				300
	To Commission paid A/c				1,000
	To Interest paid A/c				550
	To Lighting & Heating A/c				2,200
	(Being closing entry)				
" 31	Commission Received A/c	Dr.		650	
	Discount Received A/c	Dr.		750	
	Income from Inv. A/c	Dr		1,500	
	To Profit and Loss A/c				2,900
	(Being closing entry)				
" 31	Profit and Loss A/c	Dr,		21,170	
	To Capital A/c				21,170
	(Being transfer of net profit)				

Check Your Progress B

1 Distinguish between Direct and Indirect Expenses.

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2 What is the purpose of preparing a Trading Account?

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3 State whether the following statements are True or False.

i) The gross profit is the difference of total sales and credit sales ....

ii) Direct expenses are those expenses which are directly attributable to purchase of goods for resale. ....

iii) Stock is valued at cost or market price whichever is lower.. ....

iv) The het profit is the excess of gross profit and other incomes over the indirect expenses and losses.. ....

v) Income tax paid in case of a proprietory concern is charged to Profit and Loss Account.. ....

vi) Trade Expenses are charged to Trading Account.. ....

4 Fill in the blanks:

i) Carriage Outwards is an example of .... expenses.

ii) Cost of goods sold is equal to opening stock plus.. ....less ....

iii) Cost of samples distributed free of cost are treated as .... expenses.

iv) All direct expenses are debited to. .... Account:

v) Loss on Account of theft is .... to Profit, and Loss Account.

vi) Wages and salaries are charged to. ....

5 Ascertain the cost of goods sold from the following data:

	Rs.
Direct Expenses	8,000
Opening Stock	12,000
Purchases	80,000
Interest Paid	500
Closing Stock	10,000

7.4 BALANCE SHEET

After ascertaining the net profit or net loss by preparing the Trading and Profit and Loss Account, the final step in preparing final accounts is the preparation of Balance Sheet. The purpose of Balance Sheet is to ascertain the financial position of a business i.e., to know what the business owes and what it owns on a certain date. Hence it shows all assets and liabilities of the business as at the end of the accounting year.

You know that final accounts are prepared from the Trial Balance. All items of expense and income appearing in Trial Balance are transferred to the Trading and Profitand Loss Account. The remaining items which represent the balances of personal and real accounts are shown in the Balance Sheet. The accounts showing debit balances represent assets and those showing credit balances represent liabilities.

Look at figure7.3 and note how various assets and liabilities appear in the Balance Sheet.

Figure 7.3

Balance Sheet of ....
as on ....

Liabilities		Amount	Assets	Amount
Current Liabilities		Rs.	**Current Assets**	Rs.
Bank Overdraft		....	Cash in hand	....
Bills Payable		....	Bills Receivable	....
Sundry Creditors		....	Cash at bank	....
			Sundry Debtors	....
			Closing Stock	
Long-term Liabilities				
Loan		....	Investments	....
Mortgages		....	Fixed Assets	
Capital			Vehicles	....
Balance	.....		Furniture	....
Add Net			Plant & Machincry	....
Profit	.....		Land & Buildings	
Less			Goodwill	....
Drawings	.....	....		
		....		....

You should know that the Balance Sheet is prepared to ascertain the financial position at a particular point of time and not for a period. Hence the heading of the Balance Sheet will always read 'Balance Sheet as on ......' (usually last date of the accounting year).

The total of assets should always be equal to the total of liabilities. You learnt about this equality in Unit 1. If however, they do not tally, it would mean that some errors have been committed while preparing the final accounts. You must recheck the treatment of all items including the arithmetical aspect, and make the corrections where necessary so that the Balance Sheet tallies.

Assets: The term 'assets' denote the economic resources (property) of the business and includes all current and fixed assets. You know current assets are those assets which are Likely to be realised within a period of one year (or during the normal operating cycle) and includes cash, stock, debtors, bills receivable, short-term investments, etc. The fixed assets, on the other hand, are those assets which are aquired for use in the business over a long period. They may be tangible like machinery and furniture, or intangible like goodwill, patents, etc. The assets also include certain expenses and losses which have not been written off in full. Examples of such expenses are: formation expenses, expenses incurred on issue of shares and debentures, unwritten amount of expenditure on advertising, etc. These are shown as the last item under 'Assets' in the Balance Sheet.

Liabilities: The term 'liabilities' denote all claims against the assets of the business whether those of the outsiders (creditors) or those of the owners of the business. The outsider's claims may be sub-divided into (i) current liabilities, and (ii) long-term liabilities. These are shown separately in the Balance Sheet (see figure 7.3). The current liabilities are those obligation which are likely to be met within one year (or during the normal operating cycle). The long-term liabilities refer to item like loans which are not to be paid in the near future. The owner's claim is shown as capital after adjusting it with the amount of net profit and drawings during the year.

Look at Illustration 7 and see how Balance Sheet is prepared from given list of balances.

Illustration 7

From the following balances extracted from the books of Deepak Brothers, prepare Balance Sheet as on December 31,1987.

	Rs.		Rs.
Capital	12,00,000	Bills Payable	40,000
Net Profit for 1987	6,00,000	Debtors	2,50,000
Land & Buildings	7,00,000	Bills Receivable	50,000
		Loan	1,60,000
Plant & Machinery (after depreciation)	4,00,000	Cash in hand	60,000
		Bank Overdraft	20,000
Furniture (after depreciation)	50,000	Loose Tools	50,000
Investment	3,50,000	Goodwill	1,00,000
Creditors	2,00,000		
Trade Marks	25,000	Closing Stock	1,85,000

Solution:

Balance Sheet of Deepak Brothers as on December 31, 1987

Liabilities		Amount	Assets	Amount
		Rs.		Rs.
Current Liabilities			**Current Assets:**	
Bank Overdraft		20,000	Cash in hand	60,000
Bills Payable		40,000	Bills Receivable	50,000
Sundry Creditors		2,00,000	Sundry Debtors	2,50,000
			Stock in hand	1,85,000
Long-Term liabilities			**Investments**	3,50,000
Loan		1,60,000		
Capital:			**Fixed Assets**	
Balance as on			Loose Tools	50,000
Jan. 1,1987	12,00,000		Furniture	50,000
Add Net Profit	6,043,000		Plant & Machinery	4,00,000
		18,00,000	Land & Buildings	7,00,000
			Trade Marks	25,000
			Goodwill	1,00,000
		22,20,000		22,20,000

Now Look at Illustration 8. It shows how the Trading and Profit and Loss Account and the Balance Sheet are prepared from a given Trial Balance.

Illustration 8

From the following Trial Balance of Gupta & Sons, prepare Trading and Profit and Loss Account for the year ended December 31,1987 and a Balance Sheet as on that date.

Particulars	Dr. Balances	Cr. Balances
	Rs.	Rs.
Capital		5,00,000
Sales		10,00,000
Sales Returns	25,000	
Purchases	5,00,000	
Purchases Returns		15,000
Inventory as on 1.1.1987	60,000	
Land & Buildings	4,00,000	
Plant & Machinery	2,50,000	
Furniture	1,00,000	
Wages	50,000	
Carriage Inwards	10,000	
Carriage Outwards	5,000	
Cartage	5,000	
Salaries	40,000	
Loan		2,60,000
Debtors	1,50,000	
Creditors		85,000
Bills Receivable	40,000	
Acceptances		10,000
General Expenses	20,000	
Rent & Rates	10,000	
Investments	50,000	
Cash in hand	50,000	
Bank Overdraft		10,000
Discount Allowed	4,500	
Depreciation on Plant & Machinery	50,000	
Interest on Investments		5,000
Interest on Bank Overdraft	500	
Goodwill	60,000	
Bad Debts	5,000	
	18,85,000	18,85,000

The inventory on December 31, 1987 was valued at Rs. 1,00,000.

Solution:

Trading and Profit & Loss Account of **Gupta & Sons**
for the year ended December 31, 1987

Dr. | | | | | **Cr.**

Particulars		Amount	Particulars		Amount
		Rs.			Rs.
To Inventory (opening)		60,000	By Sales	10,00,000	
To Purchases	5,00,000		Less Returns	25,000	9,75,000
Less Returns	15,000	4,85,000			
To Wages		50,000	By Inventory (Closing)		1,00,000
To Carriage Inwards		10,000			
To Cartage		5,000			
To Gross Profit c/d		4,65,000			
		10,75,000			10,75,000
To Carriage Outwards		5,000	By Gross Profit b/d		4,65,000
To Salaries		40,000	By Interest on Investment		5,000
To General Expenses		20,000			
To Rent and Rates		10,000			
To Discount		4,500			
To Bad Debts		5,000			

To Depreciation	50,000		
To Interest on Bank Overdraft	500		
To Net Profit (transferred to Capital Account)	3,35,000		
	4,70,000		4,70,000

Balance Sheet of Gupta & Sons as on December 31, 1987

Liabilities		Amount	Assets	Amount
		Rs.		Rs.
Capital	5,00,000		Goodwill	60,000
Add Net Profit	3,35,000		Land & Building	4,00,000
		8,35,000	Plant& Machinery	2,50,000
			Furniture	1,00,000
			Investments	50,000
Loan		2,60,000	Inventory (closing)	1,00,000
Creditors		85,000	Debtors	1,50,000
Acceptances		10,000	Bills Receivables	40,000
Bank Overdraft		10,000	Cash in hand	50,000
		12,00,000		12,00,000

Note: In the above Balance Sheet all assets and liabilities have been shown in the order of permanence.

7.5 VERTICAL PRESENTATION OF FINAL ACCOUNTS

The Trading and Profit and Loss Account and the Balance Sheet have so far been presented as a two-sided statement. But, in practice, it is not necessary to present the final accounts in this form. Nowadays many firms present them in a simpler and more intelligible farm which is called a 'narrative style' or 'vertical presentation'. According to this style the Trading and Profit and Loss Account as well as the Balance: Sheet arc shown in the form of vertical statements. This form of presentation is adopted by many companies for publication of their final accounts. It helps the users of financial statements to appreciate the significance of different items without any difficulty. They can easily interpret the data and judge the profitability and the financial position of the company.

Look at Figure 7.4 and study how various items are shown in the Trading and Profit and Loss Account arid the Balance Sheet in vertical form.

Figure 7.4

Trading and Profit and Loss Account of........ for the year ended ....

	Rs.	Rs.
SALES		....
Less Cast of *Goods* Sold:		
Opening Stock	....	
Add Purchases	....	
Add Direct Expenses	....	
	....	
Less Closing Stock	....	....
GROSS PROFIT		....
Add Other Incomes		....

		....
Less Indirect Expenses:		
Salaries	....	
Rent	....	
Sundry Expenses	....	
Insurance	....	
		....
NET PROFIT		....

Balance Sheet of.. ....
as on.. ......

		Rs.	Rs.
Fixed Assets:			
Land and Buildings		....	
Plant and Machinery		....	
Furniture and Fixtures		....	
Vehicles		....	
			....
Current Assets:			
Stock-in-hand		....	
Debtors		....	
Cash at bank		....	
Cash in hand		....	
		....	
Less Current Liabilities:			
Creditors	....		
Bills Payable	....		
		....	
Working Capital			....
			....
Financed by:			
Capital:			
Balance as on 1.1.1987		....	
Add Net Profit for the year		....	
		....	
Less Drawings		....	
			....
			....
Loans			
			....

Look at Illustration 9 and study how Trading and Profit and Loss Account and the Balance Sheet have been prepared for vertical presentation.

Illustration 9

From the information given in Illustration 6, prepare Trading and Profit and Loss Account and the Balance Sheet in the vertical form.

Solution:

Trading and Profit and Loss Account of Gupta & Sons
for the year ended December 31, 1987

	Rs.	Rs.
Sales Less Returns (Rs. 10,00,000 – Rs. 25,000)		9,75,000
Less Cost of Goods Sold:		
Inventory (beginning)	60,000	
Add Purchases less Returns (Rs. 5,00,000 – Rs. 15,000)	4,85,000	
Add Wages	50,000	
Add Carriage Inwards	10,000	
Add Cartage	5,000	
	6,10,000	
Less Inventory (ending)	1,00,000	
		5,10,000

	Rs.	Rs.
GROSS PROFIT		4,65,000
Add interest on Investments		5,000
		4,70,000
Less Indirect Expenses:		
Carriage	5,000	
Salaries	40,000	
General Expenses	20,000	
Rent and Rates.	10,000	
Discount	4,500	
Bad Debts	5,000	
Interest on Bank Overdraft	500	
Depreciation	50,000	
		1,35,000
NET PROFIT		3,35,000

Balance Sheet of Gupta & Sons as on December 31,1987

		Rs.	Rs.
Fixed Assets:			
Goodwill		60,000	
Land & Building		4,00,000	
Plant & Machinery		2,50,000	
Furniture		1,00,000	
Investments		50,000	
			8,60,000
Current Assets:			
Inventory (ending)		1,00,000	
Debtors		1,50,000	
Bills Receivables		40,000	
Cash in hand		50,000	
		3,40,000	
Less Current Liabilities:			
Creditors	85,000		
Acceptances	10,000		
Bank overdraft	10,000		
		1,05,000	
Working Capital			
			10,95,000
Financed by:			
Capital			
Balance on 1.1.1987		5,00,000	
Add Net Profit		3,35,000	
			8,35,000
Long Term Loans			2,60,000
			10,95,000

Check Your Progress C

1 What is a Balance Sheet?

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2 Why firms use vertical form of presenting the final accounts?

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....

3 Complete the following sentences choosing one of the two alternatives given within brackets.

i) Assets represent.........balances of personal and real accounts. (debit/ credit)

ii) All liabilities which become due within one year are classified as.,,.....,.. iabilities. (long-term/current)

iii) Unwritten off amount of a deferred revenue expenditure is shown on the......... side of the Balance Sheet. (asset/liabilities)

iv) Totals of assets and liabilities are always.. ......,.. (differentlequal)

v) Loose Tools are classified as......... assets. (fixed/current)

vi) Mortgages are classified as..........liabilities. (current/long-term)

7.6 MANUFACTURING ACCOUNT

In case of trading concerns you can find out the cost of goods and the gross profit by preparing a Trading Account. But a manufacturing concern has to first prepare another account called Manufacturing Account with the help of which it works out the cost of goods produced, The cost of goods produced is then transferred to tha Trading Account for ascertaining the cost of goods sold and the gross profit.

A manufacturing concern purchases raw materials from the market and converts them into finished goods for sale. The cost of goods produced thus includes two major costs: (i) cost of raw materials consumed, and (ii) cost of conversion. These are explained below.

Cost of Raw Materials Consumed: This represents the cost of raw materials used in course of manufacture which can be worked out by adjusting the opening and closing stocks of raw materials in the purchases of raw materials. For example, a firm purchased raw materials worth Rs. 6,50,000 during 1967, and its stock of raw materials on January 1,1987 (opening stock) was Rs. 70,000 and on December 31, 1987 (closing stock) Rs, 90,000. The cost of raw materials consumed during 1987 will be worked out as follows:

	Rs.
Opening Stock of Raw Materials	70,000
Add Purchases of Raw Materials	6,50,000
	7,20,000
Less Closing Stock of Raw Materials	90,000
Cost of Raw Materials Consumed	6,30,000

The direct expenses incurred on the purchaees of raw materials such as freight, import duty, dock dues, cartage, etc. can also be included in the cost of raw materials consumed. But the usual practice is to show them separately on the debit side of the Manufacturing Account.

Cost of Conversion: This includes all expenses incurred in the factory such as wages paid to labour, salaries of supervisory staff, factory rent and rates, motive power, repairs to plant and machinery, depreciation on plant and machinery, etc, All these expenses are debited to the Manufacturing Account.

Look at Figure 7.5 for the proforma of a Manufacturing Account.

Figure 7.5
Manufacturing Account of.........
for the period ended.........

Dr. Cr.

Particulars	Amount	Amount	Particulars	Amount	Amount
	Rs.	Rs.		Rs.	Rs.
To Work-in progress at the beginning		...	By Sale of Scrap		...
To Raw Materials Consumed:			By Work-in-Progress at the end		...
Opening Stock of Raw Materials	...		By Cost of Goods Produced (Transferred to Trading Account)		...
Add Purchases of Raw Materials	...				
Less Closing Stock of Raw Materials	...	....			
		....			
To Carriage Inwards					
To Freight, Import Duty, Dock Dues, etc.		...			
To Manufacturing Wages		...			
To Motive Power		...			
To Coal, Gas and Water		...			
To Oil and Grease		...			
To Factory Lighting & Heating		...			
To Factory Insurance		...			
To Repairs to Factory Building		...			
To Repairs to Plant and Machinery		...			
To Depredation on Factory Buildings		...			
To Depreciation on Plant and Machinery		...			
		...			
		...			...

Some Important Points

Scrap: The term 'scrap' is used for waste materials coming out of the manufacturing process, Cuttings of cloth in readymade garments factory and metal cuttings in engineering factories are some examples of scrap. Any amount realised from the sale of scrap must be adjusted in the cost of goods produced. Hence, it is credited to the Manufacturing Account.

Work-in-Progress: It is quite likely that at the end of the year, there may be certain goods which are still in the process of manufacture. Such goods are called 'semi-finished goods' or 'work-in-progress'. There will always be some work-in-progress at the beginning as well as at the end of the accounting year. Their cost must be adjusted while working out the cost of goods produced. Hence the opening work-in-progress is shown on the debit side of the Manufacturing Account while the closing work-in-progress is shown on its credit side.

Stock of Finished Goods: Besides the stock of raw materials and semi-finished goods every firm will have the stock of finished goods. This is to be adjusted in the cost of goods sold and not in the cost of goods produced. Hence, it is not shown in the Manufacturing Account. As you learnt earlier, it will be shown in the Trading Account.

Look at Illustration 10 and see how Manufacturing Account is to be prepared.

Illustration 10

Prepare Manufacturing Account from the following particulars relating to the year 1987.

	Rs.
Purchases of Raw Material	1,00,000
Stock on 1.1.1987	
Raw Materials	10,000
Work-in-Progress	5,000
Finished goods	25,000
Factory wages	15,000
Factory Rent	5,000
Fuel & Power	2,000
Carriage Inwards	1,000
Repairs of Plant	2,000
Depreciation on Plant	5,000
Sale of Scrap	500
Stock on 31.12.1987	
Raw Materials	20,000
Work-in-Progress	7,500
Finished Goods	30,000

Solution:

Manufacturing Account for the year ended December 31,1987

Dr. Cr.

Particulars		Amount	Particulars	Amount
		Rs.		Rs.
To Work-in-Progress at the beginning		5,000	By Sale of Scrap	500
To Raw Materials Consumed			By Work-in-Progress at the end	7,500
Opening Stock	10,000		By Cost of Goods Produced (transferred to Trading Account)	1,17,000
Add Raw Material Purchased	1,00,000			
	1,10,000			
Less Closing Stock	20,000	90,000		
To Factory Wages		15,000		
To Factory Rent		5,000		
To Fuel & Power		2,000		
To Carriage Inwards		1,000		
To Repairs of Plant		2,000		
To Depreciation on Plant		5,000		
		1,25,000		1,25,000

You will observe that the stock of finished goods has not been shown in the Manufacturing Account. As stated earlier, it is to be taken to the Trading Account. Now, suppose the sales for the year 1987 were Rs. 1,60,000, the Trading Account will appear as follows:

Trading Account of........
for the year ending December, 31 1987

Dr. Cr.

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Opening stock of Finished Goods	25,000	By Sales	1,60,000
To Cost of Goods Produced (transferred from Mfg. A/c)	1,17,000	By Closing stock of Finished Goods	30,000
To Gross Profit (transferred to Profit & Loss A/c)	48,000		
	1,90,000		1,90,000

You have learnt that a manufacturing concern has to prepare Manufacturing Account before preparing the Trading and Profit and Loss Account. Though considered desirable but many firms do not do so because it is not compulsory. You will also generally be asked to prepare only the Trading Account without preparing the Manufacturing Account. In such a situation you will show all items of Manufacturing Account in the Trading Account itself. In other words, cost of raw materials consumed, expenses on purchases of raw materials, all manufacturing expenses, the opening and closing work-in-progress, sale of scrap, etc. will also be shown in the Trading Account. But, as per common practice, the items like depreciation and repairs to plant and machinery and factory building will be shown in the Profit and Loss Account and not in the Trading Account,

7.7 LET US SUM UP

At the end of the accounting year the businessman prepares the final accounts with the help of a Trial Balance. The final accounts consist of (i) Profit and Loss Account and (ii) Balance Sheet. The Profit and Loss Account is prepared for ascertaining the net profit/net loss of the business during the year and the Balance Sheet is prepared for ascertaining its financial position as at the end of the year.

The Profit and Loss Account is divided into two sections, The first section called Trading Account reveals the gross profit or gross loss and the second section called Profit and Loss Account shows the net profit or net loss. Gross profit is defined as the excess of sales revenue over the cost of goods sold which also includes the direct expenses. The net profit is worked out by crediting the Profit and Loss Account with the amount of gross profit and other incomes and debiting it with all indirect expenses and losses, In practice, we usually prepare a combined Trading and Profit and Loss Account. It is also necessary to pass closing entries for transferring all expenses and incomes to the Trading and Profit and Loss Account.

The Balance Sheet shows all assets and liabilities of the business. The assets represent the debit balances of the real and personal accounts plus the unwritten off amounts of deferred revenue expenses. The liabilities, on the other hand, represent the credit balances of real and personal accounts including capital, The total assets should always be equal to the total of liabilities.

The manufacturing concerns may also prepare a Manufacturing Account for ascertaining the cost of goods produced, which is then transferred to the Trading Account for ascertaining the cost of goods sold and the gross profit. This, however, is not compulsory. Most manufacturing concerns prepare the Trading Account directly by showing all expenses incurred in the factory (including cost of raw materials Consumed) in the Trading Account itself.

7.8 KEY WORDS

Closing **Stock:** Goods remaining unsold at the end of the accounting year.

Cost of Conversion: Expenses incurred in the factory (for converting raw materials into finished goods.)

Cost of **Goods** Sold: Difference between the cost of goods available for sale and the cost of goods in stock.

Cost of Production: It is the cost of goods produced which includes cost of raw materials consumed and all manufacturing expenses.

Current Assets: Assets which are likely to be realised within a period of one year or during the operating cycle. They are also called floating assets.

Current Liabilities: Liabilities which are likely to be paid within one year or during the operating cycle. They are also called short-term liabilities.

Direct Expenses: Expenses incurred on the goods purchased till they are brought to the place of business.

Fictitious Assets: Expenses and losses not yet written off and shown as assets in the Balance Sheet.

Fixed Assets: Assets acquired for use in the business for a long period. They are also called non-current assets.

Gross Profit: Excess of sales revenue over the cost of goods sold'.

Indirect Expenses: All expenses other than direct expenses. These include expenses incurred in connection with general administration, financial matters and selling and distribution of goods.

Intangible Assets: Assets in the form of rights which cannot be seen or touched such as goodwill, patents, etc.

Net **Profit:** Excess of gross profit and other incomes over the indirect expenses and losses in the business.

Non-Current Liabilities: Liabilities payable after a long time. They are also called long-term liabilities.

Owner's Capital: Claim of owners against the assets of the business. It is also called owner's equity and is equal to excess of assets over outside liabilities.

Opening Stock: Stock of goods as at the beginning of the accounting year,

Scrap: Waste material which arises in the course of manufacture.

Tangible **Assets:** Assets which have physical form and can be seen and touched such as buildings, machinery, etc.

Work-in-Progress. Goods in respect of which some work still remains to be done. They are also called semi-finished goods.

7.9 SOME USEFUL BOOKS

1 Maheshwari, S.N. **1986.** ***Introduction to Accounting,*** Vikas Publishing House: New Delhi. (Chapter **10).**

2 Patil, V.A. and J.S. Korlahalli, 1986. Principles ***and Practice of Accounting,*** R. Chand & Co.: New Delhi. (Chapter 20).

3 William Pickles. **1982.** ***Accountancy,*** E.L.B.S. and Pitman: London. (Chapter 5)

4 Gupta, R.L. and M. Radhaswamy. **1986.** ***Advanced Accountancy,*** Sultan Chand & Sons: New Delhi. (Chapters 4,5).

5 Shukla, M.C. and T.S. Grewal. 1987. ***Advanced Accountancy.*** S. Chand & Co.: New Delhi. (Chapter 2).

7.10 ANSWERS TO CHECK YOUR PROGRESS

A i)Debit ii)Debit iii)Debit iv)Credit v)Debit vi)Credit vii)Debit viii)Credit ix)Debit x)Debit xi)Debit xii)Credit

B 3 i)False ii)True iii)True iv)True v)False vi)False.
4 i)indirect ii)purchases, closing stock iii)selling iv)Trading v)debited vi)Trading Account
5 Rs. 90,000
C i)debit ii)current iii)asset iv)equal v)fixed vi)long-term

7.11 TERMINAL QUESTIONS/EXERCISES

Questions

1 Distinguish between:
a) Cost of Goods Sold and Cost of Goods Processed
b) Gross Profit and Net Profit
c) Direct Expenses and Indirect Expenses
d) Trading Account and Manufacturing Account
e) Profit and Loss Account and Balance Sheet

2 Give dosing entries for Trading and Profit and Loss Account.

3 What is a Balance Sheet? Describe different methods of arranging assets arid liabilities.

Exercises

1 Find out the Cost of Goods Sold from the following figures extracted from the books of Allied Ltd. for the year 1987:

	Rs.
Stock (1.1.1987)	50,000
Purchases	10,00,000
Sales	15,00,000
Purchases Returns	50,000
Stock (31-1-1987)	70,000
Direct Expenses	60,000
Indirect Expenses	1,00,000

(Answer: Rs. 9,90,000)

2 Find out the Cost of Goods Sold and Gross Profit from the following figures:

	Rs.
Inventory in the beginning	60,000
Purchases Less Returns	6,00,000
Carriage 'Inwards	20,000
Cartage Outwards	30,000
Cartage and Freight	10,000
Wages	50,000
Sales Less Returns	12,00,000
Inventory at the end	40,000

(Answer: Cost of Goods Sold Rs. 7,00,000; Gross Profit Rs. 5,00,000.)

3 From the data given in question No. 2 prepare Trading Account

4 From the following balances of Shyam Sunder, prepare Profit and Loss Account for the year ended March 31,1987.

	Rs.
Office Expenses	5,280
Advertising	3,000
Legal Charges	5,000
Postage and Telephone Charges	6,400
Salaries and Wages	60,000
Travelling Expenses	2,500
Interest Received	600
Rent, Rates and Taxes	20,800
Insurance	2,400
Office Lighting	1,500
Stationery	1,200
Repairs	920
Miscellaneous Income	800
Commission Paid	4,000
Bank Charges	200

The Gross Profit for the year was Rs. 73,000

(Answer: Net Loss Rs. 38,000)

5 The following balances have been extracted from the books of Plaza Electricals Ltd. for the year 1987.

	Rs.
Sales	5,00,000
Purchases	3,00,000
Return Inwards	10,001)
Return Outwards	15,000
Opening Stock	30,000
Wages	20,000
Carriage Inwards	5,000
Carriage Outwards	3,000
Salaries	25,000
General Expenses	10,000
Rent and Rates	4,000
Advertisement	5,000
Bad debts	3,000
Insurance	3,000
Trade Expenses	2,000
Depreciation	5,000

It was further given that the value of stock on December 31,1987 was Rs. 50,000. You are required to prepare Trading and Profit and Loss Account of Plaza Electrical Etd. for the year ending December 31,1987.

(Answer: Gross Profit Rs. 2,00,000; Net Profit Rs. 1,40,000)

6 From the following data pertaining to the transactions of Mehts Bros. for the year 1987, prepare Trading and Profit and Loss Account for the year ending December 31,1997.

	Rs.
Sales	10,00,000
Purchases	6,00,000
Sales Returns	20,000
Purchases Returns	10,000
Inventory (beginning)	40,000
Wages	50,000
Carriage Inwards	20,000
Carriage Outwards	15,000
Trade Expenses	10,000
Cartage and Freight	5,000
Salaries	30,000

	Rs.
General Expenses	10,000
Insurance	6,000
Rent & Rates	5,000
Distribution Expenses	6,000
Discount Received	1,000
Discount Allowed	2,000
Bad Debts	2,000
Depreciation	8,000
Interest on Investments	20,000
Interest on Bank Deposits	1,000
Interest on Bank Overdraft	500
Loss of Goods by Fire	2,500

It was further given that the value of Inventory on December 31,1987 was Rs. 80,000

(Answer: Gross Profit Rs. 3,55,000: Net Profit Rs. 2,80,000)

7 From the following balances of Hitesh, prepare a Balance Sheet as on December 31,1987

	Rs.
Hitesh's Capital	41,000
Drawings	6,100
Wife's Loan	4,000
Sundry Creditors	45,000
Cash in hand	250
Cash at bank	4,000
Sundry Debtors	40,500
Patents	2,000
Plant and Machinery	20,000
Land and Building	26,000
Stock in hand	36,500

Net Profit for the year was Rs. 45,350

(Answer: Balance Sheet Total Rs. 1,29,250)

8 From the following Trial Balance of Sameer prepare Trading and Profit and Loss Account for the year ended September, 30,1987, and Balance sheet as on that date.

Trial Balance as on September 30, 1987

Name of Account	Dr. Balances	Cr. Balances
	Rs.	Rs.
Capital		40.000
Drawings	7,500	
Stock on July 1, 1986	8,000	
Purchases	47,250	
Sales		90,000
Carriage Inwards	2,300	
Returns Inwards	2,000	
Returns Outwards		1,500
Wages	7,000	
Plant and Machinery	30,000	
Furniture and fittings	7,500	
Coal, Gas and Water	2,100	
Power	2,000	
Salaries	9,000	
Discount Allowed	750	
Discount Received		600
Office Rent	2,400	
Factory Reqt	3,000	

	Rs.	Rs.
Postage and telephone	900	
Insurance	250	
Sundry Expenses	800	
Trade Debtors	20,000	
Trade Creditors		27,150
Cash in hand	700	
Cash at Bank	4,100	
Carriage Outwards	1,700	
	1,59,250	1,59,250

The Stock.on September 30,1987 was valued at Rs. 9,250.
(Answer: Gross Profit Rs. 27,100; Net Profit Rs. 11,900; Balance Sheet Total Rs. 71,550)

9 The following figures have been extracted from the books of a manufacturer.

	Rs.
Stock 1.1.1987	
Raw Materials	25,000
Work-in-Progress	10,000
Finished Goods	50,000
Purchases of Raw Materials	3,00,000
Factory Wages	40,000
Factory Rent	5,000
Fuel & Power	5,000
Carriage Inwards	2,500
Repairs of Plant	20,000
Depredation on Plant	25,000
Sale of Scrap	2,000
Stuck on 31.12.1987	
Raw Materials	40,000
Work-in-Progress	15,000
Finished Goods	60,000

You are required to prepare a Manufacturing Account and ascertain the Cost of Goods Produced.

(Answer: Cost of Goods Produced: Rs. 3,75,500)

10 From the following Trial Balance prepare Manufacturing Account and the Trading and Profit and Loss Account for the year ended March 31, 1988, and Balance Sheet as at the end of the year.

Particulars	**Dr. Balances**	**Cr. Balances**
	Rs.	Rs.
Opening Stock of Raw Materials	60,000	
Opening Stock of Finished Goods	32,000	
Opening Stock of the Work-in-Progress	10,000	
Capital		1,44,000
Purchase of Raw Materials	5,00,000	
Sates		8,00,000
Purchase of Finished Goods	16,000	
Carriage Inwards	8,000	
Wages	1,00,000	
Salaries (75% Factory)	52,000	
Commission	6,000	
Bad Debts	4,000	

	Rs.	Rs.
Insurance	8,000	
Rent, Rates and Taxes (50% Factory)	24,000	
Postage and Telegram	5,600	
Miscellaneous Expenses	3,200	
Travelling and Conveyance (50% Factory)	7,000	
Carriage Outwards	5,200	
Machinery	80,000	
Furniture	10,000	
Debtors	1,20,000	
Creditors		1,07,000
	10,51,000	10,51,000

The Closing Stocks are as follows:

Raw Materials	80,000
Work-in-Progress	24,000
Finished Goods	16,000

(**Answer:** *Cost* of Production Rs. **6,26,750;** Gross Profit Rs. **1,41,250;** Net Profit **Rs.** 79,000; **Balance Sheet** Total Rs. 3,30,000).

> Note: These questions will help you to understand the unit better. Try to write answer for them. But do not submit your answers to the University for assessment. These are for your practice only.

UNIT 8 FINAL ACCOUNTS II

Structure

8.0 OBJECTIVES

After studying this unit you should be able to:

- explain why adjustment entries are necessary at the time of preparing the final accounts
- list the items in respect of which adjustments are usually made
- pass the necessary adjustment entries
- prepare final accounts with adjustments.

8.1 INTRODUCTION

In Unit 7 you learnt about the preparation of simple final accounts. They did not involve any adjustments. In practice, however, you are always required to make some adjustments while preparing the final accounts. It is because there may be many expenses and incomes relating to the current year which are still to be brought into the books of account. Then there may be certain items recorded in current year's books which actually relate to the previous year or the next year. Unless such items are duly adjusted in the books of account, the final accounts will not reveal the true and fair view of the state of affairs of the business. In this unit you will learn about all items which require adjustments and study how such adjustments are made in books of account and how they are incorporated in the final accounts.

	Rs.	Rs.'
Insurance	8,000	
Rent, Rates and Taxes (50% Factory)	24,000	
Postage and Telegram	5,600	
Miscellaneous Expenses	3,200	
Travelling and Conveyance (50% Factory)	7,000	
Carriage Outwards	5,200	
Machinery	80,000	
Furniture	10,000	
Debtors	1,20,000	
Creditors		1,07,000
	10,51,000	10,51,000

The Closing Stocks are as follows:

Raw Materials	80,000
Work-in-Progress	24,000
Finished Goods	16,000

(Answer; Cost of Production Rs. 6,26,750; Gross Profit Rs, 1,41,250; Net Profit Rs. 79,000; Balance Sheet Total Rs. 3,30,000).

> Note: These questions will help you to understand the unit better. Try to write answer for them. But do not submit your answers to the University for assessment. These are for your practice only.

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8.1 INTRODUCTION

In Unit 7 you learnt about the preparation of simple final accounts. They did not involve any adjustments. In practice, however, you are always required to make some adjustments while preparing the final accounts. It is because there may be many expenses and incomes relating to the current year which are still to be brought into the books of account. Then there may be certain items recorded in current year's books which actually relate to the previous year or the next year. Unless such items are duly adjusted in the books of account, the final accounts will not reveal the true and fair view of the state of affairs of the business. In this unit you will learn about all items which require adjustments and study how such adjustments are made in books of account and how they are incorporated in the final accounts.

8.2 NEED FOR ADJUSTMENTS

You know that the financial reporting requires tlie summarisation of business operations for a specific accounting period. It is quite possible that certain transactions recorded in current year's books may partly relate to the previous year or to the following year. It is also possible that certain expenditure incurred during the current year has not yet been paid and so not recorded. Siinilarly, there may be certain incomes earned during the current year which have not been recorded because they have not yet been received. If such items are not adjusted or brought into current year's books of account, the summary presented in the form of final accounts will not reveal the true picture. Let us take the example of an amount of Rs. 600 paid on July 1,1987 towards insurance premium. You know any general insurance usually covers a period of twelve months. Suppose the accounting year is ending on December 31, 1987 it would mean that half the amount of insurance premium paid on July 1,1987 pertains to the next accounting year i.e., 1988. Therefore, while preparing the final accounts of 1989, the expenditure on insurance premium that should be debited to the Profit and Loss Account is Rs. 300 (Ks. 600 paid – Rs. 300 pertaining to 1988). The remaining amount of Rs. 300 will he carried forward and charged to the Profit and Loss Account of 1988. Take another example. The wages of workers for the month of December, 1989 were paid on January 7, 1988. This means tlie Wages Account of 1987 does not include the wages for the month of December 1987. Such unpaid wages termed as 'Wages outstanding' have to be brought into the books and debited to the Trading Account along with the wages already paid. Similarly, adjustment may also become necessary in respect of certain incomes received in advance or those which are outstanding as at the end of tlie accounting year. Apart from these, there are certain items which cannot be recorded on day-to-day basis such as depreciation, interest on capital, etc. They are generally adjusted at the time of preparing the final accounts. All items which need alteration or which are to be brought into books at the time of preparing final accounts are called 'adjustments'. The purpose of making various adjustments is to ensure that the final accounts reveal the true financial position of the business. Therefore, when you are to prepare the final accounts of any business, you are provided with a Trial Balance and some additional information in respect of the adjustments to be made.

8.3 TREATMENT OF ADJUSTMENTS IN FINAL ACCOUNTS

There are several items which need adjustment at tlie tirne of preparing the final accounts. Some of the important and common adjustments are listed below:

1 Closing Stock
2 Outstanding or Accrued Expenses
3 Prepaid or Unexpired Expenses
4 Outstanding or Accured Incomes
5 incomes Received in Advance (Unearned Income)
6 Depreciation
7 interest on Capital
8 Interest on Drawings
9 Interest on Loan
10 Bad Debts
11 Provision for Bad Debts
12 Provision fur Discount on Debtors
13 Provision fur Discount on Creditors
14 Manager's Commission
15 Abnormal Loss
16 Drawing of Goods by the Proprietor

Let us now discuss tlie nature of each item of adjustment and its treatment in the final accounts. In this connection you must remember that the general principle of double entry has to be fully followed. Hence, for bringing any item into the books of account or adjusting the amount of any expense or income, you have to ensure that the amount is debited to one account and credited to another; and while showing it in the final accounts the item should appear at two places, one representing the debit and the other representing the credit, otherwise the Balance Sheet will not tally. Usually, **each adjustment will first** appear in the Trading **and Profit** and **Loss** Account and then in the Balance Sheet.

8.3.1 Closing Stock

You know that all goods purchased or produced during the year are not completely sold-aut by the end of the year. Some goods always remain unsold as at the end of the year which are called 'Closing Stock'. The Closing Stock does not usually appear in the Trial Balance. It is mostly given in the form of additional information. Since Gross Profit/Gross Loss cannot be worked out without accounting for the closing stock it is brought into books by means of the following adjustment entry.

Closing Stock A/c Dr.
To Trading A/c

The closing stock is treated in the final accounts as follows:

i) On the credit side of Trading Account: shown as a separate item, and
ii) On the assets side of the Balance Sheet: shown as a separate item under Current Assets.

Adjusted Purchases and Closing Stock: Sometimes the closing stock may be given in the Trial Balance itself. This would mean that both the opening and the closing stocks have been adjusted in the purchases. In such a situation, the opening stock will not appear in the Trial Balance. The Trial Balance will show only the figures of adjusted purchases and the closing stock. The adjusted purchases are in fact the cost of goods sold. They have been worked out by adding the opening stock to purchases and subtracting the closing stock therefrom. Hence, the adjusted Purchases are shown on the debit side of the Trading Account. In such a situation there is no need to show closing stock in the Trading Account as it already stands adjusted in purchases. It will be shown only on the asset side of the Balance Sheet.

8.3.2 Outstanding Expenses

Outstanding expenses are those expenses which have been incurred during the current accounting year but have not been paid till the end of the year. They are also called 'expenses accrued'. The common examples of such expenses are the salaries, wages and rent for the last month of the accounting year paid in the first month of the next year. Since they remained unpaid as at the end of accounting year, no entry might have been passed in the books of account. So, they must be taken into account while preparing the Trading and Profit and Loss Account otherwise it will not reveal the correct amount of profit or loss. The following adjustment entry is passed in respect of outstanding expenses.

Concerned Expense A/c Dr.
To Outstanding Expenses A/c

The outstanding expenses will be treated in final accounts as follows:

i) Added to the concerned expenses in the Trading and Profit and Loss Account, and

ii) Shown on the liabilities side of the Balance Sheet as a separate item under Current Liabilities.

8.3.3 Prepaid Expenses

Sometimes, the bedefit of some expenses will be available not only in the current accounting year but also during the next year. That portion of expense the benefit of which is yet to be received is called 'prepaid expense'. It is also called 'unexpired expense'. Examples of such expenses are unexpired insurance, interest paid in advance, etc. In such situations it is necessary to find out the unexpired portion and adjust it in the concerned expense. The following adjustment entry is passed in respect of the prepaid expenses:

Prepaid Expenses A/c Dr.
To Concerned Expense A/c

The Prepaid expenses will be treated in final accounts as follows:

i) Subtracted from the concerned expense in the Trading and Profit and Loss Account, and
ii) Shown on the assets side of the Balance Sheet as a separate item under Current Assets.

8.3.4 Accrued Income

Accrued Incomes are those incomes which have been earned during the current accounting year but have not been received till the end of the year. They are also called 'outstanding incomes' or 'incomes earned but not yet received'. Examples of such incomes are commission receivable, income on investments due but not yet received, etc. The following adjustment entry is passed in respect of accrued income.

Accrued Income A/c Dr.
To Concerned Income A/c

The Accrued income is treated in final accounts as follows:

i) Added to the concerned income in the Profit and Loss Account, and
ii) Shown on the asset side of the Balance Sheet as a separate item under Current Assets.

8.3.5 Income Received in Advance

Any income which belongs to the next accounting year but has been received during the current accounting year is called 'income received in advance' or 'unearned income'. It is the income in respect of which the service is yet to be provided. Examples of such incomes arc rent received in advance, interest received in advance, etc. In such a situation, the unearned portion of the income will have to be adjusted while preparing the final accounts. The following adjusting entry is passed in respect of the unearned income.

Concerned Income A/c Dr.
To Income Received in Advance A/c

The unearned income is treated in final accounts as foilows:

i) Deducted from the concerned income in the Profit and Loss Account, and
ii) Shown on the liabilities side of the Balance Sheet as a separate item under Current Liabilities.

Look at Illustration 1 and see how adjustments are made in the final accounts in respect of outstanding expenses, prepaid expenses, outstanding incomes and incomes received in advance.

Illustration 1

Show how you will record the following items in the Profit and Loss Account and the Balance Sheet.
The Trial Balance showed the following balances as on December 31,1987:

	Rs.
Salaries	10,000
Wages	20,000
Rent Received	6,600
Commission Received	
Interest on Investments	6,000

Additional Information

i) Salaries amounting to Rs. 2,000 are outstanding.
ii) Wages include Rs. 1,500 paid in advance.
iii) Interest on investment include Rs. 1,200 for the months of January, February and March, 1988.
iv) Rent for the month of December amounting to Rs. 600 is not yet received.

Gross Profit for the year is Rs. 40,000 and other expenses amounted to Rs. 10,000.

Profit and Loss Account
for the year ended December 31, 1987

Dr.					Cr.
Particulars		**Amount**	**Particulars**		**Amount**
		Rs.			Rs.
To Salaries	10,000		By Gross Profit b/d		40,000
Add Outstanding	2,000	12,000	By Rent Received	6,600	
To Waps	20,000		Add Outstanding	600	7,200
Less Prepaid	1,500	18,500			
To Other Expeascs		10,000	By Commission Received		2,000
To Net Profit (transferred to Capital A/c)		13,500	By Interest on Investments	6,000	
			Less Received iri Advance	1,200	4,800
		54,000			54,000

Balance Sheet
as on December 31, 1987

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Current Liabilities:		Currents Assets:	
Salaries Outstanding	2,000	Wages Prepaid	1,500
Interest Received in Advance	1,200	Rent Outstanding	600

8.3.6 Depreciation

Depreciation means decrease in the value of fixed assets due to their usage and the passage of time. You know the fixed assets are used for the purpose of earning revenue. Therefore, the fall in their value should be considered as an expense or loss incurred in realising such revenue and should be charged to the Profit and Loss Account, Depreciation is not recognised on day-to-day basis. It is brought into the books only at the end of the accounting period by passing the following journal entry.

Depreciation A/c   Dr.
    To Concerned Asset A/c

Depreciation is treated in final accounts as follows:

i) On the debit side of the Profit and Loss Account: shown as a separate item giving details of depreciation on each fixed asset, and
ii) Deducted from the concerned asset in the Balance Sheet.

Sometimes depreciation is given in the Trial Balance itself. This is possible only if the entry in respect of depredation has already been passed in the books of account. **In such a situation depreciation will be shown in the Profit and Loss Account only.** It need not be adjusted in the fixed assets in the Balance Sheet because the fixed assets already stand reduced by the amount of depredation.

Depreciation is generally calculated at the given rate for the period for which the asset has been used in the accounting year. Thus, if an asset is purchased during tlie current year the depreciation should be calculated from the date of acquisition till the end of the year. If the date on which the additions were made is not given, you should calculate depreciation on additions also for the full year. hi the case of old assets, depredation is calculated on the opening balance. Look at Illustration 2 and study how depreciation is treated at the time of preparing the final account.

Illustration 2

The following are the balances of assets as on January 1, 1987:

	Rs.
Plant and Machinery	1,20,000
Furniture	68,000

A new machinery costing Rs. 30,000 was acquired on July 1,1987. Depreciation is to be provided on Plant and Machinery at 10% and on furniture at 5% per annum. Show how depreciation will be shown in the final accounts.

Solution:

Calculation of Depreciation

		Rs.
On Furniture at 5% on Rs. 18,000,		900
On Plant and Machinery:		
10% on Rs. 1,20,000 for one year	12,000	
10% on Rs. 30,000 for six months	1,500	13,500
		14,4000

Treatment in Final Accounts

Profit and Loss Account
for the year ended December 31, 1981

Dr. Cr.

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Depreciation:			
Plant and Machinery 13,500			
Furniture 900	14,400		

Balance Sheet
as on December 31, 1981

Liabilities	Amount	Assets		Amount
	Rs.			Rs.
		Fixed Assets:		
		Plant and Machinery	1,20,000	
		Add New Machinery	30,000	
			1,50,000	
		Less Depreciation	13,500	1,36,500
		Furniture	18,000	
		Less Depreciation	900	17,100

8.3.7 Interest on Capital

You know the funds provided by the proprietor to the business constitute **capital**. Sometimes, the proprietor may like to know the profits made by the business after taking into consideration the interest on this capital. In such a situation interest is allowed at a certain rate on the capital. It is calculated on the capital at the beginning of the year. If, however, any additional capital is introduced during the year, interest on additional capital will also be calculated from the date on which it was brought into the business. Such interest is treated as an expense for the business and the following adjustment entry is passed to bring it into the books of account.

Interest on Capital A/c Dr.
To Capital A/c

Interest on capital is treated in final accounts as follows:

i) On the debit side of Profit and Loss Account: shown as a separate item of expense and
ii) Added to Capital on the liabilities side of Balance Sheet. You should note that normally no interest on capital is to be provided.

8.3.8 Interest on Drawings

In case interest is allowed to the proprietor on his capital, it is a usual practice to also charge interest on his drawings. Interest on drawings will be a gain for the business and the following adjustments entry is passed to bring it into the books of account.

Capital A/c or Drawings A/c Dr.
To Interest on Drawings A/c

Interest on Drawings is treated in final accounts as follows:

i) On the credit side of Profit and Loss Account: shown as a separate item, and
ii) Deducted from Capital on the liabilities' side of Balance Sheet.

Interest on drawings is calculated at a given rate from the date of withdrawal till the end of the year. In case no date is mentioned, the interest is charged for six months assuming the amounts were drawn evenly throughout the year, Look at Illustration 3 and see how interest on drawings is calculated when the amount and the dates of withdrawal are given.

Illustration 3

	Rs.
Feb. 1	4,000
Apr. 1	6,000
Jul. 1,	3,000
Oct,' 31	2,000
Dec. 31	5,000

Calculate the interest chargeable to the proprietor if the rate of interest on drawings is 15% per annum.

Solution:

Date (1)	Amount (2)	Months upto December 31 (3)	Product 2 x 3 (4)
Feb, 1	4,000	11	44,000
Apr. 1	6,000	9	54,000
Jul. 1	3,000	6	18,000
Oct. 31	2,000	2	4,000
Dec. 31	5,000	0	0
			1,20,000

Interest on Drawings = $\frac{15}{100} \times 1,20,000 \times \frac{1}{12}$ = Rs. 1,500.

Another way of calculating interest on drawings is to calculate it individually on each withdrawal and then add them.

8.3.9 Interest on Loan

If the firm has taken some loan, it has to pay interest theron. Hence, when we notice a loan Account in the Trial Balance, we must find out whether the full amount of due on loan has been paid or not. The rate of interest and the date on which the loan was taken is usually given. If, however, the date on which loan was taken is not given, it means that it is an old loan and full year's interest has to be provided. In any case, you should calculate the exact amount of interest due and find out from the Trial Balance whether the same has been paid or not. Generally, you will find that the interest has been paid but it is less than what is due. In such a situation, the difference is regarded as outstanding interest and the same must be adjusted at the time of preparing the final accounts. Suppose there is an item of 10% loan (taken on April 1,1987) of Rs. 20,000 appearing in the Trial Balance. Assuming the accounting year ends on December 31, the total interest on loan will work out as Rs. 1,500 (at 10% on Rs. 20,000 for nine months). On going through the Trial Balance you find that the interest paid is Rs. 1,000 only. It means Rs. 500 (Rs. 1,500 – Rs. 1,000) is the outstanding interest. This must be shown in final accounts accordingly i.e., Rs. 1,500 (Rs. 1,000 + Rs. 500 outstanding) as interest on loan on the debit side of the Profit and Loss Account and Rs. 500 as outstanding interest under current liabilities in the Balance Sheet.

It is possible that the adjustments given outside the Trial Balance already include this item. But, if they do not even then you have to account for it. This is called an implied adjustment.

Check Your Progress A

1 Fill in the blanks

i) Every adjustment has a ———— effect.
ii) Closing stock is shown on the ———— side of the Balance Sheet.
iii) Prepaid expenses are also called ———— expenses.
iv) Income received in advance is ———— for the business.
v) ———— is a decrease in the value of a fixed asset due to wear and tear.
vi) Interest on Drawings is ———— from the capital in the Balance Sheet.'

2. State whether the following statements are True or False.

i) Every adjustment affects either Trading and Profit and Loss Account or the Balance Sheet.
ii) Outstanding expense is first added to the relevant expense account and then shown on the liabilities side of the Balance Sheet.
iii) Interest on loan is an income for the business.
iv) Depreciation is deducted from the relevant fixed asset in the Balance Sheet and debited to Profit and Loss Account.
v) Proprietor is always entitled to interest on the capital invested.

8.3.10 Bad Debts

Sometimes, a debtor may fail to gay his debt either partially or completely. The amount of debt which cannot be recovered from the debtor is called Bad Debts and it will be a loss to the business. The following journal entry is passed when a debt becomes bad.

Bad Debts A/c	Dr.
To Concerned Debtor's A/c	

The effect of this entry will be (i) debtor's personal account stands, closed, and (ii) a new account called 'Bad Debts Account' is opened in the books.

The total amount of bad debts incurred during the year appears as a separate item in the Trial Balance and the sundry debtors appear at the reduced amount. The bad debts like any other expense or loss are charged to the Profit and Loss Account.

Bad Debts given outside the Trial Balance: Sometimes, the bad debts to be written off may be stated outside the Trial Balance as an adjustment item. It means that such bad debts have not yet been written off. In other words, the entry for such bad debts has not been passed. It is necessary to record such bad debts at the time of preparing the final accounts. This is done by passing the following adjustment entry:

Bad Debts Account	Dr.
To Sundry Debtors	

Such additional bad debts usually called **'further bad debts'** are treated in final accounts as follows:

i) On the debit side of Profit and Loss Account: shown as addition to bad debts already written off, and
ii) On the assets side of the Balance Sheet: shown as deduction from Sundry Debtors.

It is important to remember the difference between the treatment of bad debts given inside the Trial Balance and the bad debts given outside the Trial Balance. The bad debts given inside the Trial Balance and also those given outside the Trial Balance will be shown in the Profit and Loss Account. But only those bad debts will be deducted from Sundry Debtors in the Balance Sheet which are given outside the Trial Balance.

8.3.11 Provision for Bad Debts

In any business where goods are sold on credit, bad debts usually occur. When it is certain that a debt will not be recovered, the amount is written off as bad debt. But, it is also likely that some of the remaining debts may not be recovered in full. From experience we know that certain percentage of amounts due from debtors may not be recovered. This will be a loss to the business. You have learnt that accordingly to 'conservatism concept' all possible losses must be provided for. Hence, it is a common practice to make a suitable provision for doubtful debts at the time of preparing the final accounts. Otherwise, the Profit and Loss Account will not reveal the correct amount of profit or loss and the Balance Sheet will not show the true position of sundry debtors. The Provision for doubtful debts is usually calculated as a certain percentage of the total amount due from sundry debtors after writing of all known bad debts.

Provision for doubtful debts is also called 'Provision for Bad Debts' or 'Provision for Bad and doubtful Debts. Such a provision is made by debiting the amount of doubtful debts to the Profit and Loss Account, Thus, the journal entry for creating such provision will be as follows:

Profit and Loss A/c	Dr.
To Provision for Bad Debts A/c	

You will notice that when a debt is irrecoverable it is written off by crediting it to the personal account of the respective customer. But, when a debt is doubtful of recovery, the personal account of the customer will not be credited as the recovery is still possible. Hence, the creation of provision for bad debts does not affect the balance of debtors personal accounts. However, while showing sundry debtors in the Balance Sheet the amount of such provision is subtracted therefrom.

When provision for bad debts already exists in the books, the provision created for doubtful debts at the end of a particular year will be carried forward to the next year and it will be used for meeting the loss due to bad debts incurred during the next year. The provision for bad debts brought forward from the previous year is called 'opening provision' or 'old provision'. When such provision already exists, the loss due to bad debts during the current year will be adjusted against the same, and while making provision for bad debts required at the end of the current year called 'new provision' the balance of old provision should also be taken into account. Let us take an example and understand how these adjustments are done. Suppose old provision on January 1, 1987 was Rs.1,000. The bad debts written off during 1987 amounted to Rs.600 and the new provision required on December 31,1987 is Rs. 1,500, In such a situation, the Profit and Loss Account will be debited with Rs. 1,100 as calculated below:

	Rs.
Existing Provision for Bad Debts	1,000
Less Bad Debts	600
Surplus provision available	400
Provision required at the end of the year	1,500
Less Surplus of old provision	400
Amount to be debited to Profit and Loss Account	1,100

The above aspects will be shown on the debit side of the Profit and Loss Account as follows:

Profit and Loss Account
of the year ended.........

Dr.		Rs.		Cr. Rs.
To Provision for Bad Debts:				
Bad Debts	600			
Add New Provision	1,500			
	2,100	1,000		
Less Old Provision		1,100		

If however, the total of new provision and the actual bad debts are less than the old provision, the details will be shown on the credit side of the Profit and Loss Account as follows:

Profit and Loss Account
for the year ended...........

Dr.	Rs.			Cr. Rs.
		By Provision for Bad Debts,		
		Old Provision	......	
		Less Bad Debts	......	
			......	
		Less New Provision	......	....

In this **connection** you should note the following points.

1 **If some** bad debts are given in adjustments (further bad debts) they should also **be taken** into account.
2 The **new** provision should be calculated on sundry debtors after adjusting the **amount** of further bad debts.
3 In Balance Sheet **only** the further bad debts as given in adjustments and the **new** provision for bad debts should be subtracted from sundry debtors.

The following are the journal entries required when the provision for bad debts exists in the books:

a) **For writing off further bad debts given outside the Trial Balance:**
  Bad Debts A/c   Dr.
   To Sundry **Debtors**
b) **For transferring the total bad debts to the provision for Bad Debts Account:**
  Provision for Bad debts A/c   Dr,
   To Bad **Debts** A/c
c) **For debiting the Profit and Loss Account with the excess of the new pr... the total bad debts over the old provision:**
  Profit **and** Loss Account **A/c**   Dr,
   To Provision for Bad Debts A/c

d) For crediting the Profit and Loss Account with excess of the old provision over the total bad debts plus new provision:

Provision for Bad Debts A/c Dr.
To Profit and Loss A/c

Look at Illustration 4 and see how bad debts and provision for bad debts are recorded in the final Accounts.

Illustration 4

An extract from a trader Trial Balance on December 31,1987 is given below:

Name of the Account	Dr.	Cr.
	Re.	Rs.
Sundry Debtors	64,000	
Bad Debts	4,000	
Provision of Bed Debts		7,000

Adjustments: Write off further bad debts Rs. 2,000 and create a provision for doubtful debts at 5% on debtors. Pass the necessary journal entries and show Bad Debts and Provision for Bad Debts Accounts. Also show their treatment in the final accounts.

Journal

Date	Particulars		Rs.	Rs.
1987 Dec. 31	Bad Debts A/c	Dr.	2,000	
	To Sundry Debtors			
	(Being bad debts written off)			2,000
" 31	Provision for Bad Debts A/c	Dr.	6,000	
	To Bad Debts A/c			6,000
	(Being bad debts transferred to Provision for Bad Debts Account)			
" 31	Proflt and Loss A/c	Dr.	2,100	
	To Provision for Bad Debts A/c			2,100
	(Being the Provision required for doubtful debts)'			

Dr. **Bad Debts Account** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
1987 Dec. 31	To Balance b/d	4,000	1987 Dec. 31	By Prov. for Bad Debts A/c	6,000
" 31	To Sundry Debtors	2,000			
		6,000			6,000

Provision for Bad Debts Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1987 Dec. 31	To Bad Debts A/c	6,000	1987 Jan. 1	By Balance b/d	7,000
,, 31	To Balance c/d	3,100	Dec. 31	By Profit and Loss A/c	2,100
		9,100			9,100
			1988 Jan. 1	By Balance b/d	3,100

Note: The new provision for bad debts has been calculated at 5% on Rs. 62,000 (sundry debtors Rs. 64,000—further bad debts Rs. 2,000).

Profit and Loss Account
for the year ended December 31, 1987

		Rs.		Rs.
To Provision for Bad Debts:				
Bad Debts	4,000			
Add Further Bad Debts	2,000			
Add New provision,	3,100			
Less Old	9,100			
Provision	7,000	2,100		

Balance Sheet
as at December 31, 1987

	Rs.			Rs.
		Current Assets:		
		Sundry Debtors	64,000	
		Less Further Bad Debts	2,000	
			62,000	
		Less Provision Bad Debts	3,100	58,900

8.3.12 Provision for **Discount on Debtors**

You know cash discount is allowed to debtors as an incentive for prompt payment. When the discount is allowed it is **recorded through** the Cash Book and posted to the credit side of the **concerned** debtor's personal accounts. But, in the case of debts outstanding at the end of the current year, discounts will be allowed in the next year if the debtors make prompt payments. So, as in the case of anticipated loss on account of doubtful debts, a provision must be made for the discount likely to be allowed to the debtors in the next year, such a provision is known as the 'Provision for Discount on Debtors' it is also calculated as a percentage on the net sundry debtors (remaining after subtracting the provision for bad debts and further bad debts). For example, if Sundry Debtors amount to Rs. **40,000** and the firm wants to create a provision for bad debts at 5% and a provision for discount at 2% on the debtors they will be **calculated as** follows:

i) The **Provision** for bad debts **will** be calculated at 5% on Rs. **40,000.** It will amount to Rs. 2,000.
ii) The Provision for discount at 2% will be calculated on the debtors **after** subtracting the provision for bad debts **i.e.,** on Rs. **38,000 (Rs. 40,000 – Rs. 2,000).** It will amount to **Rs.** 760.

Note that when both provision for bad debts and provision for discount on debtors are to be **calculated,** the provision for bad debts is calculated first and **then** provision for discount is worked out on debtors after subtracting the provision for bad debts.
The adjustment entry for provision for discount on debtors is as follows:

Profit and Loss **A/c** Dr.
To Provision for Discount on Debtors **A/c**
(Being the Provision made for discount on debtors)

The Provision lor discount on debtors will be shown in the final accounts as follows:

i) On **the** debit side of Profit and **Loss** Account: shown as a separate item, and
ii) On the assets side of Balance Sheet: shown as a deduction from Sundry Debtors.

The balance of the provision for Discount on Debtors Account will be **carried** forward to the next year and the discounts allowed if any, in the next year will be set off against the provision for itself. The method of dealing with discounts allowed and provision for discount on debtors in the next year is similar to the method followed in **case** of bad debts and provision for bad debts.

8.3.13 Provision for Discount on Creditors

When prompt payment is received we allow cash discount to debtors. Similarly, we receive discount from the creditors when prompt payments are made by us. So the expected gain on account of discounts receivable from creditors in the next year should also be taken into account at the time of preparing the final accounts. Such a provision is called 'Provision for Discount on Creditors'.

It is calculated as a percentage on Sundry Creditors. The creation of such a provision, however, goes against the Conservatism Concept. Hence, it is usually avoided in practice. But you must learn how it is treated in final accounts if such a provision is required.

The adjustment entry for provision for discount on creditors is passed as follows:

Provision for Discount on Creditors A/c   Dr.
To Profit and Loss Account
(Being the Provision made for discount on creditors)

The provision for discount on creditors will appear in the final accounts as follows:

i) On the credit side of Profit and Loss Account: shown as a separate item, and
ii) On the liabilities side of the Balance Sheet: shown as a deduction from Sundry Creditors.

The balance of the Provision for Discount on Creditors Account will also be carried forward to the next year and the discount received, if any, will be adjusted against the provision itself.

8.3.14 Manager's Commission

Sometimes, the manager may also be entitled to a commission on profits earned by the business. Such commission is usually calculated as a fixed percentage on profits. Suppose the Net Profit of a firm after taking into consideration all expenses except the manager's commission is Rs. 60,000 and the manager is entitled to a commission of 5% on profits before charging such commission. His commission will work out as Rs. 3,000. However, it is still to be paid and therefore should be treated as an outstanding expense. It will be debited to Profit and Loss Account and also shown as a current liability in the Balance Sheet.

In the above example, manager's commission has been calculated on profits before charging the commission. But, sometimes, it is to be calculated on prfoit after charging such commission. In such a situation, the commission will be calculated by the following formula:

$$\frac{\text{Percentage of Commission}}{100 + \text{percentage of Commission}} \times \text{Net Profit before Commission}$$

If, in the above example, the manager's commission were to be calculated on profits after charging such commission, it will be as follows.

$$\frac{5}{100+5} \times 60{,}000 = \frac{5}{105} \times 60{,}000 = \text{Rs. } 2{,}857$$

The above amount can also be verified. After charging manager's commission the Net Profit will work out to Rs. 57,143 (Rs. 60,000 − Rs. 2,857). Now calculate 5% on Rs. 57,143. It works out to Rs. 2,857 which means the amount of commission calculated by the given formula is correct.

8.3.15 Abnormal Loss of Stock

In the course of business some loss of stock may also occur. It may occur in transit or at the godown. Such loss of stock may be normal or abnormal. Normal loss is due to inherent characteristics of goods such as evaporation, subdivision, drying up of goods, etc. On the other hand, if the loss occurs on account of seasons which are accidental or very rare, the loss is termed as abnormal loss, The examples of such losses are theft of goods, destruction of goods by fire, etc.

The normal loss does not require any special treatment in the books of account. It is absorbed by the remaining units whose cost is inflated by such loss. But, the abnormal loss has to be shown separately in the books of account. After the amount of such loss is ascertained, the following adjustment entry is passed.

Loss by Fire A/c Dr.
To Trading Account
(Being stock lost by fire)

To avoid the burden of loss due to abnormal circumstances the businessmen may get the stock insured. Thus, the loss may be

1 Uninsured,
2 Fully insured, or
3 Partially insured.

Let us see what wilt be the accounting treatment in the above three situations.

1 When the stock's is not insured: In case the stock is not insured the total abnormal loss will be transferred to the Profit and Loss Account and the following entry will be passed.

Profit and Loss A/c Dr:
To Loss by Fire A/c

2 When the stock is fully insured: When the stock is fully insured, the total amount of loss is paid by the insurance company. In that case the company does not suffer any loss. So, nothing is debited to the Profit and Loss Account. The journal entry passed is as follows.

Insurance Company Dr.
To Loss by Fire A/c

3 When the loss is partially insured: In case the loss is partially insured the amount of insurance claim is debited to Insurance Company's Account and the remaining loss (the amount to be borne by the business) is debited to Profit and Loss Account. The following journal entry is passed.

Insurance Company Dr.
Profit and Loss A/c Dr.
To Abnormal Loss A/c

Thus, the treatment of abnormal loss in final accounts is as follows.

a) Credit the Trading Account with the total loss.
b) i) In case of uninsured stock debit Profit and Loss Account with full amount.
ii) In case of fully insured loss, insurance claim will be shown as an asset in the Balance Sheet.
iii) In case of partially insured loss, the amount of insurance claim is shown as an asset: in the Balance Sheet and the remaining amount of loss is debited to the Profit and Loss Account.

Look at Illustration 5 and see how abnormal loss is treated in the books of account.

Illustration 5

On December 30,1987 the stock worth Rs. 40,000 was destroyed by fire. The stock was insured and the insurance company admitted a claim of Rs. 30,000 only. Pass the necessary journal entries and show how it will be treated in final accounts.

Journal

Date	Particulars		Dr. Amount	Cr. Amount
1987			Rs.	Rs.
Dec. 31	Loss by Fire A/c	Dr.	40,000	
	To Trading A/c			40,000
	(Being stock lost by fire)			
" 31	Insurance Company	Dr.	30,000	
	Profit and Loss A/c	Dr.	10,000	
	To Loss by Fire A/c			40,000
	(Being partial claim admitted by Insurance Company)			

Trading Account
for the year ended December 31,11887

Dr.			Cr.
		By Loss by Fire	Rs. 40,000

Profit and Loss Account
for the year ending December 31, 1987

		Rs.		
To Lass by Fire Less insurance claim	40,000 30,000	10,000		

Balance Sheet
as at December 31, 1987

			Rs.
		Current Assets: Claim due from insurance company	30,000

8.3.16 Drawing of Goods by the Proprietor

You know when the proprietor takes away some goods from the business for his personal use it is recorded in books of account by passing the following journal entry (refer to Unit 2).

Drawings Account Dr.
To Purchases Account

So, if you find that it has not been recorded in the books of account, you have to make the necessary adjustment in final accounts. The treatment in final **accounts** will **be** as Follows:

i) On the Debit side of **the** Trading Account: Deduct it from Purchases.
ii) On the Liabilities side of the Balance **Sheet:** Deduct it from capital either as a separate **item** or by including it in drawings.

Check Your Progress B

1 Why do you create a provision for bad debts?

....
....
....
....

2 Why provision for discount on creditors is regarded against the Conservatism Concept?

....
....
....
....

3 The Trial Balance shows the following balances.

	Rs.
Debtors	20,000
Bad Debts	100
Provision for bad Debts	200

8.4 PREPARATION OF FINAL ACCOUNTS WITH ADJUSTMENTS

You know there are various items which require adjustment at the time of preparing the final accounts. You have learnt how each adjustment is recorded in books through a journal entry and how it is reflected in the final accounts. However, while preparing the final accounts with adjustments you should remember **that there is no need to pass the Journal entries for any adjustment unless specifically asked to do so. All adjustments must be shown directly in the final accounts.** Look at Illustration 6 and 7 and see how final accounts are prepared with adjustments.

Illustration 6

From the following Trial Balance of Gupta & Sons, prepare Trading and Profit and Loss Account for the year ended December 31,1987 and a Balance Sheet as on that. date.

Trial Balance

Name of the Account	Debit Balances	Credit Balances
	Rs.	Rs.
Capital		5,00,000
Sales		10,00,000
Sales Returns	25,000	
Purchases	5,00,000	
Purchases Returns		15,000
Inventory as on 1.1.87	60,000	
Land & Buildings	4,00,000	
Plant & Machinery	3,00,000	
Furniture	1,00,000	
Wages	50,900	
Carriage Inwards	10,009	
Provision for Bad Debts		7,000
Carriage Outwards	5,000	
Cartage	5,000	
Salaries	40,000	
Loan		2,60,000
Debtors	1,50,000	
Creditors		70,000
Pent		8,000
Bills Receivable	40,000	
Acceptances		10,000
General Expenses	20,000	
Rent & Rates	10,000	
Investments	50,000	
Cash in hand	50,000	
Bank Overdraft		10,000
Discount	4,500	
Bad Debts	5,000	
Interest on Investments		5,000
Interest on Bank Overdraft	500	
Goodwill	60,000	
Total	18,85,000	18,85,000

Additional Information

1 The value of inventory on December 31,1987 was Rs. 1,00,000.
2 Depreciation is to be provided on: **Land** & Building @ 5% **p.a.** Furniture @ 10% **p.a. Plant** & Machinery Rs. **50,000.**
3 Provision for Bad Debts is to be **maintained** @ 5% on debtors.
4 Wages are outstanding to the extent of Rs. 4,000 and **Salaries** to **the** extent of Rs. 3,000.
5 Rent and Rates are prepaid to the extent of **1/4th** of the amount paid.
6 Interest on Investment **outstanding** is Rs. 1,000.
·7 Rent to the extent of Rs. 2,000 has been received in advance.

Solution:

Trading & Profit and Loss Account
lor the year ended December 31, 1987

Dr. Cr.

Particulars		Amount	Particulars		Amount
					Rs.
To Inventory as on 1.1.87		60,000	By Sates	10,00,000	
To Purchases	5,00,000		**Less** Sales Returns	25,000	9,75,000
Less Purchases Returns	15,000	4,85,000	By Inventory as on 31.12.87		1,00,000
To Wages	50.000				
Add Wages Outstanding	4,000	54,000			
To Carriage Inwards		10,000			
To Cartage		5,000			
To Gross Profit c/d		4,61,000			
		10,75,000			10,75,000
To Carriage Outwards		5,000	By **Gross Profit** b/d		4,61,000
To Salaries	40,000		By Rent	8,000	
Add Outstanding	3,000	43,000	**Less Received** in advance	2,000	6,000
To **General Expenses**		20,000	By **Interest** on Investment	5,000	
To Rent & Rates	10.000		Add Outstanding	1,000	6,000
Less Prepaid	2,500	7,500			
To Diiunt **Allowed**		4,500			
To Bad Debts	5,000				
Add New **Provision**	7,500				
	12,500				
Less Old Provision	7,000	5,500			
To Depreciation on Plant & Machinery		50,000			
To Interest on Overdraft		500			
To Depreciation Land & Building Furniture	20,000	30,000			
To Net **Profit** (transferred to Capital **A/c**)		3,07,000			
		4,73,000			4,73,000

Balance Sheet as on December 31, 1987

Liabilities		Amount	Assets		Amount
		Rs.			Rs.
Capital			**Fixed Assets**		
Balance	5,00,000		Goodwill		60,000
Add Net Profit	3,07,000	8,07,000	Land & Building	4,00,000	
			Less Depreciation	20,000	3,80,000
Long Term Liabilities			Plant & Machinery	3,00,000	
Loan		2,60,000	Less Depreciation	50,000	2,50,000
Current Liabilities			Furniture	1,00,000	
Creditors		70,000	Less Depreciation	10,000	90,000
Acceptances		10,000			
Bank Overdraft		10,000	Investments		50,000
Wages Outstanding		4,000	Current Assets		
Salaries Outstanding		3,000	Cash in hand		50,000
Rent Received in Advance		2,000	Debtors	1,50,000	
			Less: Provision for Bad Debts	7,500	1,42,500
			Bills Receivable		40,000
			Closing Stock		1,00,000
			Prepaid Rent & Rates		2,500
			Interest on Investment Outstanding		1,000
		11,66,000			11,66,000

illustration7

From the following balances extracted from the book of Aristo Ltd., prepare a Trading and Profit and Loss Account for the year ended December 31, 1987 and a Balance Sheet as on that date.

Trial Balance

Name of the Account	Debt Balances	Credit Balances
	Rs.	Rs.
Capital		2,00,000
Sales		5,00,000
Sales Returns	10.000	
Purchases	2,00,000	
Purchases Returns		10,000
Stock on 1.1.87	40,000	
Land & Buildings	2,00,000	
Plant & Machinery	1,00,000	
Wages	25,000	
Furniture	50,000	
Provision far Bad Debts		5,000
Salaries	25,000	
Debtors	82,800	
Creditors		1,00,000
Bad Debts	3,000	
Bills Payable		30,000
Investments	50,000	
General Expenses	20,000	
Cash in hand	5,000	
Cash at bank	15,000	
Depreciation on Land & Buildings		
	8,45,000	8,45,000

Additional Information

1 Thp inventory on 31.12.87 has been valued at Rs. 80,000. The inventory of the value of Rs.20,000 was destroyed by fire on 1.12.87 and a claim of Rs. 15,000 was admitted by the insurance company.

2 Depreciation is to be provided on Plant & Machinery and furniture at 10% per annum.

3 Debtors are bad to the extent of Rs. 2,000. Provision for bad debts is to be made at 5% on **debtors and a provision** for discount on **debtors** at 2%.
4 Wages are outstanding to the extent of Rs. 5,000.
5 Salaries are prepaid to the extent of Rs. 2,000.
6 Create a provision for **discount on** creditors at the rate of
7 Create a provision for repairs to the extent of Rs. 4,000.

Trading & Profit and Loss Account
for the year ended December 31, 1987

Dr. **Cr.**

Particulars		Amount	Particulars		Amount
		Rs.			Rs.
To Opening Stock		40,000	By Sales	5,00,000	
			Less Sales Returns	10,000	4,90,000
To Purchases	2,00,000				
Less Purchases Returns	10.000	1,90,000	By Closing Stock		80,000
			By Loss by Fire		20,000
To Wages	25,000				
Add Outstanding	5,000	30,000			
To Gross Profit c/d		3,30,000			
		5,90,000			5,90,000
To Salaries	25,000				
Less Prepaid	2,000	23,000	By Gross Profit b/d		3,30,000
			By Provision for Discount on Creditors		1,000
To Bad Debts	3,000				
Add Further Bad Debts	2,000				
Add New Provision	4,000				
	9,000				
Less Old Provision	5,000	4,000			
To General Expenses		20,000			
To Depreciation on Land & Buildings		20,000			
To Loss by Fire		5,000			
To Depreciation on Plant & Machinery		10,000			
To Depreciation on Furniture		5,000			
To Provision for Discount on Debtors		1,520			
To Provision for Repairs		4,000			
To Net Profit (transferred to Balance Sheet)		2,38,480			
		3,31,000			3,31,000

Balance Sheet as on December 31, 1987

Liabilities		Amount	Assets		Amount
		Rs.			Rs.
Capital	2,00,000		Land & Buildings		2,00,000
Add Net Profit	2,38,480				
		4,38,480	Plant & Machinery	1,00,000	
			Less Depreciation	10,000	90,000
Creditors	1,00,000		Furniture	50,000	
Less Provision			Less Depreciation	5,000	45,000
for Discount	1,000	99,000			
Bills Payable		30,000	Investments		50,000
Wages Outstanding		5,000	Cash in hand		5,000
Provision for Repairs		4,000	Cash at bank		15,000
			Closing Stock		80,000
			Debtors	82,000	
			Less Further Bad Debts	2,000	
				80,000	
			Less Provision for Bad Debts	4,000	
				76,000	
			Less Provision for Discount	1,520	74,480
			Insurance Claim Outstandings		15,000
			Salaries Prepaid		2,000
		5,76,480			5,76,480

Notes: 1 Depreciation on Land & Buildings is given in the Trial Balance. Hence, it is shown in the Profit and Loss Account only.

2 Provision for Bed Debts has been calculated at 5% on debtors after subtracting further bad debts.

3 Provision for Discount on Debtors has been calculated at 2% on debtors after subtracting further bad debts as well as provision for bad debts.

4 Loss by fire has been charged to Profit and Loss Account after taking into consideration the claim from insurance company.

8.5 ADJUSTMENTS GIVEN IN TRIAL BALANCE

You know that the adjustments are usually given outside the Trial Balance and they are shown at two places in the final accounts. But, sometimes a few adjustment items appear in the Trial Balance itself. In Illustration 7 you noticed it in respect of depreciation on Land & Buildings. It is possible that items like outstanding or prepaid insurance also appear in the Trial Balance. This happens when the journal entry in respect of an adjustment has already been passed and the same has been posted into the concerned ledger accounts. For example, when you pass journal entry for the adjustment for outstanding salaries, you will debit Salaries Account and credit Salaries Outstanding Account. The Salaries Account already exists in the ledger and the amount of outstanding salaries is also posted thereto. This leads to an increased balance in Salaries Account. But the Salaries Outstanding Account does not exist in the ledger. This will have to be opened and the outstanding amount credited thereto. When the Trial Balance is prepared, it will show the increased balance of Salaries Account in the debit balances column and the balance of Salaries Outstanding Account in the credit balances column. Now the question arises how to treat it in the final accounts. In such a situation, you will simply show Salaries Outstanding in the liabilities. No addition will be made to salaries in the Profit and Loss Account because salaries given in Trial Balance already include this amount. Thus, when salaries outstanding appear in the Trial Balance it is shown in final accounts only at one place. This applies to all items of adjustments when they are included in the Trial Balance.

In actual practice all adjustment items with the exception of closing stock are invariably incorporated in the Trial Balance before preparing the final accounts. The Trial Balance so prepared is called 'Final Trial Balance' or 'Adjusted Trial Balance'.

Look at *Chart* 8.1 and note how each item of adjustment is treated in final accounts. (i) if it is given outside the Trial Balance, and (ii) if it appears in the Trial Balance itself.

Chart 8.1
Treatment of Adjustment Items in Final Accounts

S. No.	Item	Treatment in Final Accounts: If given in Adjustments	Treatment in Final Accounts: If given in Trial Balance itself
1	Closing Stock	i) Credit side of Trading A/c: Shown as a separate item ii) Assets side of Balance Sheet: Shown as a separate item under Current Assets	Assets side of Balance Sheet only.
2	Outstanding Expenses	i) Debit side of Trading A/c or Profit and Loss A/c: Added to the concerned expense ii) Liabilities side of Balance Sheet. Shown as a separate item under Current Liabilities	Liabilities side of Balance Sheet only.
3	Prepaid Expenses	i) Debit side of Profit and Loss A/c: Deducted from the concerned expense ii) Assets side of Balance Sheet: Shown as a separate item under Current Assets	Assets side of Balance Sheet only.
4	Outstanding Incomes	i) Credit side of Profit and Loss A/c: Added to the concerned income ii) Asset side of Balance Sheet: Shown as a separate item under Current Assets	Assets side of Balance Sheet only.
5	Income Received in Advance	i) Credit side of Profit and Loss A/c: Deducted from concerned income ii) Liabilities side on Balance Sheet. Shown as a separate item under Current Liabilities	Liabilities side of Balance Sheet only.
6	Depreciation	i) Debit side of Profit and Loss A/c: Shown as a separate item ii) Assets side of Balance Sheet: Deducted from the concerned fixed asset	Debit side of Trading & Profit and Loss Account only.
7	Interest on Capital	i) Debit side of Profit and Loss A/c: Shown as a separate item ii) Liabilities side of Balance Sheet: Added to Capital	Debit side of Profit and Loss Account only.
8	Interest on Drawings	i) Credit side of Profit and Loss A/c: Shown as a separate item ii) Liabilities side of Balance Sheet: Deducted from Capital	Credit side of *Profit* and Loss Account only.
9	Interest on Loan	i) Debit side of Profit and Loss A/c: Shown as a separate item ii) Liabilities side of Balance Sheet: Added to Loan.	Debit side of Profit and Loss Account only.
10	Bad Debts	i) Debit side of Profit and Loss A/c: Added to Bad Debts ii) Assets side of Balance Sheet: Deducted from Sundry Debtors	Debit side of Profit and Loss Account only.

11	Provision for bad debts	i) Debit side of Profit and Loss A/c: Shown as a separate item ii) Assets side of Balance Sheet: Deducted from Sundry Debtors	Deduct from sundry debtors assuming it is a closing balance.
12	Provision for Discount on Debtors	i) Debit side of Profit and Loss A/c: Shown as a separate item ii) Assets side of Balance Sheet: Deducted from Sundry Debtors	Debit side of Profit and Loss Account only.
13	Provision for Discount on Creditors	i) Credit side of Profit and Loss A/c: Shown as a separate item ii) Liabilities side of Balance Sheet: Deducted from Sundry Creditors	Credit side of Profit and Loss Account only.
14	Manager's Commission	i) Debit side of Profit and Loss A/c: Shown as a separate item ii) Liabilities side of Balance Sheet: Shown as a separate item	Liabilities side of Balance Sheet only.
15	Abnormal Loss	i) Credit side of Trading A/c: Shown as a separate item with full amount of loss ii) Debit Profit & Loss A/c with the uncovered Loss iii) Insurance claim will be shown on Assets side of Balance Sheet under Current Assets	Debit side of Profit and Loss Account only.
16	Drawing of Goods by the Proprietor	i) Debit side of Trading A/c: Deducted from purchases ii) Liabilities side of Balance Sheet: Deducted from capital	Deduct from Capital.

Illustration 8

From the following Trial Balance of Pitam Stores prepare Trading and Profit and Loss Account for the year ended December 31,1987 and the Balance Sheet as on that date.

Trial Balance

Account	Debit Balances	Credit Balances
	Rs.	Rs.
Capital		60,000
Drawings	5,000	
Purchases	1,00,000	
Sales		2,10,000
Opening Stock	20,000	
Wages	15,000	
Wages Outstanding		5,000
Carriage Inwards	2,000	
Salaries	13,000	
Insurance	1,500	
Insurance Prepaid	1,500	
Income from Investments		30,000
Accrued Income from Investments	10,000	
Machinery	50,000	
Buildings	95,000	
Cash in hand	2,000	
Debtors	35,000	
Creditors		60,000
Depreciation on Buildings	5,000	
Rent	10,000	
	3,65,000	3,65,000

Additional Information

The value of stock on December 31,1987 was Rs. 40,000

Solution:

Trading and Profit and **Loss** Account
for the year **ended December** 31, 1987

Dr. Cr.

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Opening Stock	20,000	By Sales	2,10,000
To Purchases	1,00,000	By Closing Stock	40,000
To Wages	15,000		
To Carriage Inwards	2,000		
To Gross Profit c/d	1,13,000		
	2,50,000		2,50,000
To Salaries	13,000	By Gross Profit b/d	1,13,000
To Insurance	1,500	By Inwme from Investments	30,000
To Rent	10,000		
To Depreciation on Building	5,000		
To Net Profit (transferred to Capital A/c)	1,13,500		
	1,43,000		1,43,000

Balance Sheet
as on **December** 31, 1987

Dr. Cr.

Liabilities		Amount	Assets	Amount
		Rs.		Rs.
Capital	60,000		Building	95,000
Add Net Profit	1,13,500		Machinery	50,000
			Closing Stock	40,000
	1,73,500			
Less Drawings	5,000		Debtors	35,000
		1,68,500	Cash in hand	2,000
Creditors	..	60,000	Insurance Prepaid	1,500
Wages Outstanding		5,000	Accrued Income from Investments	10,000
		2,33,500		2,33,500

8.6 LET US SUM UP

At the time of preparing the final accounts a number of items need adjustments. It is because certain expenses may relate to two or more accounting years or certain expenses incurred during the current year may still remain to be paid. Unless such adjustments are made, the final accounts will not reveal the true picture. Such items are usually given outside the Trial Balance and are shown at two places in the final accounts so as to complete the double entry,

Adjustment entries can be passed in the journal for each item of adjustment. But, **normally** they are directly adjusted in the final accounts. In practice the adjustment entries are always passed for such items and a revised Trial Balance called 'Adjusted Trial Balance' or 'Final Trial Balance' is prepared. In such a situation, the adjustments will appear in the Trial Balance itself. Any item of adjustment which appears in the Trial Balance is shown only at one place in the final accounts.

8.7 KEY WORDS

Abnormal Loss: **Loss** caused by abnormal causes.

Adjustment Entry: Journal entry passed to **make** an adjustment in the relevant accounts.

Adjustment Item: An item **given** outside the Trial Balance which requires adjustment at the time of preparing final accounts.

Adjusted Purchases: Amount of purchases after adjusting both the opening and closing stocks.

Adjusted **Trial** Balance: Trial Balance prepared after incorporating various adjustments.

Depreciation: A permanent decrease in the value of a fixed asset caused by wear and tear or the passage of time.

Doubtful Debts: Debts of doubtful recovery.

Outstanding Expenses: Expenses incurred during the accounting year but not yet paid.

Outstanding Incomes: Incomes earned during the accounting year but not yet received.

Prepaid Expenses: Expenses paid but the benefit of which is yet to be received.

Unearned Income: Income in respect of which the services are yet to be rendered.

8.8 SOME USEFUL BOOKS

1 Maheshwari, S.N. 1986. ***Introduction to Accounting,*** Vikas Publishing House: New Delhi. (Chapter 10)
2 Patil, V.A. and J.S. **Korlahalli**, 1986. ***Principles and Practice of Accounting,*** R. Chand & Co., New Delhi. (Chapter 20)
3 William Pickles. 1982. ***Accountancy,*** E.L.B.S. and **Pitman**, London. (Chapter 5)
4 Gupta, **R. L** and M. **Radhaswamy**. 1986 ***Advanced Accountancy,*** Sultan Chand & Sons, New Delhi. (Chapter **4,5**)
5 Shukla, **M. C** and T.S. **Grewal**. 1987. ***Advanced Accountancy,*** S. Chand & Co., New Delhi. (Chapter 2)

8.9 ANSWERS TO CHECK YOUR PROGRESS

A 1 i) dual ii) asset iii) unexpired iv) liability v) Depreciation vi) subtracted
  2 **i) False ii) True iii) False iv) True v) False**
B 3 Provision for Bad Debts Rs. 990
    Provision for Discount on Debtors Rs. 376.20
  4 **i) Rs. 20,000 ii) Rs. 5,000 iii) Rs. 15,000**

8.10 TERMINAL QUESTIONS/EXERCISES

Questions

1 Why some adjustments become necessary at the time of preparing the final accounts? Name any two items of adjustment and explain how they are shawn in the final accounts.
2 Distinguish between:
  a) Outstanding Expenses and Unexpired Expenses
  b) Provision for Discount on Debtors and Provision for Discount on Creditors
  c) Normal Loss and Abnormal Loss

Exercises

1 Give journal entries for the following adjustments:
i) Interest received in advance Rs. 600
ii) Interest on drawings Rs. 1,200
iii) Provision for discount on creditors Ks. 200
iv) Loss of goods by theft Rs. 8,500
v) Drawings of goods by the proprietor Rs. 750

2 The following information is extracted from the hooks of a businessman:

Debtors as on **31.12.1987**	**Rs. 25,000**
Bad Debts during **1987**	Rs. 1,000

Provision for Bad Debts is to be maintained at 5% of debtors.
A Provision for discount on debtors is also to be made at **2%.** You are required to calculate the amounts to be set aside in respect of provision for bad debts and provision for discount on debtors respectively.

(Answer: Provision for Bad Debts Rs. 1,250; Provision for Discount on Debtors Rs. **475)**

3 The Proprietor withdrew the following amounts during the year ended December **31,1987.**

	Rs.
Feb. 28	4,000
May 1	6,000
Aug. 31	5,000
Nov. 1	2,000
Dec. 1	1,000

Calculate interest on drawings if the rate is 6% per annum.
(Answer: Rs. 565)

4 From the following Trial Balance of Puri & Sons as on June **30,1988,** prepare Trading and Profit and Loss Account and the Balance Sheet.

Trial Balance

Name of the Account	Debit	Credit
	Rs.	Rs.
Capital		1,00,000
Drawings	5,000	
Purchases less Returns	2,00,000	
Sales less Returns		5,00,000
Inventory (beginning)	50,000	
Wages	20,000	
Carriage Inwards	3,000	
Salaries	25,000	
Freight	2,000	
Trade Expenses	5,000	
Rent		20,000
Packing Charges	2,000	
Land & Buildings	2,00,000	
Plant & Machinery	2,50,000	
Furniture	50,000	
Bad Debts	5,000	
Debtors	75,000	
Creditors		80,000
Cash in hand & at bank	5,000	
Bills Receivable	3,000	
Loan		2,00,000
Total	9,00,000	9,00,000

Additional information

i) **Inventory (ending):** Rs. 30,000.
ii) Depreciation is to be provided as **follows:**
  Land & building @ 5% p.a
  Plant & Machinery **@** 4% **p.a.**
  Furniture @ 10% p.a
iii) **Debtors** are bad **to the** extent of Rs. 5,**000.**
iv) **Salaries are** outstanding **to** the extant of Rs. 5,000.
v) Wages are prepaid to the extent of Rs. **2,000.**
vi) Rent received **in** advance Rs. **3,000.**

(**Answer:** Gross Profit Rs. 2,57,000; Net Profit Rs. 2,02,000; **Balance** Sheet **total Rs. 5,85,000)**

5 From the following Trial Balance of **Kawatra** stores, prepare Trading and Profit and **Loss** Account for the year ended December 31,1987, and a **Balance** Sheet as on that date.

Trial Balance

Name of the Account	Debit	Credit
	Rs.	Rs.
Capital		5,00,000
Drawings	20,000	
Purchases	4,00,000	
Purchases Returns		10,000
Sales		7,00,000
Sales Returns	20,000	
Inventory (beginning)	1,00,000	
Land & Building	3,00,000	
Plant & Machinery	1,50,000	
Goodwill	50,000	
Trade Marks	30,000	
Wages	40,000	
Trade Expenses	20,000	
Furniture	50,000	
Provision for Bad Debts		10,000
Debtors	1,07,000	
Bad Debts	3,000	
Salaries	60,000	
Creditors		1,00,000
Acceptances		80,000
Investments	10,000	
Rent	15,000	
Distribution Expenses	5,000	
Cash in hand and at bank	10,000	
Depreciation on Furniture	10,000	
Total	14,00,000	14,00,000

Additional information,

i) The **inventory** on December 33,1987 was valued at Rs. **1,50,000.** Inventory **of** the value Rs. **10,000** was destroyed by fire on 1.12.1987. It was fully insured and a claim of Rs. **10,000** was admitted by the insurance company.
ii) Depreciation is to be provided on the following assets:
  Land & Buildings @ 5% **p.a.**
  Plant & Machinery @ **12½%** p.a.
iii) Debtors are bad to the extent of Rs. **2,000.** Provision of 5% on debtors is to be created in respect of bad debts and a provision for discount on debtors is to be created at 2% of debtors.
iv) Wages **are** outstanding to the extent of Rs. 10,000.
v) Rent is prepaid to the extent of Rs. 5,000.
vi) The general manager is to be provided a commission of 2% on net profits before charging such **commission.**

(Answer: Gross Profit Rs. **3,00,000;** Net Profit Rs. **1,55,887;** Balance Sheet **total** Rs. **8,29,005)**

6 From the following Trial Balance of V. Ramana prepare his final accounts for the year ended December 31,1986.

Name of the Account	Dr.	Cr.
	Rs.	Rs.
Capital		70,000
Drawings	10,000	
Adjusted Purchases	2,32,500	
Sales		2,95,000
Cash in hand	3,800	
Cash at bank	12,800	
Salaries	18,000	
Freight	1,200	
Advertising	800	
General Expenses	5,400	
Furniture	10,800	
Expenses Outstanding		2,500
Depreciation	2,200	
Building	39,000	
Discount	700	800
Insurance	600	
Prepaid Insurance	300	
Rent Received		6,000
Rent Received in Advance		3,000
Trade Debtors	14,100	
Trade Creditors		24,600
Loss by Fire	2,000	
Commission		1,500
Stock on December 31,1986	49,200	
Total	4,03,400	4,03,400

(Answer: Gross Profit Rs. 61,300; Net Profit Rs. 39,900; Balance Sheet total Rs. 1,30,000)

7 The Trial Balance of S. Karim as on December 31,1986 was as under:

Name of the Account	Dr.	Cr.
	Rs.	Rs.
Capital		1,10,000
Drawings	15,000	
Gross Profit earned during 1986		32,400
Salaries and Wages	22,000	
Rent and Taxes	8,400	
Cash in hand	2,300	
Bauk Overdraft		8,600
Sundry Debtors and Creditors	41,000	36,000
Insurance (including premium of Rs. 400 per annum paid up to March 31, 1987)	1,000	
Loose Tools	5,000	
Bad Debts	500	
Provision for Bad Debts		800
Entertainment Expenses	300	
Commission		2,100
General Charges	2,600	
Furniture and Fixtures	12,000	
Plant and Machinery	60,000	
Stock on December 31,1986	19,800	
	1,89,900	1,89,900

Prepare the Profit and Loss Account for the year ending December 31, 1986 and the Balance Sheet as on that date.

(Answer : Net Loss Rs. 11,100; Balance Sheet total Rs. 1,30,500)

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 9 ERRORS AND THEIR RECTIFICATION

Structure

9.0 OBJECTIVES

After studying this unit you should be able to:

- describe the types of errors which are usually committed in the process of accounting
- explain the procedure of locating the errors
- rectify errors before preparing the final accounts
- explain the use and preparation of suspense account
- rectify errors located during subsequent accounting years
- compute the effect of rectifying errors on profits.

9.1 INTRODUCTION

You know that the Trial Balance is prepared to verify the arithmetical accuracy of accounting records. When the Trial Balance does not tally, it means there are errors in the books of account. These errors must be detected and rectified before preparing the final accounts, otherwise they will not reflect a true and fair view of the state of affairs of the business. In this unit you will learn about the types of errors which are usually committed in the process of accounting, the procedure for locating and rectifying those errors, and the effect of rectifying-entries on the profits of the business.

9.2 TYPES OF ERRORS

The errors may occur while recording transactions in the subsidiary books, or while posting them into the ledger or at the time of closing or balancing various accounts, or while preparing the Trial Balance itself. Whatever the stage at which the error is committed, it may be either an error of principle or an-error of clerical nature. All errors can therefore be broadly divided into (a) the errors of principle, and (b) the clerical errors. The clerical errors can be further divided into (i) errors of omission, (ii) errors of commission, and (iii) compensating errors. Let us now discuss these errors one by one.

1 **Errors of Principle:** When a transaction has not been recorded as per the rules of debit and credit, or it violates some other principle, the errors so arising are **called** 'errors of principle'. Examples of such errors are:

i) A credit purchase of fixed assets recorded in the Purchases Journal instead of the Journal Proper. This results in debiting the Purchases Account instead of the concerned fixed asset account. This is an error of **principle** because it amounts to treating an expenditure of capital nature as a revenue expenditure.

ii) An expenditure incurred on repairs of machinery debited to Machinery Account. You know repairs to machinery is a revenue expenditure **and** should have been debited to Repairs to Machinery Account. Debiting this expenditure to Machinery Account amounts to treating it as a capital expenditure. It is therefore an error of principle.

iii) Salary paid to Ganga Ram recorded in Cash Book as a payment to **Ganga** Wam. This would result in debiting **Ganga** Ram's personal account instead of treating it as an expense and debiting it to Salaries Account.

The errors of principle do not affect the Trial Balance because they simp$ amount to debiting or crediting wrong accounts, the debit-credit **correspondence** is not upset.

2 **Errors of Omission:** When a transaction is completely or partially **omitted** to be recorded in books of account, it is called **an** 'error of **omission'.** If the **transaction** is not **recorded in** the subsidiary books or its posting is completely **omitted,** it is called an **'error of complete omission'.** If, however, the posting is done in one account but omitted from the other, it is called an **'error** sf **partial omission',.** For **example,** if a credit purchase of goods from **Shyam** is **not** recorded in the Purchases Journal or a credit purchase of furniture from Ram is recorded in the Journal **Proper** but no posting is done in any of the two accounts involved, then these will be termed as errors of complete omission. **If** the purchase of goods **from Shyam** is recorded in the Purchases Journal but is not posted in **Shyam's** Account, it will be **called** an error of partial omission. Other examples of partial omission are: **Omission** in carrying forward the total from one page to the other, omission to balance **an** account, and so on.

The errors of complete omission do not affect the Trial Balance. But the errors of partial omission would certainly cause disagreement of the Trial Balance because they would lead to either short debit or short credit.

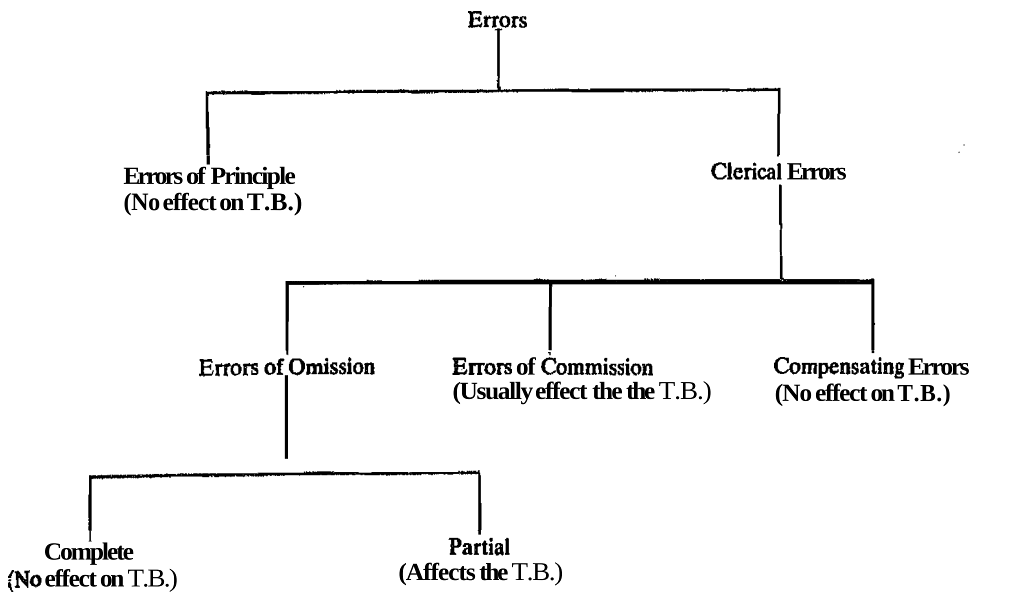
3 **Errors of Commission:** When an error is committed in recording a transaction **with** wrong amount, or posting it to a wrong account or the wrong side of an account, it is **called** an 'error of **commission'.** For example, a credit sale of Rs. 720 is recorded in the Sales Journal as Rs. 270, or it is **posted** to the debit of C's Account instead of B's **Account** or it is posted on the credit side of **B's** Account. Errors like double posting, wrong totalling, wrong carry forward, wrong balancing etc. are also regarded as **errors** of **commission. Such** errors usually cause disagreement in the **Trial** Balance. **But,** the **errors committed** while recording the transaction in subsidiary books or **posting** it **to a** wrong **account** (but with **correct amount** and on the correct side) do not affect the **Trial Balance,**

4 **Compensating Errors:** Those errors which **nullify** the effect of each other are called 'compensating **errors'.** In other words, compensating errors refer to such a group of errors **wherein** the effect of one error is **compensated by** the effect of other **error** or **errors.** For **example,** while **posting an** entry of Rs. **200** to the' debit of Ram's **Account** we **wrongly** wrote **Rs. 400.** Then, **while** posting an **entry** of Rs. 500 **to** the debit **of** some other account we wrote Rs. 300. The first error led to a higher debit of Rs. **200** whereas the **second error** resulted in a lower debit of Rs. 200. Thus, the effect of the **first error** is nullified by the **effect of the second** error. Take another example. **The Purchases** Journal is overcast **in** excess by **Rs.** 1,000 which means the Purchases Account **will be debited** in **excess** by Rs. 1,000. The Sales Journal also, **by mistake,** is **overcast by Rs. 1,000** whish **means the Sales** Account will be credited in excess by Rs. **1,000. These two** mistakes, **together,** result in an excess debit of **Rs. 1,000 as well as** an excess **credit** of Rs. 1,000. Thus, they **cancel** out of the effect of each other. Such **errors** do not affect the Trial **Balance.**

Look at Figure 9.1. It shows various types of errors and indicates whether a particular type of error affects the Trial Balance or not.

Figure 9.1

Types of Errors and their Effect on Trial Balance



Cheek Your Progress A

1 Give two examples of errors of principle.

....

....

2 What do you mean by compensating errors?

....

....

....

3 A few errors committed in Rao's books are given below. State in each case the type of error involved and whether it would affect the Trial Balance or not.

i) Sales of Rs. 950 to Ram completely omitted from books of account.
ii) Purchases of Rs. 720 from Shyam entered in the Purchases Journal as Rs. 700.
iii) Purchases Journal is overcast by Rs. 1,000.
iv) Sales Returns Journal is undercast by Rs. 200.
v) Amount paid to Agarwal wrongly posted to the debit of Mittal's Account.
vi) Bank overdraft is shown undor the debit balances column in the Trial Balance.
vii) Sales of Rs. 500 to Sadiq entered in Sales Journal as sales to Mushtaq.
viii) Wages paid for installation of machinery debited to Wages Account.

S. No.	Type of Error	Whether it affects the Trial Balance
i)	....	Yes/No
ii)	....	Yes/No
iii)	....	Yes/No
iv)	....	Yes/No
v)	....	Yes/No
vi)	....	Yes/No
vii)	....	Yes/No
viii)	....	Yes/No

9.3 LOCATION OF ERRORS

You have learnt the types of errors which are usually committed in the process of accounting. These errors must be located and rectified before preparing the final accounts. You know that some of the errors affect the agreement of the Trial Balance while some do not. The errors such as errors of principle, errors of complete omission and errors of compensating nature which do not affect the Trial Balance are difficult to locate. They are usually found out during the course of audit or when the statement of accounts is received by the business or sent to customers for confirmation. However, the location of errors of omission and commission which affect the Trial Balance is not so difficult. The following routine procedure is usually adopted for locating such errors.

a) Check the totals of both the debit and the credit columns of the Trial Balance.
b) If the difference still persists, ascertain the exact amount of difference; and then
   i) see wheiher an account having that balance has been omitted from the Trial Balance. Suppose the debit column in Trial Balance is short by Rs. 630, it is just possible that an account with a debit balance of Rs. 630 has not been entered in the Trial Balance.
   ii) check whether an account with a balance equal to that difference has been entered twice in the Trial Balance.
   iii) take half the amount of difference, see whether there is any account with such balance in the Trial Balance, and if so, check whether it is entered in the correct column or not. If an account with a debit balance of Rs. 315 has been entered in the credit column, the debit column becomes short by Rs. 630.
c) Verify whether (i) the balances of all the accounts are included in the Trial Balance (ii) they are entered in the correct column, and (iii) their amounts have been correctly written.
   If no errors are found upto this stage, or the errors located have been duly corrected, but still the Trial Balance does not tally, there is need to take further action. You may take the following steps:
d) Check the totals of the lists of sundry debtors and sundry creditors.
e) Check the totals andbalances of all accounts in the ledger.
f) Check the totals and the postings of all subsidiary books.
g) Check the postings of all amounts equal to the difference in the trial balance. It is possible that a posting has been omitted. Similarly, check the postings of all amounts equal to half the difference. It is possible that the amount has been posted on the wrong side of the concerned account.
h) See that correct amounts have been brought forward from the previous pages.
i) Verify that all opening balances have been correctly entered in various accounts.
j) Compare the current year's Trial Balance with that of the previous year. Any variation noticed should be carefully checked.

The procedure outlined above, if carefully followed, should normally reveal all this errors. The errors are then rectified and a revised Trial Balance is prepared. If no other errors exist, the revised Trial Balance is likely to tally.

9.4 RECTIFICATION OF ERRORS

Any error when located must be rectified. The **rectification** should **not be made by** overwriting or by **striking off the wrong entry.** This would destroy the authenticity of the books of account. Hence, the errors should always be corrected by making suitable entries called rectifying entries. For purposes of rectification the errors are divided into two categories: (i) one-sided errors, and (ii) two-sided errors.

One-sided Errors: Certain errors affect only one side of an account, either the debt side or the credit side. Such errors are called 'ope-sided errors'. Examples of one-sided errors are:

i) Rs. 100 received from Deshmukh was posted to his account as Rs. 10. It means Deshmukh's Account has been credited with Rs. 10 instead of Rs. 100 and there is no mistake in the Cash Book. Thus, this error has affected only one-side of an account.

ii) The Purchases Book is overcast by Rs. 1,000. This will affect the debit side of Purchases Account where the total of the Purchases Book is posted, and no other account is affected.

Two-sided Errors: Certain errors may affect two or more accounts. Such errors are called 'two-sided errors'. Examples of two-sided errors are:

i) A credit sale of Rs. 1,080 to Anand was wrongly recorded in the Sales Book as Rs. 1,800. This error will affect two accounts. viz., Anand's Account and Sales Account. Anand's Account has been debited by Rs. 1,800 instead of Rs. 1,080. The Sales Account has also been credited by an additional amount of Rs. 720 (Rs. 1,800—1,080) because the Sales Book will show a higher total.
ii) A sale of Rs. 500 made to Kamal has been posted on the debit side of Kishore's Account. This error will affect two accbunts viz., Kamal's Account and Kiskore's Account. An entry of Rs. 500 does not appear on the debit side of Kamal's Account whereas Kishore's Account has been wrongly debited with that amount.

9.4.1 Rectification of one-sided Errors

Generally errors are corrected by passing suitable journal entries. You know passing a journal entry means debiting one account and crediting another. But in the case of one-sided error only one account is involved. So it cannot be corrected by passing the journal entry. It is rectified simply by noting the correction on the appropriate side. Take the first example of one-sided error. Deshmukh's account was credited short by Rs. 90. This will be corrected by an additional entry for Rs. 90 on the credit side of his account as follows:

Deshmukh's Account

Dr. Cr.

			Rs.
		By Difference in amount received from him posted on...	90

In the second example of one-sided error, the Purchases Account is debited in excess by Rs. 1,000. This will be corrected by crediting the Purchases Account with Rs. 1,000 as follows:

Purchases Account

Dr. Cr.

			Rs.
		By Overcasting of Purchases Book for the month of...	1,000

The wrong total in the Purchases Book will be circled with red ink and the correct total entered above or below the circle. The person doing the rectification will also put his initials.

9.4.2 Rectification of Two-sided Errors

You have learnt that one-sided errors are corrected simply by noting the correction on the appropriate side of the account affected by the error. They cannot be rectified by suitable journal entries because only one account is involved. But, the two-sided errors are mostly rectified by journal entries. It is because such errors affect two or more accounts and in most cases the debit and credit are equally affected. Take the case of first example of two-sided error given earlier. A credit sale of Rs. 1,080 to

Anand was wrongly recorded in the Sales Book as Rs. 1,800. The two accounts affected are: (i) Anand's Account which shows an excess debit of Rs. 720 and (ii) Sales Account which stands credited in excess by Rs. 720. To rectify this error we must credit Anand's Account with Rs. 720 and debit the Sales Account with Rs. 720. So, a journal entry can be passed as follows:

		Rs.	Rs.
Sales Account	Dr.	720	
To Anand			720
(Being sales of Rs. 1,030 to Anand wrongly recorded in the Sales Book as Rs. 1,800 now rectified)			

Take the second example of two-sided errors given earlier. A sale of Rs. 500 made to Kamal was posted to the debit side of Kishore's Account. The two accounts affected are: (i) Kamals Account which has not been debited by Rs. 500, and (ii) Kishore's Account which has been wrongly debited with Rs. 500. To rectify this error we have to debit Kamal's Account with Rs. 500 and credit Kishore's Account with Rs. 500. So journal entry for the rectification of this error will be as follows:

		Rs.	Rs.
Kamal	Dr.	500	
To Kishore			500
(Being rectification of wrong debit to Kishore for sales made to Kamal)			

Look at illustrations 1 and 2 and study how various errors have been corrected.

Illustration 1

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

1 The Sales Return Book has been undercast by Rs. 500.
2 The total of the Bills Receivable Book amounting Rs. 4,500 has been posted to the credit of Bills Receivable Account.
3 While posting Purchases Book to the ledger the personal account of Kumar has been credited with Rs. 221 instead of Rs. 212.
4 Rs. 60,000 paid for the purchase of a TV set for the proprietor is debited to General Expenses Account.
5 An amount of Rs. 1,000 paid by Pran has been credited to the account of Praneet.
6 Goods sold to Inder for Rs. 1,200 have been entered in the Purchases Book.

Solution:

1 This error will-be rectified by entering Rs. 500 on the debit side of Sales Returns Account by writing "To Undercasting of Sales Returns Book for the Month of ....Rs. 500".
2 This error will be rectified by entering an amount of Rs. 9,000 on the debit side of Bills Receivable Account by writing "To Wrong posting of the total of Bills Receivable Book on the opposite side....................., Rs. 9000".
3 Kumar's Account has been credited with an excess amount of Rs. 9 (Rs. 221 - Rs. 212). This error will be rectified by debiting his account with Rs. 9 by writing "To Difference in amount posted from the Purchases Book on.. ...., Rs. 9".
4 The following journal entry is required for rectification.

		Rs.	Rs.
Drawings A/c	Dr.	10,000	
To General Expenses A/c			10,000
(Being rectification of purchase of TV for the proprietor wrongly debited to General Expenses A/c)			

...urnal entry is required for rectification:

		Rs.	Rs.
Prancet	Dr.	1,000	
To Pran			1,000
(Being rectification of wrong credit to Praneet for the amount paid by Pran)			

6 The following journal entry is required for rectification:

		Rs.	Rs.
Inder	Dr.	2,400	
To Purchases A/c			1,200
To Sales A/c			1,200
(Being rectifying entry for sale to Inder wrongly entered in the Purchases Book)			

Illustration 2

How would you rectify the following errors:

1 Rs. 3,000 received for the sale of old machinery has been wrongly posted to Sales Account.
2 Rs. 600, the cost of repairing the machinery has been wrongly charged to Machinery Account.
3 Goods purchased for Rs. 500 from Sanjay has been wrongly debited to Furniture Account,
4 A sale of Rs. 600 has been wrongly credited to the customer's account.
5 A payment of Rs. 400 on account of rent has been posted twice to the Rent Account.
6 An item of Rs. 197 has been debited to a personal account as Rs. 179.

Solution:

1 The following journal entry is required for rectification:

		Rs.	Rs.
Sales A/c	Dr.	3,000	
Machinery A/c			3,000
(Being rectifying entry for sale of machinery credited to Sales Nc)			

2 The following journal entry is required for rectification:

		Rs.	Rs.
Repairs A/c	Dr.	600	
To Machinery A/c			600
(Being rectification of wrong debit to Machinery A/c instead of Repairs A/c)			

3 The following journal entry required for rectification:

		Rs.	Rs.
Purchases A/c	Dr.	500	
To Furniture A/c			500
(Being rectifying entry for purchase wrongly debited to Furniture Nc)			

4 This error will be rectified by debiting the customer's account with Rs. 1,200 (double of Rs. 600) by writing "To Wrong posting from Sales Book on the credit side on .... Rs. 1,200."

5 This error will be rectified by entering Rs. 400 on the credit side of the Rent Account by writing "By Double posting from Cash Book on.......... Rs. 400".

6 The personal A/c has been debited Rs. 18 short (Rs. 197–179. To rectify this error, the personal A/c will be debited with difference by writing "To Difference in amount posted on ...., Rs. 18."

Check **Your Progress** B

Following errors have been detected:

a) A credit purchase of goods from Chetan amounting to Rs. 15,000 has been wrongly passed through the Sales Book.
b) A sale of an old typewriter for Rs. 800 was passed through the Sales Book.
c) Rs. 700 withdrawn for personal use has been debited to General Expenses Account.
d) A credit sale of Rs. 2,300 to Jatin was omitted from Sales Book.
e) Purchase of a wooden cupboard for Rs. 3,000 has been passed through the Purchases Day Book.

You are required to answer the following questions.

1. In case of each error name the accounts affected.

a) i) ....

ii) ....

iii) ....

b) i) ....

ii) ....

c) i) ....

ii) ....

d) i) ....

ii) ....

e) i) ....

ii) ....

2. In case of each error, write the effect on each account involved.

a) i) ....

ii) ....

iii) ....

b) i) ....

ii) ....

c) i) ....

ii) ....

d) i) ....

ii) ....

e) i) ....

ii) ....

9.5 SUSPENSE ACCOUNT AND RECTIFICATION

You have learnt the method of rectifying the errors. This method is used for rectifying the errors located before preparing the final accounts. After the corrections have been made, a revised Trial Balance is prepared which should normally tally. But, if it does not tally, it means thdre are still some errors which have not been detected. As considerable time and effort have already been spent in locating and rectifying the errors, it may not be possible to wait any longer because it will delay the preparation of final accounts. Hence, in such a situation the usual practice is to place the difference to Suspense Account and tally the Trial Balance for the time being. If the total of the debit column in the Trial Balance is more than the total of its credit column total, the difference is placed to the credit of Suspense Account and the Trial Balance will tally. Similarly, if the credit column total is more than the debit column total the difference is placed to the debit of Suspense Account. The Suspense Account thus created is shown in the Balance Sheet and is carried forward to the next year. Note that the Suspense Account is not the result of any transaction, It merely represents the net effect of errors which still remain undetected. Therefore, during the next accounting year, after the errors: are located and rectified, the Suspense Account will get closed. Let us now understand how arrors will be corrected in the following year. As for the two-sided errors, there is no change in the method of rectification. These errors do not affect the agreement of Trial Balance and hence do no: involve the Suspense Account. They are rectified by means of the journal entries as usual. This is not the case in respect of one-sided errors. When one-sided errors were to be corrected before preparing the Trial Balance we did it by writing an appropriate note in the concerned account. But, when they are to be corrected during the next year **i.e.,** after Suspense Account has been created, the rectification will be through an appropriate journal entry. The one-sided error usually affects only one account. So to pass a journal entry for rectification of such error, we shall now take Suspense Account as the other account involved. For example, Rs. 580 received from Shyam were posted to his account as Rs. 850. It means Shyam's Account is to be debited with Ms. 270. You can now pass the' following journal entry to rectify this error.

		Rs.	Rs.
Shyam	Dr.	**270**	
To Suspense Account			270
(Being rectification entry)			

Thus all errors, whether they are two-sided or one-sided will now be rectified by means of journal entries.

Let us assume that a businessman could not tally his Trial Balance. The difference of Re. 1 between the totals of the two columns was put against the Suspense Account on its debit side and the Trial Balance was made to tally temporarily. The Suspense Account was carried forward to the next accounting year.

The following errors were then located:

1 An amount of Rs. 99 was omitted to be posted to the credit of a customer's account from the Cash Book.
2 The Sales Book was overcast by Rs. 100.

The first error involved the omission of posting to the credit of customers account. So, to rectify this error you will have to credit customer's account with Rs. 99. As the Suspense Account is in existence, the corresponding debit would be given to the Suspense Account. Thus, the journal entry will be:

		Ms.	Rs.
Suspense A/c	**Dr.**	**99**	
To Customer's A/c			99
(Being the rectification of omission in posting)			

The second error refers to Sales Book being overcast by Rs. 100. It means that the Sales Account has been credited with Rs. 100 in excess. To rectify this error, the Sales Account will have to be debited with Rs. 100. The corresponding credit would be given to Suspense Account. The rectifying entry will bc:

		Rs.	Rs.
Sales A/c	**Dr.**	**100**	
To **Suspense A/c**			100
(Being the rectification of Overcasting in Sales Book)			

The Suspense Account, after posting the *two* rectification entries, would appear as follows:

Suspense Account

Dr.	Rs.		Cr. Rs.
To Balance b/d (dif. in T.B.)	1	By Sales A/c	100
To Customer's A/c	99		
	100		100

With the posting of the two rectification entries the Suspense Account is closed. Note that the opening balance in Suspense Account simply shows the net effect of these errors. Sometimes, the balance of Suspense Account is **not given.** In that **case it can be** worked out after completing the posting of the **rectification** entries.

Suppose in the above example the amount with which the Suspense Account was opened was not given. Leave the first line blank on both the debit and credit sides of the Suspense Account and post the rectification entries. The difference between the totals of the two sides will be considered as the balance with which the Suspense Account was opened. This is based on the assumption that there are no more errors remaining undetected.

Look at illustrations 3 and 4 and study how **errors** are rectified when Suspense Account is in existence.

Illustration 3

The Trial Balance of Siva did not tally. The credit side exceeded by **Rs. 1,455.** This amount was entered in the debit **column** against Suspense Account and the Trial Balance was made to tally.

Later, the following errors were discovered.

1 Goods worth **Rs. 1,250** were sold to Mahesh on credit. This was entered in the Sales **Book** but was not posted.
2 **Goods worth Rs.** 313 were returned by **Ahmed.** The amount was credited to **his** account but was not recorded in the Returns Inwards **Book.**
3 **Manoj** paid Rs. 670 but his account was wrongly credited with **Rs.** 607.
4 An amount of Rs. 375 owed by **Dinesh** was omitted from the schedule of sundry debtors.
5 The Sales **Book was undercast** by Rs. 420.

Rectify the errors and show the Suspense Account

Solution:

Journal

			Rs.	Rs.
1	**Mahesh** To Suspense A/c (Being sales to Mahesh not posted)	Dr.	1,250	1,250
2	**Returns Inward A/c** To Suspense A/c (Being goods returned not recorded in Returns Inwards Book though credited to personal account	Dr.	313	313
3	**Suspense A/c** To Manoj (Being Cash paid by Manoj underposted)	Dr.	63	63
4	**Sundry Debtors A/c** To Suspense A/c (Being Dinesh's debit omitted from the list of sundry debtors)	Dr.	375	375

5	Suspense A/c Dr. To Sales A/c (Being rectification of overcasting in Sales Book)	420	420

Suspense Account

Dr.	Rs.		Cr. Rs.
To Difference in Trial Balance	1,455	By Mahesh	1,250
To Manoj	63	By Returns Inwards A/c	313
To Sales A/c	420	By Sundry Debtors A/c	375
	1,938		1,938

Illustration 4

Rectify the following errors assuming that a Suspense Account was opened.

1 A purchase made from Anthony & Co. for Rs. 8,000 was not entered in the Purchases Book.
2 An amount of Rs. 500 received from Mr. Roy was credited to Ray's A/c.
3 A sale of Rs. 600 to Gopal was debited to his account as Rs. 6,000.
4 Salaries paid amounting to Rs. 1,000 was wrongly debited to Wages Account.
5 Rs. 450 received on account of interest stands wrongly credited to Commission Account.
6 The total of Returns Outwards Book amounting to Rs. 560 was not posted in the ledger.
7 A credit sale of Rs. 250 to Rakesh was wrongly credited to his account.
8 A credit sale of Rs. 520 to Madhu debited to him as Rs. 250.
9 A credit purchases from Kailash of Rs. 400 was debited to him,
10 In Cash Book the total of discount allowed column of Rs. 304 has been carried forward as Rs. 403.

Solution:

Journal

		Rs.	Rs.
1	Purchases A/c Dr. To Anthony & Co.'s A/c (Being the omission of credit purchases, now rectified)	8,000	8,000
2	Ray Dr. To Roy (Being credit given to Ray's A/c instead of Roy's A/c now rectified)	500	500
3	Suspense A/c Dr. To Gopal (Being excess debit given to Gopal's A/c, now rectified)	5,400	5,400
4	Salaries A/c Dr. To Wages A/c (Being debit to Wages A/c instead of Salaries A/c now rectified)	1,000	1,000
5	Commission A/c Dr. To Interest A/c (Being credit given to Commission A/c instead of interest A/c now rectified)	450	450
	Suspense A/c Dr. To Returns Outwards A/c (Being the omission of posting total of Returns Outwards Book, now rectified)	560	560

			Rs.	Rs.
7	Rakesh To Suspense A/c (Being wrong credit given to Rakesh, now rectified)	Dr.	500	500
8	Madhu To Suspense A/c (Being short amount debited to Madhu's A/c, now rectified)	Dr.	270	270
9	Suspence A/c To Kailash (Being debit given to Kailash instead of credit. now rectified)	Dr.	800	800
10	Suspense A/c To Discount Allowed A/c (Being excess amount carried forward in Cash Book, now rectified)	Dr.	99	99

Suspense Account

Dr. Cr.

	Rs.		Rs.
To Gopal	5,400	By Balance b/d (balancing figure)	6,089
To Returns Outwards A/c	560	By Rakesh	500
To Kailash	800	By Madhu	270
To Discount Allowed A/c	99		
	6,859		6,859

9.6 EFFECT OF RECTIFYING ENTRIES ON PROFITS

You have seen that the creation of Suspense Account helps in tallying the Trial Balance and avoiding delay in the preparation of final accounts. The errors still remain to be detected and rectified so, the Profit and Loss Account prepared from such Trial Balance is subject to the undetected errors. The profit thus arrived at may be more or less than the actual profits. Similarly, when the errors are detected and rectified during the next year, the rectifying entries will have their effect on the profit of the next year.

The profit is affected only if the errors involve accounts which usually appear in the Trading and Profit and Loss Account (nominal accounts) and not those which appear in the Balance Sheet (real and personal accounts).

Let us understand it with the help of an example. Suppose Rs. 24,000 paid for salaries during 1986 was posted to the Salaries Account as Rs. 20,400. This error has resulted in short debit of Rs. 3,600 to Salaries Account and so the salaries charged to Profit and Loss Account are short by Rs. 3,600. This would overstate the profits of 1986. When this error will be detected in 1987 and the rectifying entry passed, Rs. 3,600 will be added to salaries of 1987 and so the profit of 1987 will be decreased by Rs. 3,600. Thus, the errors as well as the rectifying entries affect the profit. Of course, the effect of rectifying entries will be almost the reverse of the effect of errors.

Look at illustration 5. It shows rectifying entries and their effect on profits.

Illustration 5

A businessman finds that he could tally his Trial Balance of 1986 only by opening a Suspense Account. During 1987, he discovered the following errors.'

1 The Discount Allowed column of the Cash Book was overcast by Rs. 25.
2 Sale of old machinery amounting to Rs. 550 had been credited to Sales A/c.
3 A sale of Rs. 780 to Ahmed had been debited to his account as Rs. 870.
4 The total of Bills Payable Book Amounting to Rs. 4,000 for the month of June was not posted into the ledger.

Rectify the above errors and prepare the Suspense A/c. Also explain the effect of rectifying the errors on the profits of 1987.

Solution:

Journal

			Rs.	Rs.
1	Suspense A/c To Discount Allowed A/c (Being the rectifying entry for wrong casting of discount allowed column)	Dr.	25	25
2	Sales A/c To Machinery A/c (Being the rectifying for sale of machinery wrongly credited to Sales Account)	Dr.	550	550
3	Suspense A/c To Ahmed (Being rectifying entry for excess amount debited)	Dr.	90	90
4	Suspense A/c To Bills Payable A/c (Being the rectifying entry for omission of posting the total of B/P Book)	Dr.	4000	4000

Suspense Account

Dr.	Rs.		Cr. Rs.
To Discount Allowed A/c	25	By Balance b/d	4,115
To Ahmed	90	(balancing figure)	
To Bills Payable A/c	4,000		
	4,115		4,115

Effect on Net Profit of 1987

Rectifying Entry	Increase	Decrease
	Rs.	Rs.
1 *Credit to* Discount Allowed A/c	25	
2 Debit *to Sales* A/c	—	550
3 *No* nominal account is involved	—	—
4 *No* nominal account *is* involved	—	—
	25	550
Net decrease in Profits		525

Profit **and** Loss **Adjustment** Account: In the above illustration you observed that errors were committed during 1986 and the **rectifying** entries were passed in the books **of** 1987. This unnecessarily affected the profits of 1987. In order that the profits of the year in which rectifying entries are passed is not affected, a new account celled Profit and Loss Adjustment Account is opened. Then, all amounts whish are to be debited or credited to nominal account in the rectifying entries may **be** debited or credited to the Profit and Loss Adjustment Account. The balance of the Profit and Loss Adjustment Account is directly adjusted in the capital. Thus, the profit **of** the year in **which** the rectifying entries are made remains unaffected. The rectifying entries 1 and 2 of Illustration 5 which involve debit and credit to nominal account can now be shown **as follows:**

Journal

			Rs.	Rs.
1	Suspense A/C To Profit and Loss Adjustment A/c (Being the rectification of overcasting the discount allowed column)	Dr.	25	25
2	Profit & Loss Adjustment A/c To Machinery A/c (Being the rectification for wrong credit given to Sales Account)	Dr.	550	550

The Profit and Loss Adjustment Account will be as follows:

Profit and Loss Adjustment Account

Dr.			Cr.
	Rs.		Rs.
To Machinery A/c	550	By Suspense A/c	25
		By Capital A/c (Transfer)	525
	550		550

9.7 LET US SUM UP

When the Trial Balance does not tally, it means there are errors in books of account. These may be the errors of principle, errors of omission, errors of commission or compensating errors. Some of these errors affect the agreement of Trial Balance while some do not. The errors which do not affect the Trial Balance are difficult to locate but those which affect it are easily located by following a series of steps. The errors thus located must be rectified before preparing the final accounts.

One-sided errors which affect only one account are rectified by means of a suitable note on the relevant side in the concerned account. Two-sided errors involving two or more accounts are rectified by means of journal entries. If the Trial Balance does not tally even after the detected errors have been rectified, it means that there are still some errors which have not been detected. In such a situation, the difference in Trial Balance is put against a Suspense Account to avoid delay in preparing the final accounts. Later, when these errors are discovered, they can be rectified through journal entries and the Suspense Account may be closed.

When errors are rectified during the next accounting year, the rectification entries involving nominal accounts affect the profits of the next year. To avoid such effect, a Profit and Loss Adjustment Account can be opened and its balance directly adjusted in capital.

9.8 KEY WORDS

Audit: Checking the books of account by auditors for detection and prevention of errors and frauds.

Compensating Errors: A group of errors wherein the effect of one error is counter-balanced (compensated) by the effect of the other errors.

Errors of Commission: A clerical error committed while recording or posting the transactions or while totalling, balancing, ete.

Error of Complete Omission: An error committed by completely omitting to record a transaction in books.

Error of Partial Omission: An error committed in omitting to post one aspect of an entry in the ledger.

Error of Principle: An error committed by ignoring or misapplying some principles of accounting while recording a transaction in books.

One-sided Error: An error which affects the debit or credit side of one account only,

Profit and Loss Adjustment Account: An account opened for avoiding the effect of tectifying entries in respect of the previous year's errors on the profits of the current year.

Rectifying Entries: Entries made in books of account for correction of errors.

Suspense Account: An account opened to tally the Trial Balance temporarily. It represents the net effect of undetected one-sided errors.

Two-sided errors: An error which involves two or more accounts and effect both the debit and credit aspects.

8.9 SOME USEFUL BOOKS

Maheshwari, S.N. 1986. ***Introduction to Accounting,*** Vikas Publishing House: New **Delhi.** (Chapter 11)

Patil, V.A. and J.S. **Korlahalli,** 1986. ***Principles and Practice of Accounting, R.*** Chand & Co. New **Delhi.** (Chapter 16)

William Pickles. 1982. ***Accountancy,*** E.L.B.S. and **Pitman:** London. (Chapter 14)

Gupta, R.L. and M. Radhaswamy. 1986. ***Advanced Accountancy,*** Sultan Chand & Sons: New Delhi. (Chapter 9)

9.10 ANSWERS TO CHECK YOUR PROGRESS

A 3 i)	Error of Complete Omission	No effect on Trial Balance
ii)	Error of Commission	No effect on Trial Balance
iii)	Error of Commission	Affects the Trial Balance
iv)	Error of Commission	Affects the Trial Balance
v)	Error of Commission	No effect on Trial Balance
vi)	Error of Commission	Affects the Trial Balance
vii)	Error of **Commission**	No effect on Trial Balance
viii)	Error of Principle	No effect on Trial Balance

B 1 a) i) **Chetan's** Account ii) **Purchases** Account iii) Sales Account
b) i) Typewriter Account ii) Sales Account
c) i) Drawings Account ii) General Expenses **Account**
d) i) Jatin's Account ii) Sales Account
e) i) **Furniture** Account ii) Purchases Account

2 a) i) Chetan's Account debited **with** Rs. 15,000 instead of being credited
ii) Purchases **Account** not debited with Rs. **15,000**
iii) Sales Account credited in excess by Rs. 15,000
b) i) Typewriter Account not credited with Rs. 800.
ii) Sales **Account** credited in **excess** by Rs. **800.**
c) i) Drawings Account not debited
ii) **General** Expenses Account debited in excess
d) i) Jatin's Account not debited
ii) Sales Account not credited
e) i) Furniture Account not debited
ii) Purchases Account debited in excess

C 1) i) Debit Sales Returns Account and Credit Suspense Account
ii) Debit Suspense Account and Credit **Purchase** Account.
iii) Debit Suspense Account and **Credit Kant's** Account (With Rs. 1,500).
iv) Debit Nagesh's Account and Credit Suspense Account.
v) Debit Interest Account and Credit Rent Account.

2 Difference in Trial Balance Rs. **1,506** placed to the credit of Suspense Account.

9.11 TERMINAL QUESTIONS/EXERCISES

Questions

1 What are its various types of errors which are usually committed in the process of accounting? Explain them with examples.
2 Is Trial Balance a conclusive proof of the accuracy of the hooks of account? If not, discuss the errors which arc not disclosed by the Trial Balance.
3 Describe briefly the procedure for locating the errors.
4 What is Suspense Account? State its advantages.
5 Does rectification of errors in the subsequent accounting periods always affect the trading result of those years? Give examples of errors which affect it and which do not.

Exercises

1 Rectify the following errors.
   a) Rs. 690, the amount of rent paid to the landlord, was debited to his personal account.
   b) Goods taken away by the proprietor for personal use costing Rs.600, was debited to the Purchases Account.
   c) Rs. 1,080 paid as wages for construction of a room was debited to the Wages Account.
   d) Total of purchases Book of one page was carried forward to the next page as Rs. 876 instead of Rs. 786.
   e) Discount allowed amounting to Rs. 25 had been credited to Discount Received Account.
   f) Total of Sales Book of one page was carried forward to the next pages as Rs. 872 instead of 782.

2 Rectify the following errors.
   a) Rs. 700 recovered on account of bad debts written off earlier, credited to the customer's personal account.
   b) Goods returned by Murari amounting to Rs. 250 has been entered in the Returns Outwards Book.
   c) An amount of Rs. 800 withdrawn by the proprietor for his personal use has been debited to General Expenses Account.
   d) Discount allowed to Kurien amounting to Rs. 47 has not been entered in the discount column of the Cash Book, but it has been posted to the customer's personal account.
   e) A cash sale to Ashok for Rs. 690 was recorded in the Cash Book and also in the Sales Book. Postings were made from both the books.
   f) The Bank Column on the credit side of the Cash Book was overcast by Rs. 50.

3 On taking out a Trial Balance a book-keeper finds an excess credit of Rs. 2,460. Being desirous of closing the books, he places the difference in a Suspense Account, which is carried forward. In the next period, he discovers the following errors. Pass the rectifying entries and prepare the Suspense Account.
   a) The total of Returns Inwards Book has been found to be Rs. 400 short.
   b) A sum of Rs. 4,800 written off as depreciation on machinery, has not been posted to the Depreciation Account,
   c) A discount of Rs. 1,000 allowed to a customer has been posted to his account as Rs. 100.
   d) The Sales Book was undercast by Rs. 4,000.
   e) Purchase of Ws. 480 was posted as Rs. 840 in the supplier's account.
   (Answer: Suspense Account still show a debit balance of Rs. 1,800.)

4 A book-keeper failed to balance his Trial Balance. He places the difference to a newly opened Suspense Account which is carried forward. The following errors were subsequently discovered. Give journal entries to rectify these errors and show the Suspense Account.
   a) The total of Purchases Day Book had been undercast by Rs. 200.
   b) Purchase of a typewriter on credit from Harnath for Rs. 9,600 was entered in the Purchases Book.

c) Goods returned by Hari amounting to Rs. 2,000 has been entered in the Returns Outwards Book, however, the posting was done correctly to Hari's Account.
d) A cash sale sf Rs. 2,500 to Somnath, correctly entered in the Cash Book, was posted to the credit of his personal account.
e) A cheque received from Mahinder far Rs. 8,160 had been debited in the Cash Book, but the double entry had not been completed.
(Answer: Suspense Account was started with a credit balance of Rs. 3,960)

5 The Trial Balance prepared by Dhanraj did not tally and the difference was transferred to a Suspense Account. Subsequently, the following errors were found. Rectify the errors and show the Suspense Account. Also explain the effect of rectifying entries on the profits.
a) A sale of Rs. 1,600 to Kamalnath was posted to Karunanath.
b) Insurance amounting to Rs. 250 paid was posted twice.
c) A sale of Rs. 1,500 for old machinery was gassed through the Sales Book.
d) A Purchase worth Rs. 600 from Kamesh was not passed through the books.
e) The debit balance on Commission Account amounting to Rs.80 was omitted from the Trial Balance.
f) The Purchases Returns Book was undercast by Rs. 700.
(Answer: Suspense Account was started with a credit balance of Rs. 870. Profit will decrease by Rs. 1,230).

6 An accountant could not tally the Trial Balance. He placed the difference of Rs. 2,380 to the credit of Suspense Account and prepared the final accounts. The following errors were discovered in the next year.
i) The Sales Book was undercast by Rs. 500.
ii) Entertainment expenses sf Rs. 950, though entered In the Cash Book, were omitted to be posted in the ledger.
iii) Commission of Rs. 250 paid was posted twice to Commission Account.
iv) Discount column of the receipt side of the Cash Book was wrongly added as Rs. 1,400 instead of Rs. 1,200.
v) A sale of Rs. 1,390 to Kamesh, though correctly entered in the Sales Book, was wrongly posted to his personal account as Rs. 1,930.
vi) A purchase from Nahar worth Rs. 920, though correctly entered in the Purchases Book, was wrongly debited to his personal account.
Pass the necessary rectifying entries, prepare Suspense Account and state the effect of rectifying the entries on the profits.
(Answer: Suspense Account was closed. Effect on Profit: nil).

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.

ECO-02 ACCOUNTANCY-I
Course Components

BLOCK	UNIT NO.	PRINT MATERIAL
I		**Accounting Fundamentals**
	1	Basic Concepts of Accounting
	2	The Accounting Process
	3	Cash Book and Bank Reconciliation
	4	Other Subsidiary Books
	5	Bills of Exchange
2		**Final Accounts**
	6	Concepts Relating to Final Accounts
	7	Final Accounts-I
	8	Final Accounts-11
	9	Errors and their Rectification
3		**Consignments and Joint Ventures**
	10	Consignment Accounts-I
	11	Consignment Accounts-11
	12	Consignment Accounts-I11
	13	Joint Venture Accounts
4		**Accounts from Incomplete Records**
	14	Self Balancing System
	15	Accounting from Incomplete Records-I
	16	Accounting from Incomplete Records-II
	17	Accounting from Incomplete Records-III
5		**Accounts of Non-trading Concerns, Depreciation, Provisions and Reserves**
	18	Accounts of Non-trading Concerns-I
	19	Accounts of Non-trading Concerns-I1
	20	Depreciation-I
	31	Depreciation-II
	22	Provisions and Reserves

UNIT 10 CONSIGNMENT ACCOUNTS-I

Structure

10.0 OBJECTIVES

After studying this unit you should be able to:

- explain the meaning of consignment
- distinguish it from sale
- identify the parties involved in consignment and describe their relationship
- explain the basic framework of accounting for consignment transactions in the books of the consignor and the consignee.

10.1 INTRODUCTION

The producers often make ~ ~ $ selling agents and distributors in their channel of distribution, This is particularly true of the agricultural goods. The selling agents/distributors act in various ways. One of the methods used is to receive the goods on consignment basis. Under this system the agent receives the goods and undertakes to sell it on behalf of the consignor. He often settles the account of the consignor after all the goods received from him have been sold. This involves certain peculiarities in accounting. In this unit you will learn about various concepts relating to consignment and the basic framework of accounting for consignment transactions in the books of the consignor and the consignee.

10.2 CONCEPTS OF CONSIGNMENT

You know that goods are often sent by the producer on consignment basis to the selling agents or distributors. Let us now understand what exactly we mean by consignment, how does it differ from sale and what kind of relationship exists between the consignor and the consignee.

10.2.1 What is Consignment ?

When goods are sent by a manufacturer or a trader to an agent to be sold by him on commission basis and at the risk and account of the former, they are said to be sent on consignment. In other words a producer/trader forwards his products to his selling agents, appointed at different places, to sell them on his behalf for an agreed commission. The process of sending goods on this basis by one firm to another for sale is known as 'Consignment' and this transaction is called a 'Consignment Transaction'. The consignment is 'Outward Consignment' for the person who sends the goods and an 'Inward Consignment' for the person who receives the goods for sale.

10.2.2 Parties to Consignment

You know that in consignment the goods are sent by one person to another for sale by the latter on behalf of the fomier. Therefore. there are two parties involved: (1) the person who sends the goods and, (ii) the person to whom the goods are sent. The person who sends the goods to the agent is called the consignor and the person to whom the goods are sent for sale is called the consignee.

If 'X' sends goods to 'Y' for sale, 'X' is known as consignor and 'Y' consignee. The Consignor is the 'principal' and the consignee is the 'agent'. Their mutual relations are governed by the Law of Agency and, of course, hy the terms of the contract between themselves. The consignee is a special kind of agent who is in possession of the goods. He passes the title of the goods to those who buy from him even if he sells the goods in contravention to the principal's instructions. Suppose, the consignor instructs the consignee not to sell the goods below a certain price. If the consignee sells the goods below the stipulated price, the buyer will have good title to the goods. The consignor may, of course, ask the consignee to pay damages for breaking the terms of the contract with him. Like all agents, the consignee must render true accounts to the consignor, be faithful to him, and act according to his instructions. He is entitled to remuneration and reimbursement of expenses incurred by him on behalf of the consignor.

10.2.3 Features of Consignment

- Goods are forwarded by the consignor to the consignee with an objective of sale at a profit.
- Under the consignment. goods are to be treated as the property of the consignor and to be sold at his risk entirely. The consignee does not buy the goods, he merely undertakes lo sell them on behalf of the consignor. He is not responsible for any loss or even for any destructions or damages to the goods. But the consignee should not show any negligence.
- The consignor does not sell the goods to the consignee. Therefore, he can not ask the consignee to pay the price of the goods unless they are sold and the sale proceeds are actually realised.
- The consignee agrees to sell the goods for an agreed rate of commission and is allowed to deduct his commission due from the sale proceeds.
- The agent enters into the picture only when he sells the goods and realises the amount. He becomes indebted for amounts realised on behalf of the principal. The relationship between the consignor and the consignee is that of a principal and an agent.
- As it is not a sale, whatever the consignee does is on behalf of the consignor and, therefore, all legitimate expenses incurred by the consignee for receiving and selling the goods should be reimbursed.
- Any stock remaining unsold with the consignee belongs to the consignor.
- As the consignee acts on behalf of the consignor, the profit or loss on sale of goods sent on consignment belongs to the consignor.

10.2.4 Distinction between Sale and Consignment

Although the possession of goods is transferred from one person to the other both in case of sale and in case of consignment, they differ from each other in various ways. The difference between an outright sale and the goods sent on consignment has been explained as follows:

No. and Item	Sale	Consignment
1 Parties	Seller and Buyer	Consignor and Consignee
2 Ownership and title of goods	Ownership and title of goods is transferred to the buyer of the goods.	The legal ownerahip and title of goods is not transferred to the consignee. It remains with the consignor till they are sold.
3 Relationship	The relationship hctween the seller and the buyer of the goods is that of a creditor and debtor.	The relationship between the consignor and the consignee is that of a principal and an agent. The consignee is to sell goorls on behalf of the consignor.
4 Expenses	Expenses incurred after sale of goods are borne by the buyer.	Expenses incurred by the consignee in connection with the goods consigned to him are bome by the consignor.
5 Risk	Risk attached to the goods sold is transferred to the buyer of goods as soon as goods are sold. In case, the goods are destroyed after sale, the loss is suffered by the buyer	Risk attached to the goods consigned lies with the consignor till the goods consigned ore sold. In case the goods are destroyed the loss is borne by the consignor.
6 Return of Goods	Return of goods is not possible as goods once sold are not returnable	Goods can be returned if they are not sold by the consignee.
7 Account Sales	No Account sale is required to be submitted hy the buyer to the seller.	Account sale has to be submitted by the consignee to the consignor from time to time.
8 Unsold Goods	The seller has nothing to do with the goods which could not be resold.	Unsold goods with the consignee will be treated as stock of the consignor.

The distinction between sale and consignment given above also amply clarifies the difference between the rights and duties of the buyer and the consignee.

Check Your Progress A

1 Read the following carefully and tick mark the correct answer.

a) The relationship between the consignor and the consignee is that of
   i) Buyer and Seller
   ii) Principal and Agent
   iii) Debtor and Creditor

b) The term used for consignee's remuneration is
   i) Comtnission
   ii) .Brokerage
   iii) Discount

c) The party responsible for thk risk attached to the goods in consignment is
   i) Consignee
   ii) Consignor
   iii) Both

d) The legal ownership of the goods is not transferred till the goods are sold in case of
   i) Sale
   ii) Consignment.
   iii) Both

2 State whether the following statements are True or False.

i) .Despatch of goods on consignment amounts to sale of goods by the consignor ....

ii) All the legitimate expenses incurred by the consignee relating to consignment are borne by the consignor. ....

iii) For the consignor the consignment is an outward consignment and the same becomes an inward consignment for the consignee. ....

iv) Goods are treated as sales under consignment when they are consigned. ....

v) The consignee does not become the debtor of the consignor on receipt of goods. ....

10.2.5 Important Terms in Consignment

There are a few terms relating to consignment which are commonly used. These are proforma invoice, account sales, non-recurring and recurring expenses, commission, advance, etc. These are explained as follows:

Proforma Invoice : Since the goods sent on consignment cannot be treated as sales, the consignor does not prepare proper invoice. He simply prepares a Proforma Invoice and sends it to the consignee, along with the goods despatched. This is prepared with a view to inform the consignee about price of goods, expenses incurred, mode of transportation and the minimum sale price at which the goods are to be sold. A specimen of proforma invoice is given in figure 10.1

Figure 10.1
Specimen of Proforma Invoice.

BABBAR TRADERS

Proforma Invoice

222, Mount Road
Madras
Oct. 10, 1986

For Goods Sent on consignment basis to:
M/s Hari Kishan Enterprises,
Hauz Khas, New Delhi.

Serial No.	Particulars		Amount
		Rs.	Rs.
	500 Bush Radio sets at Rs. 600 each		3,00,000
	Charges :		
	Packing and Cartage	4,000	
	Freight	3,000	
	Insurance	6,000	13,000
	Total		3,13,000
	Goods despatched vide R.R.NO. Srmt. G.834866, Dated 10/10/86 Freight to pay,		

E. & O. E.

For Babbar Trnder
(D. BABBAR)
Partner

Note: E.&.O.E. stands for Errors and Omissions Excepted. Which mean that invoice is subject to the errors of omission and commission.

In the above invoice Babbar Traders are the consignors and Hari Kishan Enterprises the consignee. Goods worth Rs. 3,00,000 have been consigned on which a sum of Rs. 13,000 has been incurred on various expenses.

Account Sales : As the consignee is an agent and is selling the goods on behalf of the consignor, he has to furnish the details of sale proceeds, expenses, commission, etc. to the consignor. He furnishes all these details by means of a statement called 'Account Sales'. This shows the quantity and description of goods sold, sale proceeds realised, the exp. nses incurred by the consignee, commission due to him, and the balance amount payable by him to the consignor. While preparing an Account Sales the consignee will deduct all expenses incurred by him in relation to the consignment and the commission due to him. The remittances made in advance, if any, are also to be deducted from the balance so obtained. The consignee will send a bank draft or his acceptance for the balance due to the consignor. Illustration 1 will give you a clear understanding as to how an Account Sales is prepared.

Illustration 1

On January 1, 1987 Babbar Traders of Bombay consigned 500 Bush Radio sets to Hari Kishan Enterprises, Madras. The cost of each set was Rs. 750. On receiving the consignment, Hari Kishan Enterprises sent a bank draft for Rs. 25,000 as an advance to

Babbar Traders. Hari Kishan Enterprises paid Rs. 1,500 for freight. Rs, 2,000 for octroi, Rs. 2,500 for godown rent and other selling expenses. Hari Kishan enterprises submitted an Account Sale on March, 1, 1987 showing that all the sets had been sold at Rs. 850 each. They were entitled to 10% commission on sales. Prepare the Account Sales.

Solution

ACCOUNT SALES

of 500 Bush Radio Sets received from Babbar Traders, Madras

S.No.	Particulars		Amount
			Rs.
	Sale Proceeds :		
	500 Bush Radio Sets sold at Rs. 850 each		4,25,000
	Less:		
	Freight	1,500	
	Octroi	2,000	
	Godown rent & selling expenses	2,500	6,000
			4,19,000
	Less :		
	Commission at 10% on sale proceeds (i.e. Rs. 4,25,000 x 10%/100)		42,500
			3,76,500
	Less :		
	Advance (Bank Draft)		25,000
	Balance due to Babbar Traders ,remitted as per draft enclosed		3,51,500

E. & O. E. For Hari Kishan Enterprises

HARI KISHAN

Dated 01/03/87 Managing Partner

Commission : It is the remuneration paid to the consignee by the consignor in consideration of the services rendered by the former in selling the goods consigned. This commission can be divided into two types (a) Ordinary Commission, and (b) Special Commission.

a) Ordinary Commission : It is a commission usually paid as a fixed percentage on gross sale proceeds. The terms commission normally denotes ordinary commission, unless specified otherwise. The consignee is not responsible for any bad debts and he does not guarantee the payment from all those who buy on credit so long as he is getting ordinary commission only.

b) Special Commission : This is the commission which the consignee gets over and above the ordinary commission. It can be sub-divided into two categories viz., (i) Over-riding Commission and (ii) Del Credre Commission.

i) Over-riding Commission :This is an extra commission allowed over and above the normal commission and is generally offered when the agent is required to put in hard work either in introducing a new product in the market or where he is entrusted with the work of supervising the performance of other agents in a particular area. This commission is also given for sales at prices higher than the price fixed by the consignor.

ii) Del Credre Commission : Usually, all the losses are borne by the consignor. Sometimes the consignor expects that the consignee should also be responsible for recovering the debts and bear the loss on account of bad debts, if any. In order to compensate him for this responsibility he is given some extra commission called 'Del Credre Commission'. Such commission is calculated on the total sales unless there is a special agreement to the effect that it is to be paid only on the amount of credit sales. Payment of this commission imposes extra liability on the consignee and induces him to deal in a prudent and cautious manner.

In Illustration 2 we have given you the details regarding the computation of commission. It would certainly give you an idea about the calculation of normal commission and special commission.

Illustration 2

Rajadhani Cycles Ltd, sent 2,000 dynamos costing Rs. 50 each for sale on consignment basis to Banerjee & Co. Calcutta. Normal selling price per dynamo is Rs. 60. Consignee is entitled to commission at i) 5% on normal selling price; ii) 10% additional commission on excess sales and iii) 1 ½% Del credre commission on total sales for guaranteeing collection of credit sales. Banerjee & Co. reported sales of 500 dynnmos at Rs. 60 each and dynamos at Rs. 75 each on cash basis and 400 dynamos at Rs. 75 each and another 400 at Rs. 80 each on credit basis, Compute consignee's commission.

Solution :

Total Sales :

500 units @ Rs 60 each	30,000
200 units @ Rs 75 each	15,000
400 units @ Rs 75 each	30,000
400 units @ Rs 80 each	32,000
	1,07,000

i) **Normal Commission :**

5% on normal price of goods sold.
Number of units sold are: 1,500 (500 + 200 + 400 + 400)
Normal selling price per unit : Rs. 60
Normal Sale: 1500 x 60 = Rs. 90,000
Normal Commission: $\frac{5}{100} \times 90,000$ = Rs. 4, 500

ii) **Additional Commission : 10% on amount realized in excess of the normal price**

	Rs.
Total Sales Value:	1,07,000
Normal Sales Value:	90,000
Excess Sales Value:	17,000

Additional Commission: $\frac{10}{100} \times 17,000$ = Rs. 1, 700

iii) **Del Credre Commission**

$1\frac{1}{2}$% on Total Sales

$\frac{3}{200} \times 1,07,000$ = Rs. 1,605

Total Commission (i) + (ii) + (iii) = Rs.4,500 + Rs.1,700 + Rs.1,605
= Rs. 7,805

Expenses: Expenses relating to consignment of goods are divided into two categories viz., (i) Non-recurring Expenses. and (ii) Recurring Expenses.

i) Non-recurring Expenses: All the expenses which are incurred for bringing goads to the godown of the consignee are non-recurring in nature. Such expenses arc generally incurred on the consignment as a whole, The non-recurring expenses will be incurred partly by the consignor and partly by the consignee.

The consignor usually incurs expenses on sending the goods to the consignee such as packing, cartage, loading charges, insurance, freight, ctc. The consignee usually incurs expenses on receiving the goods from the consignee such as dock dues, customs duty, clearing charges, octroi, etc.

ii) Recurring Expenses : These expenses are incurred after the goods have reached the consignee's place or godown. They are recurring in nature because they may be incurred repeatedly by the consignor and the consignee. The examples of recurring expenses incurred by the consignor are: advertising, discount on hills, commission on collection of cheques, travelling, expenses of salesmen. bad debts etc. The examples of recurring expenses incurred by the consignee are godown rent: godown insurance, sales promotion, etc.

Advance : It is a common trade practice for the consignor to demand some advance from the consignee as a security for the goods despatched to him. It may be in the form of cash or bank draft or in the form of a bill of exchange. The consignee will send some amount as an advance before or after he receives the goods from the consignor. The advance received from the consignee should not be credited to consignment account as it is not a part of the sale proceeds. The advance will be adjusted against the amount due from the consignee when the accounts are finally settled. In some cases, a bill may be drawn on the consignee if he is not in a position to pay advance money. The consignor can discount the bill with his bankers. In such a case the value of the hill (as advance) so accepted will be deducted from the sale proceeds. The discount paid to the bank can be straight away charged to the Profit & Loss Account as it represent cost of raising finance.

Check Your Progress B

1 Distinguish between Account Sales and Sales Account?

....

....

....

....

2 Under what circumstances can the consignee get a special commission'?

....

....

....

....

3 Fill in the blanks :

i) E. & O.E. stands for ....

ii) Consignor allows .... Commission to the consignee to bear the bad debts.

iii) .... expenses are those expenses which arc incurred after the goods reach the consignee's godown.

iv) The consignee gives advance to the consignor as a .... for goods despatched.

v) Unloading charges paid by the consignee are .... expenses.

10.3 ACCOUNTING TREATMENT

The transactions relating to each consignment are recorded in such a way that the profit or loss of each consignment can be worked out separately. For this purpose the consignor prepares a Consignment Account relating to each consignment to which all concerned expenses including the cost of goods consigned are debited and the sales proceeds and the closing stock are credited. In addition, he also maintain a consignee's account in order to compute the amount due from him. The consignee, on the other hand, simply maintains consignor's account in his books to which he debits the amounts remitted to the consignor the expenses incurred by him in relation to the consignment and the commission due to him. Consignor's Account is credited mainly by the amount of sale proceeds. Now let us study how various transactions related to consignment are recorded in the books of the consignor and the consignee.

10.3.1 Books of the Consignor

You know each transaction is recorded first in a subsidiary book and then posted to the respective accounts in the ledger. All transactions related to consignment therefore, are first recorded in the Journal. The entries passed in respect of various transaction are as follows:

Goods despatched to the consignee: As you know the consignment of goods cannot be treated as a sale of goods. Therefore, Sales Account will not be credited. In its place. an account called 'Goods sent Consignment Account' will be credited and the Consignment Account is debited with the cost of the goods consigned'. Thus the journal entry will be as follows:

Consignment A/c Dr.
To Goods Sent on Consignment A/c
(Being the value of the consignment)

If consignments have been sent to more than one consignee, the consignment accounts may be distinguished by adding the names of the places to the Consignment Account. (For example Consignment to Calcutta Account, Consignment to Gonda Account, etc.)

2 Expenses incurred by the consignor : All expenses incurred by the consignor on consignment of goods are debited to the Consignment Account and are thus added to cost of goods consigned. The entry would be:

Consignment A/c Dr.
To Cash / Bank A/c
(Being the expenses incurred on the consignment)

3 Advance made by the consignee : The amount of advance received from the consignee cannot be treated as sale proceeds, and so should not be credited to the Consignment Account. It is treated as follows.

Cash/Bank/Bills Receivable A/c Dr.
To Consignee's A/c
(Being an advance from the consignee)

4. Bill received from the consignee discounted with the bank : If the consignor gets the bills receivable discounted from his bankers, the entry will be :

Bank A/c Dr.
Discount A/c Dr.
To Bills Receivable A/c
(Being bill discounted with the bank)

5 **Receipt** of account sales from the consignee : When the goods are sold out, the consignee will send an Account Sales to the consignor intimating him the total sales and the amount of his expenses and commission. The following three entries will be recorded in this connection

a) For sales made by the **consignee :**

Consignee's A/c Dr.
To Consignment A/c
(Being gross proceeds of sales)

b) For consignee's **expenses :**

Consignment A/c Dr.
To Consignee's A/c
(Being expenses incurred by the consignee in dealing with consignment)

c) For consignee's **commission:**

Consignment A/c Dr.
To Consignee's A/c
(Being commission payable on sale proceeds)

6 Goods **returned** by the consignee: Sometimes defective or obsolete goods are returned by the consignee to the consignor. When such goods are received, the journal entry will be :

Goods Sent an Consignment A/c Dr.
To Consignment A/c
(Being goods returned by the consignee)

7 **Bad debts incurred:** When the consignee is entitled to del credre commission no entry for bad debts is to be passed as such loss is to be borne by the consignee himself. But when del credre commission is riot paid, the loss on account of bad debts is to be borne by the consignor, the entry will be:

Consignment A/c Dr.
To Consignee's A/c
(Being value of bad debts)

8 **Remittance by the consignee in full settlement:** The balance amount will have to be remitted by the consignee to the consignor on settlement of the account. The following entry will be recorded, when the consignee remits to the consignor:

Cash/Bank/Bills Receivable A/c Dr.
To Consignee's A/c
(Being balance due from the consignee received).

9 **Profit or loss on consignment:** When you balance the Consignment Account, it reveals profit or loss. If the total of credit side is more than the total of debit side it is a profit and if the total of debit side is more than that of the credit side, it is a loss. The profit or loss is transferred to the Profit & Loss Account and thus the Consignment Account is closed.

The following entries will be recorded:

a) **If there is a profit:**

Consignment A/c Dr.
To Profit & Loss A/c
(Being profit on consignment)

b) **If there is loss:**

Profit & Loss A/c Dr.
To Consignment A/c
(Being loss on consignment)

10 **Closing entry for goods sent on consignment** : Goods sent on Consignment Account is closed by transfer to the Trading Account. The entry passed is as follows:

Goods Sent on Consignment A/c Dr.
To Trading A/c
(Being goods sent on consignment account closed)

11 **Unsold stock with the consignee:** It is quite possible that all the goods sent on consignment are not sold by the consignee up to the date on which final accounts are prepared.' Some goods may remain unsold known as the consignment stock. This should be properly valued and credited to the Consignment Account. Ybu will learn about the valuation of unsold stock in unit 11. However, the entry for consignment stock will be

Consignment Stock A/c Dr.
To Consignment A/c
(Being unsold goods with the consignee)

You have learnt how to record consignment transactions in the Journal of the consignor. Now let us see how various accounts effected are shown in the ledger and how profit or loss on consignment is worked out. The consignor usually maintains the following three accounts:

1 **Consignment Account:** It is prepared by the consignor showing all transactions relating to a particular consignment. The objective of this account is to ascertain net profit/loss arising from each consignment. Once goods are consigned by the consignor, its cost is debited to the Consignment Account alongwith various expenses incurred by the consignor and the consignee in dealing with that particular consignment. The commission due to the consignee is also debited to the Consignment Account. When Del Credre commission is not paid, the bad debts, if any, are also to be debited to this account. Once the goods reach the consignee some of these will be unsold and the rest sold either on cash or on credit, Irrespective of the type of sale, the entire sale proceeds will be shown on the credit side of

the Consignment Account. The unsold goods are treated as consignment stock and credited to this Account. If same goods are found unsuitable for sale, the consignee will send them back to the consignor and the same will appear on the its credit side. After all these items are recorded, the Consignment Account is balanced. The difference between the debit and credit totals of Consignment Account is regarded as profit or loss which is transferred to the Profit and Loss Account and the Consignment Account stands closed. It is infact a nominal account and is just like Trading and Profit and Loss Account about which you have studied earlier in final accounts. Therefore, the principles applied to Trading and Profit & Loss Account hold good for this account also. Like Trading and Profit & Loss Account all expenses and purchases are debited to this account and all sales and incomes are credited. The proforma of the consignment account is given in Figure 10.2.

Figure 10.2

Consignment to Patna Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.			Rs.
	To Goods Sent on Consignment A/c	xxx		By Consignee's A/c (Cash and Credit sales).	xxx
	To Cash A/c (Consignor's Expenses)	xxx		By Goods Sent on Consignment A/c (Goods returned by the Consignee)	xxx
	To Consignee's A/c (Consignee's Expenses)	xxx			
	To Consignee's A/c (Commission)	xxx		By Consignment Stock A/c (Unsold Stock)	xxx xxx
	To Consignee's A/c (Bad Debts if any)	xxx		By Profit and Loss A/c (Loss transferred)	xxx
	To Profit and Loss A/c (Profit transferred)	xxx			
		xxxx			xxxx

2 Goods Sent on Consignment Account: This is a real account. It deals with the goods transferred from the consignor to the consignee and goods returned by the consignee to the consignor. All the goods consigned by the consignor will be credited lo this account and the goods returned by the consignee are debited to this account. The balance represents the cost of goods with consignee for sale, and is transferred to the Trading Account. The proforma of the Goods Sent on Consignment Account is depicted in Figure 10.3

Figure 10.3

Goods Sent on Consignment Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.			Rs.
	To Consignment A/c (Goods returned)	xxx		By Consignment A/c (Goods consigned)	
	To Trading A/c (Balance transferred)	xxx			
		xxx			xxx

3 Consignee's Account: It is a personal account of the consignee. It is prepared for ascertaining the amount due from the consignee. The consignee's account is debited with all cash and credit sales effected by the consignee. The various expenses incurred hy the consignee, the commission charged by him as well as the-advance remitted by him are credited to this account. This account usually shows a debit balance indicating the amount due from the consignee. At times it may show credit balance, if the advance given by the consignee is more than the sale affected by him. The balance revealed by this account is shown in the balance sheet of the consignor, debit balance on the assets side, and credit balance on the liabilities side, unless the account is settled by the required remittance. Figure 10.4 shows the proforma of Consignee's Account.

Figure 10.4

Consignee's Account

Dr.					Cr.
Date	Particulars	Amount	Date	Particulars	
		Rs.			
	To Consignment A/c (Cash and Credit Sales)	xxx		By Cash/Bank/Bills Receivable A/c (Advance)	xxx
				By Consignment A/c (Consignee's Expenses)	xxx
				By Consignment A/c (Consignee's Commission)	xxx
				By Banks A/c or Balance c/d	
		xxx			xxxx

Look at Illustration 3 and see how various transactions relating to consignment are recorded in the books of the consignor

Illustration 3

Bush Radio 4 Co,, Delhi sent on consignment to Chadda & Co., Calcutta 100 radio sets, invoiced at Rs. 100 each on January 6, 1986. Bush Radio & Co. paid Rs. 1,000 on the same day for despatching goods to the consignee. Consignee remitted Rs. 5,000 as an advance by bank draft on January 14. The consignee is entitled to a commission of 10% on the sale proceeds. On receipt of goods the consignee paid Rs. 1,000 for freight and Rs. 500 for godown charges.
On January 28, Chadda & Co. sent an Account Sales showing that the radio sets have realised Rs. 200 each. He remits the amount due to Bush Radio & Co. Pass Journal entries and prepare ledger accounts in the books of the consignor.

Books of Bush Radio & Co., Delhi

JOURNAL

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1986			Rs.	Rs.
Jan. 6	Consignment to Calcutta A/c Dr.		10,000	
	To Goods Sent on Consignment A/c			10,000
	(Being cost of consignment sent to Chrdda & Co.)			
" 6	Consignment to Calcutta A/c Dr.		1,000	
	To Bank A/c			1,000
	(Being expenditure incurred on despatching of goods)			
" 14	Bank A/c Dr.		5,000	
	To Chadda & Co.			5,000
	(Being receipt of an advnnce payment from the consignee)			
" 28	Consignment to Calcutta A/c Dr.		1500	
	To Chadda & Co.			1500
	(Being expenses paid by the consignee)			
" 28	Chadda & Co. Dr.		20,000	
	To Consignment to Calcutta A/c			20,000
	(Being the gross proceeds of sales made by tho consignee)			
" 28	Consignment to Calcutta A/c Dr.		2,000	
	To Chadda & Co.			2,000
	(Being commission payable on sale proceeds)			

Jan. 31	Bank A/c Dr. To Chadda & Co. (Being balance payment received from the consignee)		11,500	11,500
" 31	Consignment to Calcutta A/c Dr. To Profit & Loss A/c (Being Profit on consignment transferred to Profit & Loss Account)		5,500	5,500
" 31	Goods Sent on Consignment A/c To Trading A/c (Being goods sent on consignment transferred to Trading Account)		10,000	10,000

LEDGER

Consignment to Calcutta Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1986		Rs.			Rs.
Jan. 6	To Goods Sent on Consignment A/c	10,000	Jan, 28	By Chadda & Co.	20,000
" 6	To Bank A/c (Consignor's Expenses)	1,000			
" 14	To Chadha & Co (Consignee's Expenses)	1,500			
" 28	To Chadha & Co (Consignee's Commission)	2,000			
" 31	To Profit & Loss A/c (Profit transferred)	5,500			
		20,000			20,000

Goods Sent on Consignment Account

1986		Rs.	1986		Rs
Jan. 30	To Trading A/c	10,000	Jan. 6	By Consignment to Calcutta A/c	10,000

Chadha & Co's Account

1986		Rs.	1986		Rs.
Jan. 28	To Consignment to Calcutta A/c (Sale Proceeds)	20,000	Jan. 14	By Bank A/c (Advance)	5,000
			" 28	By Consignment to Calcutta A/c (Expenses)	1,500
			" 28	By Consignment to Calcutta A/c (Commission)	2,000
			" 28	By Bank A/c (Balance received)	11,500
		20,000			20,000

10.3.2 Books of the Consignee

The Consignee mainly prepares a consignor's account in his books to find out what is finally due to the consignor. He records all transactions relating to the consignment first in the Journal and then posts them tb-the relevant accounts (including Consignor's Account) in the ledger. The journal entries passed by the consignee are:

1 **Receipt of goods from the consignor:** No entry is passed by the consignee when he receives goods from the consignor because receipt of goods on consignment does not amount to purchases of goods by him. He keeps them in his godown on behalf of the consignor for which he usually maintains an Inwards Consignment Book.

2 **Expenses incurred by the consignor:** No entry is passed by the consignee.

3 **Advance made by the consignee**

Consignor's A/c Dr.
To Bank/Bills Payable A/c
(Being advance made by the consignee)

4 **Bill discounted by the consignor with the bank:** No entry is passed by consignee.

5 **Sale of goods by the consignee**

Cash A/c (cash sales) Dr.
Consignment Debtors A/c Dr.
(Credit sales)
To Consignor's A/c
(Being goods sold)

6 **Expenses incurred by the Consignee:** Being an agent of the consignor, all legitimate expenses incurred by the consignee related to the consignment are to be reimbursed by the consignor, the entry will be:

Consignor's A/c Dr.
To Cash/Bank A/c
(Being expenses incurred on consignment)

7 **Commission due to the consignee:** This should include all types of commissions due to the consignee: The entry will be

Consignor's A/c Dr.
To Commission A/c
(Being commission due on sales)

8 **Return of goods to the consignor:** No entry will be passed in the books of the consignee as no entry was passed at the time of receipt of the goods.

9 **Payment received from debtors**

Cash/Bank A/c Dr.
To Consignment Debtors A/c
(Being amount collected from debtors)

10 **Bad debts incurred**

a) If consignee does not get del credre commission all bad debts have to be borne by the consignor himself. The entry will be.

Consignor's A/c Dr.
To Consignment Debtors A/c
(Being bad debts on consignment)

b) If del credre commission is paid to the consignee, the bad debts are to be borne by him. The entry will **be:**

Bad Debts A/c Dr.
To Consignment Debtors A/c
(Being bad debts incurred on consignment)

11 **When the bills payable accepted in favour of consignor is met on the due date:**

Bills Payable A/c Dr.
To Bank A/c
(Being bills payable honoured)

12 **Remittance In final settlement**

Consignor's A/c Dr.
To Cash/Bank Account
To Bills Receivable Account
(Being payment of the balance due to the consignor)

13 Unsold stock in possession of the consignee: No entry will be passed for unsold goods in the books of the consignee as no entry is passed when he received goods from the consignor.

14 Profit or Loss on consignment: No entry is passed for profit or loss on consignment as the consignee is not concerned with it.

The Consignee also prepares ledger accounts after passing all the journal entries. The Consignor's Account and Commission Account are the two important accounts prepared by the consignee in his books. Of course, he will also do the postings to the other accounts such as Consignment Debtor's Account, Consignment Expenses Account and Bills payable Account, etc. But these are of less importance, hence not discussed here.

1 Consignor's Personal Account: This is the main account in Consignee's ledger which is prepared for working out the amount due to the consignor. Whatever amount he receives from sales of goods is credited to this account. All expenses incurred by the consignee in relation to consignment, the commission due to him, and the advance given by him to the consignor will be debited to this account. Further, if the consignee does not. get del credre commission, the bad debts on account of credit sales are also debited to the Consignor's Account. The balance of this account indicates the amount payable to the consignor. This account is just the opposite of the Consignee's Account in the books of the consignor. The profonna of the Consignor's Account is given in Figure 10.5

Figure 10.5

Consignor's Personal Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.			Rs.
	To Bank/Cash A/c (Consignee's Expenses)	xxx		By Bank A/c (Cash Sales)	xxx
	To Bank/Bills Payable A/c (Advance)	xxx		By Consignment A/c (Credit Sales)	xxx
	To Commission A/c (Consignee's Commission)	xxx		By Bank A/c (Balance remitted)	xxx
		xxx			xxx

2 Commission Account: This is nominal account. It shows the income earned by the consignee for the services rendered by him. All types of commission whether, ordinary or special, due to the consignee is credited to this account. The Commission Account will be debited with had debts if the consignee is to bear such loss because of del credre commission. The proforma of the commission Account is given in Figure 10.6

Figure 10.6

Commission Account

Dr. Cr.

		Rs.			Rs.
	To Bad Debts A/c	xxx		By Consignor's A/c (Consignee's Commission)	
	To Profit & Loss A/c	xxx			
		xxx			

Taking the data of Illustration 3 let us see how transaction related to consignment will be recorded in the books of the consignee, Books of Chadha & Co.

JOURNAL

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1986			Rs.	Rs.
Jan. 14	Bush & Co. Dr. To Bank A/c (Being advance paid by the consignee)		5,000	5,000
" 15	Bush & Co. Dr. To Cash/Bank/A/c (Being expenses incurred on consignment)		1,500	1,500
" 28	Bank A/c Dr. To Bush & Co. (Being cash sales on consignment)		20,000	20,000
" 28	Bush & Co. To Commission A/c Dr. (Being commission due on goods sold)		2,000	2,000
" 31	Bush & Co. Dr. To Bank A/c (Being balance payment made)		11,500	11,500

LEDGERS

Bush & Co's Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.	1986		Rs.
Jan. 14	To Bank A/c	1,500	Jan. 31	By Bank A/c (Sales)	20,000
" 14	To Bank A/c (Advance)	5,000			
" 14	To Commission A/c	2,000			
" 14	To Bank A/c (Balance)	11,500			
		20,000			20,000

Commission Account

Date	Particulars	Amount	Date	Particulars	Amount
1986		Rs.	1986		Rs.
Jan, 31	To Profit & Loss A/c	2,000	Jan. 28	By Bush & Co.	2,000

Check Your Progress C

1 Fill in the blanks.

i) All expenses incurred by the consignee are .... to Consignment Account.

ii) When the defective goods are returned by the consignee, the consignor debits it to ....,. Account.

iii) When there is no del credre commission, bad debts ate borne by the ....

iv) Consignment Account is similar to .... Account.

v) Consignee passes .... entry for closing stock.

vi) Commission Account is a .... Account.

2 Explain why the consignee does not pass any entry for

a) Goods sent on Consignment

b) Profit or loss on consignment, and

c) Closing stock.

....

....

....

....

10.4 LET US SUM UP

Consignment is a kind of arrangement where the manufacturer or a trader sends goods to his agents for sale to small traders or consumers. The agents sell goods on behalf of the manufacturer or the trader. The person who sends the goods is called the consignor and the person to whom the goods are sent is called the consignee. The relationship between the consignor and the consignee is that of a principal and an agent.

While sending goods to the consignee, the consignor sends a proforma invoice which gives full details about the goods consigned. After the goods have been sold, the consignee prepares an Accouht Sales, giving full details about the number of units sold, the price at which they have been sold, and the expenses and commission due to him.

The consignee is entitled to commission for the services rendered to the consignor. The commission can be ordinary or special commission.

In order to work out the profit or loss on each consignment and the amount due from each consignee, the consignor prepares Consignment Account, Goods Sent on Consignment Account and Consignee's Personal Account in his ledger for each consignment. The consignee, on the other hand, mainly prepares two accounts in his books viz., Commission Account and Consignor's Personal Account.

This helps him to know the amount due to the consignor and his income from commissions.

10.5 KEY WORDS

Account Sales: A statement submitted by the consignee to the consignor giving account of the sale proceeds, details of various expenses incurred, and the commission due to him.

Consignee: A person to whom the goods are sent on consignmeat basis.

Consignment: Goods sent by a producer or a trader to his agents for sale on their behalf and at their risk.

Consignor: A person who sends the goods to his agents on consignment basis.

Del Credre Commission: Commission paid by the consignor to the consignee for bearing the risk of bad debts arising out of credit sales made by him on behalf of the consignor.

Over-riding Commission: It is the commission over and above the normal commission paid to the consignee for extra services provided by him or excess price realized by him.

Proforma Invoice: A statement prepared by the consignor and sent to the consignee giving details of goods consigned.

10.6 SOME USEFUL BOOKS

Maheshwari, S.N. 1986. *introduction to Accounting.* Vikas Publishing House: New Delhi. (Chapter 1 Section II).

Patil, V.A. and **J.S.** Korlahalli. 1986. *Principles* and *Practice* of *Accounting*, R. Chand & Co. : New Delhi. (Chapter **2).**

William Pickles. 1982. *Accountancy*, R.L.B.S. and Pitman: London. (Chapter 17).

Gupta, R.L. and M. Radhaswamy. 1986. *Advanced Accountancy,* Sultan Chand & Sons; New Delhi (Chapter 15).

10.7 ANSWERS TO CHECK YOUR PROGRESS

A 1 a) ii b) i c) ii d) ii

2 i) False ii) Tme iii) True iv) False v) True

B 3 i) Errors and Omissions Excepted.

ii) Del Credre Commission iii) Recurring iv) security

v) Non-recurring

C 1 i) debited ii) Goods Sent on Consignment
iii) Consignor iv) Trading and Profit & Loss Account.
v) no vi) nominal

10.8 TERMINAL QUESTIONS/EXERCISES

Questions

1 "Consignment is the same thing as sale". Discuss.

2 What is an 'account sales'? How do you prepare it? State how it is useful to the consignor?

3 Distinguish between
a) Non-recurring and Recurring Expenses
b) Ordinary Commission and Del Credre Commission
c) Account Sales and invoice

Exercises:

1 'X' & Co. Bombay consigned 250 Weston T.V. sets to 'Y' & Co. Banglore. Each T.V. set costs Rs. 7,500. Y & Co. received the consignment and sold the sets as follows:

160 T.V. sets at Rs. 9,000 each on cash basis and
90 T.V. sets at Rs. 10,500 each on credit basis

The consignor allowed 5% normal commission and 2-1/2% del credre commission to the consignee on the sales effected by him. Compute total commission due to Y & Co.

(Answer: Normal Commission Rs. 1,19,250; Del Credre Commission Rs. 59,625)

2 Harish & Co. Lucknow, consigned goods valued at Rs. 1,25,000 to Dinesh Enterprises, Ahmedabad. Harish paid Rs. 1,800 towards freight, insurance and carriage, Dinesh received the consignment and accepted a bill for Rs. 50,000. He paid Rs. 1,500 for freight, Rs. 2,200 for carriage and godown rent, and Rs. 2,500 as salesman's salaries. The consignee is allowed to take 7% commission on the total sales. Consignee sold all goods for Rs. 1,68,000. Balance owed by Dinesh was remitted by a bank draft. Prepare an Account Sales.

(Answer: Balance due from the consignee: Rs. 1,00,040)

3 On January 1, 1987 Gopal Enterprises, Hyderabad, sent 50 radio sets to Rakesh & Co., Bombay invoiced at Rs. 1,200 per set and incurred the following expenses in relation to the consignment: dock dues Rs.2,000; customs duty Rs.1,000 and frieght Rs.2,300. Rakesh & Co. remitted Rs.20,000 by bank draft on January 5, 1987. It sold all the sets at Rs 1,500 each by January 31, 1987 and incurred Rs. 2,500 as godown rent. Commission is allowed at 5% on sales, The consignee sent the Account sale and enclosed a bank draft for the balance.

Journalise the above transaction in the books of the Consignor and the Consignee. Also prepare necessary ledger accounts and calculate the profit on consignment.

(Answer: Profit on consignment Rs. 3,450; Balance due from the consignee Rs. 48,750)

4 Krishna of Bombay consigned goods costing Rs. 2,50,000 to Kajriwal of Jodhpur. Krishna paid Rs. 1,500 for carriage and Rs. 5,250 for freight and insurance. Kajriwal is entitled to a commission of 5% on all sales in addition to 2% del credre commission. Krishna draws on Kajriwal a bill for Rs. 80,000, payable two months after date, which the latter accepts. The bill is discounted with the bank for Rs. 79,000. An Account sale is received from Kajriwal stating that the goods had been sold for Rs. 3,10,000 (Rs. 1,60,000 on credit and Rs. 1,50,000 for cash), while expenses incurred by him were: unloading Rs. 1,250; godown rent Rs. 2,500 insurance Rs. 500. A bank draft was enclosed for the balance due. Kajriwal could not recover Rs. 2,500 from a customer to whom goods were sold on credit.

Pass Journal entries in the books of the consignor and the consignee and prepare necessary ledger accounts.

Hints:

i) Discount will not be debited to consignment Account
ii) Bad Debts will be borne by the Consignee and debited to his commission account.
iii) Del Credre commission is computed on total sales.

(Answer: Profit on consignment Rs. 27,300; Amount due from consignee Rs. 2,04,050.)

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 11 CONSIGNMENT ACCOUNTS-II

Structure

11.0 OBJECTTVES

After studying this unit you should be able to:

- record consignment transactions directly in the ledger accounts of the consignor and the consignee
- compute the value of unsold stock
- explain the nature of normal and abnormal losses
- compute the value of unsold goods in case of normal loss
- explain the treatment of normal and abnormal losses of goods and their impact on profit.

11.1 INTRODUCTION

In Unit 10 you leamt about the basic accounting framework relating to the goods sent on cohsignment basis i.e., the entries to be passed in the books of consignor and the consignee. You know the method of working out the profit on each consignment when all goods are sold out. In practice you will find that at the time of submitting the Account Sales, some goads may remain unsold. Then, there is also a possibility of loss while the goods are in transit or while they are lying in the godown of the consignee. Such loss may occur due to normal or abnormal causes. In this unit you will learn how the value of unsold goods is worked out and recorded in books of account. You will also learn about the treatment of normal and abnormal losses which may take place in transit or in the godown of the consignee and their impact on valuation of stock and the profit on consignment.

11.2 DIRECT RECORDING IN THE LEDGER

You know for each consignment the consignor prepares the consignment Account, the Goods Sent on Consignment Account and the Consignee's Account in his books, whereas the consignee prepares the Consignor's Account and the Commission Account in his books. In Unit 10 you Ieamt that all transactions relating to consignment are first recorded in the Journal and then posted into the above mentioned ledger accounts. Sometimes, you may be asked to prepare the ledger accounts directly i.e., without passing any journal entries. You should therefore learn how to prepare these accounts directly.

You should debit the Consignment Account with the cost of goods consigned, expenses

Hints:

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ii) Bad Debts will be borne by the Consignee and debited to his commission account.
iii) Del Credre commission is computed on total sales.

(Answer: Profit on consignment Rs. 27,300; Amount due from consignee Rs. 2,04,050.)

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You should debit the Consignment Account with the cost of goads consigned, expenses incurred by the consignor, expenses incurred by the consignee and the consignee's commission; and credit it with sales (both cash and credit) and the goods returned by the consignee. The Consignee's Account will be debited with the sales made by him and credited with his expenses, commission and the remittances made to the consignor.

The Consignor's Account in the books of consignee is just the reverse of Consignee's Account in Consignor's books. It is debited with the expenses incurred by the consignee, the commission due to him and the remittances made to the consignor on account; and credited with the total amount of sales.

Look at Illustration I and see how the consignment transactions are recorded directly in the ledger accounts.

Illustration 1

Gursharan & Co. of Delhi consigned on January 1, 1988, 50 cases of glassware costing Rs. 40.000 to Singh & Co. of Calcutta for sale on commission @ 5% on gross sale proceeds. Gursharan & Co. paid Rs. 500 for freight and carriage and Rs. 600 for packing.

Singh & Co. took the delivery of goods on January 5, 1988 and paid Rs. 300 for clearing charges, Rs. 200 for carriage, Rs. 50 for miscellaneous expenses, and Rs, 100 for godown rent.

They sold 15 cases @ Rs. 1,000 each, 25 cases @ Rs. 1,200 each and 10 cases @ Rs. 1,100 each.

On April 5, 1988 Singh & Co. sent a bank 'draft for Rs. 15,000 to Gursharan & Co. on account, On April 10, 1988 Singh & Co. forwarded an Account Sales together with a bill of exchange for the balance due.

Prepare the necessary ledger accounts in the books of both the parties.

Solution

Books of Gursharan & Co.

Consignment to Singh & Co's Account

Dr. Cr.

Date	Particulars		Amount	Date	Particulars	Amount
1988			Rs.	1988		Rs.
Jan. 1	To Goods Sent on Consignment A/c		40,000	Apr.10	By Singh & Co. (Sales)	56,000
" 1	To Bank A/c					
	Freight and Carriage	500				
	Packing	600	1,100			
Apr.10	To Singh & Co. (Expenses)					
	Clearing charges	300				
	Carriage	200				
	Misc. Expenses	50				
	Godown Rent	100	650			
" 10	To Singh & Co. (commission)		2,800			
" 10	To Profit & Loss A/c (Profit transferred)		11,450			
			56,000			56,000

Goods Sent on Consignment Account

Date	Particulars	Amount	Date	Particulars	Amount
1988		Rs.	1988		Rs.
Apr.10	To Trading A/c	40,000	Jan. 1	By Consignment to Singh & Co. A/c	40,000

Singh & Co's Account

1988		Rs.	1988		Rs.
			Apr. 5	By Bank A/c	15,000
Apr. 10	To Consignment to Singh & Co. A/c	56,000	" 10	By Consignment to Singh & Co. A/c (Expenses)	650
			" 10	By Consignment to Singh & Co. A/c (Commission)	2,800
			" 10	By Bills Receivable A/c (Balance)	37,550
		56,000			56,000

Uooks of Singh & Co

Gursharan & Co's Account

Dr.					Cr.
1988		Rs.	1988		Rs.
Apr. 5	To Bank A/c	15,000	Apr. 10	By Bank A/c (Sales)	56,000
" 10	To Cash A/c (Expenses)	650			
" 10	To Commission A/c	2,800			
" 10	To Bills Payable A/c	37,550			
		56,000			56,000

Commission Account

1988		Rs.	1988		Rs.
Apr. 10	To Profit & Loss A/c	2,800	Apr. 10	By Gursharan & Co. A/c	2,800

11.3 UNSOLD STOCK

In Illustration 1 you saw that Singh & Co. sold all the goods consigned to them. But, in practice, you will find that at the time of submitting the account sale, a part of goods consigned will still be unsold arid will be lying with tlie consignee. In order to calculate tlie true profit or loss on consigninent the unsold stock should be valued and accounted for. Let us therefore learn first how the unsold stock is valued.

11.3.1 Valuation of Unsold Stock

You know that valuation of unsold stock is usually done at cost. Cost in case of consignment stock would include the cost at which the goods are consigned plus the proportionate non-recurring expenses i.e., all those expenses incurred till the goods reach the godown of the consignee. You should note that all non-recurring expenses, whether incurred by the consignor or by the consignees, are to be taken into account. In the absence of details of expenditure incurred by the consignee, all expenses incurred by him are to be taken as recurring expenses and thus are not to be considered in the calculation of closing stock. In other words, while valuing the closing stock we add such proportionate expenses to the cost price that have been incurred upto the time the goods are brought to the plnce of the consignee. Any other expenses paid by the consignor or the consignee after this point will not be considered, as these expenses do not add to the value of the goods. Such expenses are godown rent, selling expenses, carriage outwards, godown insurance, discount etc.

Following expenses are usually added for calculation of closing stock.

Carriage and Freight
Loading Charges
Customs Duty
Clearing Charges
Dock dues
Carriage paid upto the godown
Unloading Charges

Following are the expenses which are not considered for calculation of closing stock

Godown Rent
Discount
Bad Debts
Insurance of the goods in the godown
Selling and Distribution Expenses.

You will notice that all expenses incurred by the consignor are considered for valuation of the closing stock. The problem arises only in case of consignee's expenses. The consignee's expenses which are to be included in the value of closing stock are those expenses which are incurred till the goods reach the godown of the consignee. Any other expenses incurred thereafter are ignored for purposes of closing stock valuation.

Look at Illustration 2 and see how the unsold stock is valued.

Illustration 2

A sent goods worth Rs. 10,000 to B and paid Rs. 1,200 for packing and Rs. 800 for insurance. B took the delivery of the goods and paid Rs. 2,000 for freight, Rs. 400 for cartage and unloading, Rs. 600 for godown rent, Rs. 400 as selling expenses and Rs. ROO for insurance, B sold three fourth of the goods for Rs, 1,800. Calculate the value of closing stock.

Solution

1. Coat of Unsold Stock:	Rs. 2,500	(1/4 of 10,000)
2. Non-recurring Expenses :		
Incurred by Consignor	Ks, 2,000	(1,200 + 800)
Incurred by Consignee	Rs. 2,400	(2.000 + 400)
	Rs. 4,400	

3 Value of Closing Stock :

$$\text{Cost of Unsold stock} + \left(\text{Non-recurring Expenses} \times \frac{\text{Cost of Unsold Stock}}{\text{Cost of Goods Consigned}}\right)$$

= Rs. 2.500 + (4,400 × 2,500/10,000)
= Rs. 2.500 + 1,100
= Rs. 3,600

Note : The godown rent, selling expenses and insurance being recurring expenses have not been included in tne value of closing stock

11.3.2 Accounting Treatment of Unsold Stock

Since the value of unsold stock affects the profit or loss on any consignment, its valuation and recording In the books of consignor is very important, It is shown on the credit side of Consignment Account for which the following journal entry will be passed.

Consignment Stock A/c Dr.
To Consignment A/c
(Being the value of closing stock)

The Consignee, however, will not pass any entry for the closing stock. It is because he is not the owner of the goods and does not pass any entry even when he receives or returns the goods,

Look at Illustration 3 and see how the closing stock is valued and treated in the books of account.

Illustration 3

On January 1,1988 Universal Sports, Delhi consigned 180 cases of sports goods costing Rs. 360 each to Gemini Sports, Bombay. They paid Rs 360 for insurance nnd Rs. 1,800 for freight. Gemini Sports are entitled to a commission of 10% on gross sales.

Gemini Sports received the consignment on January 15 and sent a 60 days bill for Rs 10,000 Io Universal Sports. The bill was discounted for Rs. 9,900.

On opening the cases the consignee found 10 cases of wrong description and returned them, paying return freight of Rs 400.

Gemini Sports sold 120 cases @ Rs 600 each for cash and 20 cases @ Rs. 700 each on credit. Gemini Sports spent Rs. 720 on clearing charges and Rs. 600 on carriage outwards. They incurred bad debts amounting to Rs 400. The accounts were settled on June 30, and the balance remitted by cheque. Show necessary ledger accounts in the books of both the parties.

Solution

Books of Universal Sports, Delhi

Consignment Account

Dr. Cr.

Date	**Particulars**	Amount	Date	Particulars	Amount
1988		Rs.	1988		Rs.
Jan 1	To Goods Sent on Consignment A/c	64,800	Jan. 15	By Goods Sent on Consignment A/c (Returns)	3,600
" 1	To Bank A/c (Expenses) Insurance 360 Freight 1,800	2,160	June 30	By Gemini Sports Cash Sales 72,000 Credit Sale 14,000	86,000
" 15	To Gemini Sports (Freight on goods returned)	400	" 30	By Consignment Stock A/c	11,280
June 30	To Gemini Sports (Expenses) Clearing Charges 720 Carriage Outwnrd	1,320			
" 30	To Gemini Sports (Bad Debts)	400			
" 30	To Gemini Sports (Commission)	8,600			
" 30	To Profit & Loss A/c (Profit transferred)	23,200			
		1,00,880			1,00,880

Gemini Sports Account

Date	Particulars	Amount	Date	Particulars	Amount
1988		Rs.	1988		Rs.
June 30	To Consignment A/c (Sales)	86,000	Jan. 15	By Bills Receivable A/c (Advance)	10,000
			" 15	By Consignment A/c (Freight on returns)	400
			June 30	By Consignment A/c (Expenses)	1,320
			" 30	By Consignment A/c (Bad Debts)	400
			" 30	By Consignment A/c (Commission)	8,600
			" 30	By Bank A/c	65,280
		86,000			86,000

(foods **Sent on Consignment** Account

Date	Particulars	Amount	Date	Particulars	Amount
1988		Rs.	1988		Rs.
Jan. 15	**To Consignment A/c**	3,600	Jan. 1	By **Consignment A/c**	64,800
June 30	To Trailing A/c	61,200			
		64,800			64,800

Hooks of Gemini Spurts

Universal Sports Account

Dr.					Cr.
Date	Particulars	Amount	Date	Particulars	Amount
1988		Rs.	1988		
Jan. 15	To Bills payable A/c	10,000	June 30	By Cash A/c (Cash Sales)	72,000
" 15	To Cash A/c (Freight on returns)	400	" 30	By Debtors A/c (Credit Sales)	14,000
June30	To Cash A/c (Expenses)	1,320			
" 30	To Debtors A/c (Bud Debts)	400			
" 30	To Commission A/c	8,600			
" 30	To Bank A/c	65,280			
		86,000			86,000

Commission Account

1988		Rs.	1988		Rs.
June 30	To Profit & Loss A/c	8,600	June 30	By Universal Sports	8,600

Working Notes

1 **Closing Stock Valuation** :

$$\text{Number of Closing Units} \times \text{Cost Price Per Unit} + \left(\text{Non-recurring Expenses} \times \frac{\text{Closing Stock Units}}{\text{No. of Units Consigned}}\right)$$

$= 30 \times 360 + (2,880 \times 30/180)$

$= 10,800 + 480$

$=$ Rs. 11,280.

(Nan-recurring Expenses include all the expenses of consignor and clearing charges paid by the consignee)

2 **Goods Returned to the Consignor** : The goods returned are to be valued at Cost Price only. They should not include any other expenses. However, all the expenses incurred by the consignee to return the goods should be considered as the expenses on that consignment. So the Consignment Account is debited and the Consignee's Account is credited with the arnount of expenses incurred on returns.

Check Your Progress-A

1 Tick the correct alternative

a) The cost of consignment stock is the cost at which the goods are consigned plus
   i) the non-recurring expenses'
   ii) proportionate non-recurring,expenses
   iii) all the recurring expenses

b) Non-recurring expenses are the expenses incurred
   i) after the goods reach the godown of the consignee
   ii) in transportation
   iii) till the goods reach the godown of the consignee

c) Consignment stock is shown on
   i) credit side of Consignee's Account
   ii) credit side of Consignment Account
   iii) debit side of Consignor's Account ,

d) Goods returned by the consignee should be charged to the Consignment Account at
   i) cost price
   ii) market price
   iii) cost or market price whichever is lower

e) Expenses incurred in forwarding the defective goods should be debited to
   i) Profit and Loss Account
   ii) Consignment Account
   iii) Goods Sent on Consignment Account

11.4 LOSS OF GOODS

Under Consignment arrangement, when goods are transferred from one place to another, there is a possibility of loss in transit. The loss can also take place in the godown of the consignee. The loss may occur due to factors like evaporation, leakage, mishandling etc., or due to some accident or theft. Such losses can be broadly divided into two types.

a) Normal Loss and
b) Abnormal Loss.

Let us discuss the exact nature of these losses and their accounting treatment,

11.4.1 Normal Loss

It is a loss which is due to the inherent nature of the goods consigned. It may arise in the process of loading and unloading of goods, breaking of bulk pieces into smaller ones, weighing or due to evaporation, processing, etc. For example while loading or unloading or weighing coal, some part is bound to fall down in powdered form. Similarly the petroleum products are bound to loose weight due to evaporation or leakage. This type of loss is unavoidable. It can be reduced to some extent but cannot be eliminated altogether. Since this loss occurs in the ordinary course of business and is on account of inner characteristics of the goods, it is'called a normal loss.

Nonnal loss is not shown separately in the books of accounts. The cost of normal loss is spread over the remaining units, thereby increasing the cost per unit of the goods. For example 10,000 tons of coal is sent on consignment costing Rs. 100 each. The normal wastage is 2% i.e., 200 tons. Let us see how normal loss leads to an inflated cost price per unit.

Total Cost of 10,000 = Rs. 10,00,000 (10,000 X 100)
Total units = 10,000 tons
Normal Loss = 200 tons
Remaining units = 9,800 tons

Rs. 10,00,000 will now be the cost of 9,800 tons as the cost of normal loss is borne by the remaining units. The cost per unit will therefore be 10,00,000/9,800 = Rs. 102.04 approximately.

As stated earlier, **no separate entry is passed for the normal loss. The effect of this is reflected in the valuation of closing stock only.**

If the consignee is able to sell all the goods so that there is no stock left unsold, the question of normal loss becomes irrelevant. The problem arises only when some goods are left unsold with the consignee. In that case we shall first calculate the inflated cost per unit as explained above, and then the closing stock shall be valued by multiplying the number of units in stock with the inflated cost per unit. The value of closing stock can also be computed directly (without calculating the inflated cost per unit) with the help of the following formula.

$$\text{Total Cost of Goods Consigned} \times \frac{\text{Unsold Units}}{\text{Remaining Units}}$$

Look at Illustration 4 and see how the closing stock is valued when there is normal loss.

Illustration 4

Ram consigned 2,000 tons of coal at Rs. 50 per ton to Shyam of Delhi. He paid Rs. 20,000 as freight. Due to normal wastage 1,950 tons only were received by Shyam. He paid Rs. 5,000 as unloading charges. Goods sold were 1,300 tons. You are required to calculate the value of closing stock.

Solution

		Rs.
Cost of 2,000 tons of coal at Rs. 50 per ton		1,00,000
Add:		
Freight paid by the Consignor		20,000
Unloading charges paid by the consignee		5,000
Total Cost of Goods		1,25,000

	Tons.
Unsold **units** :	
Total Units	2,000
Units Lost	50
Remaining Units	1,950
Units Sold	1,300
Units Unsold	650

Value of Closing **Stock :**

		Rs.
Cost of 2,000 tons	=	1,25,000
Cost of 1,950 (2,000 – 50) tons	=	1,25,000

Inflated Cost per ton $= \dfrac{1,25,000}{1,950}$ = Rs. 64.10

Value of Closing Stock = Number of unsold units × Inflated cost per unit

= 650 × 64.10

= 41.665 approx.

Alternatively

Total Cost of Goods Consigned × $\dfrac{\text{Unsold Units}}{\text{Remaining Units}}$

= Rs. 125,000 × $\dfrac{650}{1,950}$

= Rs. 41,667

11.4.2 Abnormal Loss

The loss which occurs due to negligence, inefficiency or some accident is treated as abnormal loss. For example loss of goods due to fire, floods, earth quakes, riots. war, theft etc. Such a loss does not occur on account of inherent nature of the product but on account of the operation of certain external forces.

Abnormal loss is calculated in the same manner as the value of closing stock. In other words in order to calculate the abnormal loss all the proportionate non-recurring expenses incurred upto the point of loss are also added to the cost of abnormal loss units. The formula for calculation of abnormal loss is as follows:

Cost of Abnormal Loss Units=

No. of Abnormal Loss Units x Cost Per Unit +

Non-recurring Expenses upto the point of loss x $\dfrac{\text{No. of Abnonnal Loss Units}}{\text{No. of Units Consigned}}$

Since the abnormal loss is not incidental to the consignment, it should be shown separately in the books of accounts. The total abnormal loss is credited to the Consignment Account. The following entry is passed in the books of the consignor.

Abnormal Loss A/c Dr.
To Consignment A/c
(Being loss on account of ...)

Such an abnormal loss may be

i) Uninsured
ii) Partially Insured
iii) Fully Insured

i) **When the loss is Uninsured:** In case the abnormal loss is not insured with an insurance company, the total amount of the loss is transferred to Profit & Loss Account by passing the following entry.

Profit & Loss A/c Dr.
To Abnormal Loss A/c
(Being Abnormal Loss transferred to P&L A/c)

ii) When the loss is partially insured: In case the abnormal loss is insured and the claim is admitted for a part of the loss then the following entry is passed

Insurance Company's A/c Dr.
Profit & Loss A/c Dr.
To Abnormal Loss A/c
(Being partial claim admitted)

Insurance Company will bedebited with the amount of claim admitted and only the balance amount (total loss minus the claim) is transferred to Profit & Loss Account.

iii) When the toss is fully insured: In case the loss is fully insured and the total 'claim' is admitted by the insurance company, the following entry will be passed.

Insurance Company's A/c Dr.
To Abnormal Loss A/c
(Being claim fully admitted)

Nothing is transferred to the Profit & Loss Account as the claim for the whole amount of loss had been admitted by the insurance company. No loss is to be borne by the Consignor,

Look at Illustration 5 and see how abnormal loss is calculated and treated in the books of accounts.

Illustration 5

Philips Radio Company consigned 100 transistors to their agent Paul Radios, Delhi. The cost price of each transistor is Rs. 75. The consignors paid Rs. 200 for freight, Rs. 50 for cartage and Rs. 400 for insurance. Five transistors were totally destroyed in transit. The insurance claim of Rs. 300 was admitted by the insurance company. The consignee took the delivery of 95 radios and spent Rs. 190 for clearing charges, Rs. 95 for cartage, Rs. 250 on godown rent and Rs. 150 as selling expenses. They sold all the units at Rs 100 each. Paul Radios are entitled to 5% commission on total sales. The balance due was remitted by way of a bank draft. Calculate the abnormal loss and prepare necessary ledger accounts in the books of both the parties.

Solution

Abnormal Loss = Number of Abnormal Loss Units x Cost Price Per Unit +

$$\text{on-recurring expenses before loss} \times \frac{\text{Abnormal Loss Units}}{\text{Total Units}}$$

= 5 x 75 + (650 x 5/100)
= 375 + 12.50
= Rs. 407.50 say Rs. 4.08

Books of Philips Radio Company

Consignment Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.			Rs.
	To Goods Sent on Consignment A/c	7,500		By Abnormal Loss A/c	408
	To Bank A/c (Expenses)	650		By Paul Radios (Sales)	9,500
	To Paul Radios (Expenses)	685			
	To Paul Radios (Commission)	475			
	To Profit & Loss A/c (Profit transferred)	598			
		9,908			9,908

Paul Radio's Account

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.			Rs.
	To Consignment A/c (Sales)	9,500		By Consignment A/c (Expenses)	685
				By Consignment A/c (Commission)	475
				By Bank A/c	8,340
		9.500			0,500

Goods Sent on Consignment A/c

	To Trading A/c	Rs. 7,500		By Consignment A/c	Rs. 7,500

Abnormal Loss Account

	To Consignment A/c	Rs. 408		By Insurance Company's A/c By Profit & Loss A/c	Rs. 300 108
		408			408

Books of Paul Radios

Philips Radio's Account

Dr. Cr.

	To Bank A/c (Expenses) To Commission A/c To Bank A/c	Rs. 685 475 8,340		By Bank A/c (Sales)	Rs. 9,500
		9,500			9,500

Commission Account

	To Profit & Loss A/c	Rs. 475		By Philips Radios	Rs. 475

Effect of abnormal loss on valuation of closing stock: The value of closing stock is also effected in case of abnormal loss. Abnormal loss may occur either in the godown of the consignee or in transit. Let us see the effect of abnormal loss on the closing stock under both situations,

When the abnormal loss occurs in the godown of the consignee the valuation of closing stock is not effected because the expenses incurred after reach the godown of the consignee are not to be taken into account for the purpose. Hence, the normal formula will be followed for the valuation of closing stock. Look at Illustration 6 and see how the abnormal loss and the value of closing stock is calculated when the abnormal loss occurs in the godown of the consignee.

Illustration 6

Vanaspati Ltd. consigned 5,000 kg, of vanaspati ghee to Ashoka Dealers, Chandigarh. Each kg. of ghee costs Rs. 8. Vanaspati Ltd. paid Rs 50 for carriage, Rs. 250 for packing and Rs. 200 for insurance in transit.

After three months from the date of the consignment of goods Ashoka Dealers reported that 3,500 kg. of ghee was sold @ Rs. 9.50 per kg. and expenses were Rs. 500 on godown rent and Rs. 750 on salesmen salary. Ashoka Dealers are entitled to a commission of 5% on sales 500 kg. of ghee was accidentally destroyed in the godown. Insurance claim of Rs. 3,500 was admitted. Prepare the necessary ledger accounts in the books of both the parties.

Solution:

Books of Vanaspati Ltd.

Consignment Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.			Rs.
	To Goods Sent on Consignment A/c To Bank A/c (Expenses)	 40,000 500		By Abnormal Loss A/c By Ashoka Dealers (Sales)	4,050 33,250

	Rs.		Rs.
To Ashoka Dealers (Expenses)	1,250	By Consignment Stock A/c	8,100
To Ashoka Dealers (Commission)	1,662		
To Profit & Loss A/c	1,988		
	45,400		45,400

Ashoka Dealer's Account

	Rs.		Rs.
To Consignment A/c (Sales)	33.250	By Consignment A/c (Expenses)	1,250
		By Consignment A/c (Commission)	1,662
		By Balance C/d	30,338
	33,250		33.250

Goods Sent on Consignment **Account**

	Rs.		Rs.
To Trading A/c	40,000	By Consignment A/c	40,000

Abnormnl Loss Account

	Rs.		Rs.
To Consignment A/c	4,050	By Insurance Company's A/c	3,500
		By Profit & Loss A/c	550
	4,050		4,050

Note: Abnormal loss has been worked out as follows:

Cost of 500 units = 4,000
(500 × 8)
Add Proportionate
non-recurring expenses = 50
(500/5,000 × 500) = 4,050

Books of Ashokn Dealers

Vanaspati Ltd's Account

Dr. Cr.

	Rs.		Rs.
To Bank A/c (Expenses)	1,250	By Bank A/c (Sales)	33,250
To Commission A/c	1,662		
To Balance c/d	30,338		
	33,250		33,250

Commission Account

	Rs.		Rs.
To Profit & Loss A/c	1,662	By Vannspnti Ltd.	1,662

You have learnt that when abnormal loss occurs in the godown of the consignee the closing stock valuation is not affected. But it is not so when the abnormal loss occurs in transit. The closing stock valuation is also affected due to abnormal loss in transit because some non-recurring expenses may be incurred after the loss has taken place. Hence, when such loss occurs in transit, you will have to distinguish between the non-recurring expenses incurred before the loss and the non-recurring expenses incurred after the loss. The non-recurring expenses incurred before the loss relate to the total units consigned whereas the non-recurring expenses incurred after the loss relate to the remaining units (total units'rninus abnormal loss units) only. So, the expenses before the loss will be proportionately divided amongst the total units, whereas the expenses incurred after the loss will be proportionately divided amongst the remaining units.

Look at Illustration 7 and see how closing stock and abnormal loss are calculated and treated when such a loss occurs in transit.

Illustration 7

On June 10,1988, Modi & Co., Patiala consigned 500 cases of goods costing Rs. 150 each to Sethi & Co., Calcutta. On the same date, the consignor paid Rs. 2,500 for freight and carriage, Rs. 1,000 as loading charges, and Rs. 1,200 for insurance. On July 1, 1988 the consignee paid Rs. 1,800 for clearing charges, Rs. 1,750 for warehousing and storage charges, and Rs. 900 for packing and selling expenses. He also remitted a bank draft for Rs. 15,000 as an advance against the consignment. On July 5, 1968 they sold 275 cases at Rs. 200 each. Sethi & Co. are entitled to 5% commission on the gross proceeds of sales. It is found that 50 cases have been lost in transit. Sethi & Co submitted an account sale on July 10, 1988. Prepare the necessary ledger accounts in the books of the consignor.

Solution

Books of Modi & Co

Consignment Account

Dr. **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
1988		Rs.	1988		Rs.
June 10	To Goods Sent on Consignment A/c (500 cases)	75,000	July 10	By Sethi & Co. (Soles 275 cases)	55,000
" 10	To Bank A/c (Consignor's Expenses)	4,700	" 10	By Abnormal loss A/c (Loss in transit 50 cases)	7,970
			" 10	By Consignment Stock A/c	28,595
July 10	To Sethi & Co. (Consignee's Expenses)	4,450			
" 10	To Sethi & Co. (Commission)	2,750			
" 10	To Profit & Loss A/c (transfer of profit)	4,665			
		91,565			91,565

Sethi & Co. Account (Consignee)

1988		Rs.	1988		Rs.
July 10	To Consignment A/c (Sale proceeds)	55,000	July 1	By Bank A/c (Advance)	15,000
			" 10	By Consignment A/c (Consignee expenses)	4,450
			" 10	By Consignment A/c (Commission)	2,750
			" 10	By Balance c/d	32,800
		55,000			55,000

Goods Sent on Consignment Account

1988		Rs.	1988		Rs.
July 10	To Trading A/c	75,000	June 10	By Consignment A/c	75,000

Notes:

1 **All** expenses incurred by the consignor and the clearing charges incurred by the consignee are non-recurring expenses.

2 Abnormal Loss:

Number of Abnormal Loss Units x Cost Price Per Unit

$$+\left(\text{Non-recurring Expenses up to the point of loss x } \frac{\text{Abnormal Loss Units}}{\text{Total Units Consigned}}\right)$$

$$= (50 \times 150) + \left(4{,}700 \times \frac{50}{500}\right)$$

$$= 7{,}500 + 470 \quad = \quad \text{Rs. } 7{,}970$$

3 Valuation **of** Closing Stock:

Number of Closing Units = 175

Cost Price Per Unit = Rs. 150

So, Cost of Unsold stock will be = 175 x 150 = Rs. 26,250

Non-recumng expenses before loss = Rs. 4,700

(2,500 + 1,000 + 1,200)

Since these expenses are incurred on total consignment i.e., 500 units, the proportionate amount of expenses for consignment stock will be

$$4{,}700 \times \frac{175}{500} = \text{Rs. } 1{,}645$$

Non-recurring expenses after loss = Rs. 1,800 i.e., clearing charges of the consignee, as they are incurred after the consignment reaches the consignee they would relate to 450 units (500–50). Hence, the proportionate amount of these expenses for consignment stock will be 1,800 × 1751450 = Rs. 700

Now the value of closing stock will be as follows:

Cost of unsold stock (175 x 1150)	= Rs. 26,250
Add proportionate Expenses	
i) before loss	= Rs. 1,645
ii) After loss	= Rs. 700
Value of Unsold stock	= Rs. 28,595

The above method of valuation of closing stock can be put in the form of a formula which is as follows:

Number of Unsold Units × Cost price per unit

$$+ \text{ Non-recurring expenses before loss} \times \frac{\text{Unsold Units}}{\text{Total Units}}$$

$$+ \text{ Non-recurring expenses before loss } \times \frac{\text{Unsold Units}}{\text{Total Units} - \text{Abnormal Loss Units}}$$

11.4.3 Where Normal and Abnormal Losses Occur Simultaneously

In the Illustration done earlier you had either the normal loss or the abnormal loss on the consignment. But it is quite possible that both normal and abnormal losses occur simultaneously in connection with the same consignment. In such a situation, the abnormal loss will be calculated in the same manner as discussed in sub-section 11.4.2. But, the valuation of closing stock needs special attention as the normal loss is also involved. In order to calculate the value of closing stock the following procedure will be followed:

i) Take the total cost of goods consigned and add all the non-recumng expenses incurred by the consignor as well as the consignee.

ii) Deduct the quantity and cost of abnormal loss from the total number of goods consigned and the cost as obtained in (i) above respectively.

iii) Deduct the quantity of normal loss from the quantity worked out in (ii) above without making any adjustment in cost.

iv) Now you will be left with the cost of goods of the good units with the consignee. Calculate cost per unit of these-units by dividing the cost (remaining after deducting the cost of abnormal loss) by the number of good units.

v) Multiply the number of unsold units with the cost per unit obtained in (iv) above to arrive at the value of unsold stock.

Look at Illustration 8 and *see* how cost of abnormal loss and the value of unsold stock are calculated when the normal and abnormal losses occur simultaneously.

Illustration 8

Deepak Oil Mills, Cochin consigned 2,500 kg. of castor oil to Madhu & Co., Varanasi on April 1, 1987. The cost of oil was Rs. 18 per kg. The consignor paid Rs. 900 towards carriage, freight and insurance in transit. During transit 250 kg. oil was accidentally destroyed for which the insurance company paid Rs. 2,200 in full settlement of the claim directly to the consignor.

Madhu & Co. took delivery of the consignment on April 10 and accepted a bill drawn on them by Deepak oil Mills of Rs. 5,000 for 2 months. On June 30, 1987, Madhu & Co. reported that 1,750 kg. were sold at Rs. 25 per kg. The expenses of the consignee were Rs. 1,850 towards godown rent, advertisement and salaries of salesmen. Madhu & Co. charged a commission of 3% plus 2% del credre commission. Madhu & Co. further reported a loss of 20 kg. due to leakage. Prepare the necessary ledger accounts in the books of the consignor.

Books of Deepak Oil Mills

Consignment Account

Dr. Particulars	Amount	Particulars	Cr. Amount
	Rs.		Rs.
To Goods Sent on Consignment A/c (2,500 kg)	45,000	By Madhu & Co. (Sale proceeds of 1,750 kg.)	43,750
To Bank A/c (Consignor's expenses)	900		
To Madhu & Co. (Consignee's expenses)	1,850	By Abnormal Loss A/c (250 kg)	4,590
To Madhu & Co. (Commission 3%) = 1,313; (Del credre 2%) = 875	2,188	By Consignment Stock A/c	8,892
To Profit & Loss A/c (Balance)	7,294		
	57.232		57,232

Abnormal Loss Account

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Consignment A/c (Sales)	4,590	By Bank A/c (Amount from Insurance Co.)	2,200
		By Profit & Loss A/c (Balance)	2.390
	4,590		4,590

Madhu & Co. Account

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Consignment A/c	43,750	By Consignment A/c (Expenses)	1,850
		By Consignment A/c (Commission)	2,188
		By Bank A/c (Advance)	5,000
		By Bnlance	34,712
	43,750		43,750

Goods Sent on Consignment Account

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Trading A/c	45,000	By Consignment A/c	45,000

Working Notes:

i) Abnormal Loss

Number of Abnormal Loss Units x Cost Price Per Unit

$$+\left(\text{Non-recurring expenses before loss} \times \frac{\text{Abnormal Loss Units}}{\text{Total Units}}\right)$$

$$= (250 \times 18) + \left(900 \times \frac{250}{2,500}\right) = 4,500 + 90 = \text{Rs. } 4,590$$

ii) Value of Closing Stock

	Number of Units	Cost
Total Quantity and Cost of Oil	2,500	45,000
Add Non-recurring Expenses	—	900
Total Units	2,500	45,900
Less Abnormal Loss	250	4.590
	2,250	41,310
Less Normal Loss	20	—
Good Units	2,230	41,310
Number of Units Sold	1,750	

So unsold units are (2,230 – 1,750) = 480

Now Value of closing stock (480 units) will be

= 41,310 x 480/2,230

= Rs. 8,892

Check Your Progress-B

1 Fill in the blanks

i) Losses occur either due to inherent nature of the product or due to operation of ....

ii) Loss of weight due to evaporation is a ....loss.

iii) Normal loss affects the valuation of ....

iv) Abnormal loss is .... to Consignment Account.

v) Insurance claim is ....to Abnormal Loss Account.

vi) The amount of loss not accepted by the insurance company is transferred to .... Account

2 How will you treat abnormal loss if

a) loss is fully insured: ....

b) loss is uninsured: ....

c) loss is partly insured: ....

11.5 LET US SUM UP

Sometimes the consignee is not able to sell all goods consigned to him. He is left with some unsold stock, the cost of which must be shown on the credit side of the Consignment Account before calculating the profit on consignment. The cost of the unsold stock shall include the proportionate amount of non-recurring expenses.

When goods are consigned, it is possible that some goods are lost in transit or destroyed while it is lying in the consignee's godown. Such losses may occur either due to the inherent nature of goods or due to some accident. The first is called normal loss and the second abnormal loss.

The normal loss is not shown anywhere in the books of account. It simply inflates the cost per unit of the goods consigned and, therefore, affects the revaluation of closing stock and the profit. But the abnormal loss requires special treatment in the books of account of the consignor. The cost of such loss is worked out in the same manner as the cost of unsold stock and credited to the Consignment Account. Any amount received from the insurance company must be subtracted from the abnormal loss before it is transferred to the Profit and Loss Account.

11.6 KEY WORDS

Normal Loss : Loss caused in the ordinary course of things due to evaporation, leakage, breaking the bulk into pieces etc.

Abnormal Loss : Loss caused on account of storm, fire. accident theft, etc.

11.7 SOME USEFUL BOOKS

Maheshwari S.N. 1986. ***Introduction to Accounting,*** Vikas Publishing House: New Delhi. (Chapter 1 Section II)

Patil, V.A. and J.S. Korlahalli, 1986. ***Principles*** and ***Practice of Accounting, R.*** Chand & Co:, New Delhi. (Chapter 2)

William Pickles. 1962 ***Accountancy*** , E.L.B.S. and Pitman, London. (Chapter 17)

Gupta R.L. and M. Radhaswamy. 1986. ***Advanced Accountancy*** Sultan Chand & Sons, New Delhi (Chapter 15)

11.8 ANSWERS TO CHECK YOUR PROGRESS

A a) ii b) iii c) ii d) i e) ii

B 1 i) external forces ii) normal iii) closing stock iv) credited v) credited vi) Profit & Loss

11.9 TERMINAL QUESTIONS/EXERCISES

Questions.

1 List the expenses taken into account while valuing the unsold stock.
2 What is the difference between normal loss and abnormal loss? Give examples.
3 What procedure is followed for valuation of closing stock when the abnormal and normal losses occur simultaneously.

Exercises

1 Kabir of Jhansi consigned to Moses of Cochin 400 chairs on April 10, 1986. The cost of each chair was Rs. 250. The consignor paid Rs. 2,000 for cartage, freight etc., oh April 12, 1986, and drew a bill on the consignee as an advance against the consignment at 3 months for Rs. 60,000. Later, it was discounted at their bank at 5%. The consignee sold all the goods on July 1, 1986 and submitted an Account Sales showing that the goods realised Rs. 1,20,000. He incurred Rs. 1,000 on carriage inwards and Rs. 550 on selling and other expenses. He was allowed to take 5% commission on the total sales. You are required to show ledger accounts for the above transactions in the books of the consignor and the consignee.

(Answer : Profit Rs. 10,450)

2 X of Bangalore consigned 100 bags of cement for sale to his agent Y. Cost price of each bag is Rs. 120. 'X' immediately drew a 4 months bill for Rs. 5,000 on the latter and discounted it with bank at 6% per annum. 'X' paid Rs. 800 on packing and Rs, 250 for carriage. 'Y' spent Rs. 300 as selling expenses. The consignee returned 5 bags. He realised 20 bags at Rs. 130 per bag and 50 bags on credit at Rs. 140 per bag and took the balance in his own stock at Rs. 135 per bag.

Consignee is entitled to get commission of 3% and 2% del credre commission on credit sales. 'Y' recovered all money from debtors except Rs. 500. Prepare the necessary ledger accounts in the books of both parties.

(Answer : Loss Rs. 204)

3 Grover Enterprises, Delhi sent 100 bicycles to Khan Enterprises, Patna. Cost of each cycle was Rs. 640. Grover incurred Rs. 1,500 for freight and Rs. 1,100 for insurance in transit. Khan paid Rs. 650 for cartage and 2,000 towards godown rent and selling expenses. 20 bicycles remained unsold at the end. The remaining bicycles realised Rs. 800 per cycle. Calculate the value of unsold stock.,

(Answer : Cost of unsold stock Rs. 13,450)

4 Kiran Bros. on January 1, 1986 consigned sports materials costing Rs. 10,000 to their agent Kabir Agency. Kiran Bros. paid Rs. 200 for freight and Rs. 100 for insurance and other charges. Consignee received the delivery by paying Rs. 150 for non-recurring expenses on January 15, 1986.

He sent an account sale on February 20,1986 showing that 20% of the stock realised Rs. 3,200 and 30% of the stock was sold on credit for Rs. 3,600.

One customer from whom Rs. 500 was due became insolvent and only 25% of the debt could be recovered. Consignee is entitled to a commission of 5% on sales. Pass journal entries and prepare the necessary ledger accounts.

(Answer : Profit Rs. 860 : Stock Rs. 5,225)

5 Srikanth consigned 2,500 kg. of coconut oil costing Rs. 50,000. Expenses incurred were Rs. 1,400. Consignee spent Rs. 2,000 on unloading and cartage. 100 kg. of oil was lost due to natural deterioration and 1,500 kg. were sold. Calculate the cost of stock at the end?

(Answer : Cost of Stock Rs. 20,025)

6 Kapur of Lucknow consigned 200 bags of rice, each costing Rs. 300 to Jain Traders of Bombay on April 1,1987. The consignor paid Rs. 2,000 towards freight and insurance. 30 bags were damaged in transit. The consignee received on May 31, 1987 Rs. 2,000 on account of the damaged bags from the Insurance Company. On May 31, 1987 the consignee reported that 140 bags were sold at Rs. 375 per bag. The consignee incurred Rs. 2,000 for godown rent and selling expenses. The consignee is allowed 10% commission on the sale proceeds. You are required to prepare the ledger accounts in the books of Mr. Kapur assuming that Jain Traders remit the balance by bank draft on May 31, 1987.

(Answer : Profit Rs. 1,850 : Accidental Loss Rs. 9,300)

7 Dinesh of Delhi consigned 200 sewing machines costing Rs. 150 each to Chander of Calcutta. He paid Rs. 2,800 on insurance and received an advance of Rs. 20,000 from Chander. 30 machines were damaged in transit. Chander took the delivery of the remaining goods and paid Rs. 1,700 for unloading the consignment. He sold 50 machines @ Rs. 270 each for cash and 100 machines @ Rs. 300 each on credit. Chander could not realise Rs. 2,000 from his debtors. Chander recovered Rs. 1,500 from the insurance company. He sold damaged machines for Rs. 2,300.

Chander is entitled to an ordinary commission @ 5% and 3% del credre commission. The accounts were settled and balance remitted by bank draft. Show the necessary ledger accounts in the books of Dinesh.

Hint :

i) Sale of damaged stock as well as the amount recovered from insurance company will be credited to Abnormal Loss Account and debited to Chander's Account.

ii) Commission on sale proceeds of damaged goods @ 5% will be debited to Abnormal Loss Account and credited to Chander's Account.

Answer : Abnormal Loss Rs. 4,920; Value of Unsold Stock Rs. 3,480; Profit Rs. 13,920; Balance due from Chander Rs. 22,005)

8 Sohna Vanaspati, Faridabad consigned 10,000 kg. of ghee to Krishna Dealers of Delhi at Rs. 16 per kg. The consignor paid Rs. 950 as carriage, Rs. 250 as freight and Rs. 400 as insurance in transit. 1,000 kg, of ghee was accidentally destroyed for which an amount of Rs. 8,000 was recovered from the insurance company in full settlement.

Krishna Dealers reported that 8,000 kg. of ghee was sold @ Rs. 20 per kg. They spent Rs. 500 on salesmen salary and Rs. 200 on godown rent. The consignee is entitled to a commission of 5% on sales. Krishna dealers reported a shortage of 40 kg. due to leakage. Prepare necessary ledger accounts in the books of both the parties.

(Answer : Profit Rs. 22,443; Abnormal Loss Rs. 16,160; Closing stock Rs. 15,583)

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 12 CONSIGNMENT ACCOUNTS-III

Structure

12.0 OBJECTIVES

After studying this unit you should be able to:

- explain the meaning of invoice price and the reasons for consigning goods at invoice price
- compute cost price and invoice price in different situations
- explain the meaning sf loading and pass necessary entries for its adjustment in consignment account
- prepare books of the consignor and the consignee based on invoice price

12.1 INTRODUCTION

In Units 10 and 11 you have learnt about the recording of transactions relating to consignments in books of both the consignor and the consignee. You know that the goods sent on consignment are recorded in Consignment Accaunt at cost price. Sometimes, the consignor does not want to reveal the cost of goods to the consignee and, therefore, invoices the goods at a price which is higher than the cost price. Such price is known as 'invoice price' and the difference between the invoice price and the cost price is called 'loading'. In such a situation, the entry for goods sent on consignment is also recorded at the invoice price which would need an adjustment for loading at the time of computing the profit on consignment. In this unit you will learn how Consignment Account is prepared when the goods are consigned at invoice price and how the necessary adjustments are made at the time of working out the profit on consignment. You will also learn how the invoice price is calculated when the loading is given in the form of a percentage at the cost price or the invoice price.

12.2 CONCEPTS OF INVOICE PRICE

In Unit 11 you learnt that when the consignor sends goods on consignment to the Consignee, he records it in his books at cost and the same is reflected in the proforma invoice. Sometirnes, the consignor does not want the consignee to know the actual cost of goods sent to him, in that case he would consigne the goods at a price other than the cost price. Such price would generally be higher than the cost. It is called the invoice price. In other words the invoice price is equal to the cost price plus a certain amount of profit.

Apart from the intention of not revealing the cost of goods to the consignee there are a number of other reasons why the consignor consignes the goods at invoice price. These are the:

i) The consignee will not be able to assess the profit earned on consignment and therefore may not demand a higher commission.

ii) If the consignee knows about the actual cost of goods he may resort to some dishonest practices such as buying goods for himself at a lower price and then selling them at a higher price in the market.

iii) It would give a fair idea to the consignee of the minimum price at which he is to sell the goods.

You should note that invoice price is not the same thing as selling price. The invoice price is the price at which the consignor sends the goods to the consignee, whereas the selling price is the price at which the consignee sells the goods to the customers. Let us take an example in order to clearly understand the difference between the three prices i.e., the cost price, the invoice price and the selling price. Suppose Gopal consigns goods worth Rs. 15,000 to his agent Ashok at an invoice price of Rs. 18,000. Ashok sells the goods at Rs. 20,000. In this example the cost price (CP) of the goods is Rs. 15,000, the invoice price (IP) of the goods is Rs. 18,000, and the selling price (SP) of the goods Rs. 20,000.

You will observe that the IP is higher than CP whereas SP is higher than the CP as well as the IP, and that the SP and the IP are not the same. If, however, the Consignor directs the consignee to sell the goods at invoice price itself, then the SP and the IP will be the same.

3123 CALCULATION OF COST PRICE AND INVOICE PRICE

You know the relationship between the invoice price (IP) the cost price (CP) and the profit. This can be expressed in the form of an equation as follows.

$$IP = CP + Profit$$

With the help of the above equation, you can find out the missing figure i.e., if any two figures are given the third one can be worked out. For example, if the CP is given as Rs. 150 and the profit as Rs. 50, the invoice price will be

$$\begin{aligned} IP &= CP + Profit \\ &= 150 + 50 \\ &= \text{Rs. } 200 \end{aligned}$$

Similarly, if invoice price and profit are given as Rs. 200 and Rs. 50 respectively, the cost price will be

$$\begin{aligned} IP &= CP + Profit \\ 200 &= CP + 50 \\ CP &= 200 - 50 \\ &= \text{Rs. } 150 \end{aligned}$$

In the above examples, the profit is given as an absolute figure. But, in many cases the profit may be given in the form of a percentage either on cost price or on invoice price. In that case, the calculation of missing price may become difficult. Of course, if the percentage of profit is based on the price, the figure of which is given, you may not face much problem. But if the percentage of profit is based on the price, the figure of which is not given, you may find it difficult to work out the profit and so also the missing price. Let us take different situations where the profit is given in the form of a percentage and we have to work out the missing price. These situations are :

1 CP is given and Profit is given as a percentage of CP, you have to work out IP
2 CP is given and Profit is given as a percentage of IP, you have to work out IP
3 IP is given and Profit is given as a percentage of IP, you have to work out CP
4 IP is given and Profit is given as a percentage of CP, you have to work out CP

Let us take them one by one and find out the missing figure with the help of examples.

1 **CP is given and the profit is given as a percentage on CP**

Suppose the CP of a product is Rs. 200 which is invoiced at 20% profit on cost. The IP will be calculated as follows.

$$IP = CP + Profit$$

$$IP = 200 + \left(\frac{20}{100} \times 200\right)$$

IP = 200 + 40
IP = Rs. 240

2 **CP is given and the profit is given as percentage on IP**
Suppose CP of a product is Rs. 200 which is invoiced at 20% profit on IP. IP will be calculated as follows.

Let us assume that the IP is X
IP = CP + Profit

$$X = 200 + \left(\frac{20}{100} \times X\right)$$

$$X = 200 + \frac{20}{100}X$$

$$X - \frac{20}{100}X = 200$$

$$\frac{100X - 20X}{100} = 200$$

$$\frac{80}{100}X = 200$$

$$X = \frac{200 \times 100}{80} = \text{Rs. } 250$$

So the IP is Rs. 250 and the Profit is Rs. 50. Now you can verify that the profit is 20% on invoice Price.

$$\text{Profit} = \frac{20}{100} \text{ of IP}$$

$$= \frac{20}{100} \times 250$$

= Rs. 50

3 **IP is given and the profit is given as percentage of IP :** Suppose the IP of a product is Rs. 500 and Profit is ***25%*** on ***IP.*** The missing figure **i.e.,** the CP is worked out **as** follows.

IP= CP + Profit

$$500 = CP + \frac{25}{100} \times 500$$

500 = CP + 125
CP = 500 − 125
CP = Rs. 375

4 **IP is given and the profit is given as a percentage of CP: Suppose** the IP is Rs. 600 and Profit is 20% on CP then CP will be calculated as follows.

Let us assume CP to be X

IP = CP + Profit

$$600 = X + \frac{20}{100}X$$

$$600 = \frac{100X + 20X}{100}$$

$$600 = \frac{120}{100}X$$

$$X = \frac{600 \times 100}{120}$$

X = Rs. ***500***

So the CP is Rs. 500 and Profit is Rs. 100. Now you can verify that the profit is 20% on cost.

$$\text{Profit} = \frac{20}{100} \times CP$$

$$= \frac{20}{100} \times 500$$

= Rs. 100

12.4 LOADING

12.4.1 What is Loading?

You know that the invoice price is obtained by adding a certain amount of profit to the cost price. The amount of profit which is added to the cost in order to arrive at the invoice price is called loading. In other words, loading is the difference between the invoice price and the cost price

Loading = IP – CP

For example, if the invoice price is Rs. 10,000 and the cost price is Rs. 7,500, the amount of loading will be

Loading = IP – CP or Number of units × (IP per unit – CP per unit)
= 10,000 – 7,500
= Rs. 2,500.

If the invoice price or the cost price is given and the profit (loading) is given in the form of a percentage either on IP or CP, the loading can be worked out directly in the same manner as we worked out the IP or CP in the examples under sub-section **12.3.**

12.4.2 Items which Involve Loading

Loading is usually involved in all such items which are recorded at the invoice: price in the Consignment Account. These items are:

1 Opening Stock
2 Goods Sent on Consignment
3 Goods Returned by the Consignee
4 Closing Stock.

You have to compute the loading in respect of all the above items and make necessary adjustments in books of the consignor.

12.4.3 Adjustment of Loading

You know the profit is the difference, between selling price and cost price. In Consignment Account prepared earlier, the goods sent on consignment and the other related items were shown at cost. Hence you had no problem in computing the profit. But, when the goods sent on consignment and other related items are shown in the Consignment Account at invoice price, it becomes necessary to adjust the loading in the Consignment Account so as to bring down the invoice price to the level of cost. If such adjustment is not done, the profit figure will be incorrect. There is also a possibility that the Consignment Account shows loss because the difference between the selling price and the invoice price is generally small which cannot cover all expenses. Look at figure **12.1** and see the difference between the actual profit and the profit without adjustment. The profit thus calculated will be the difference between sales and invoice price.

Figure 12.1

	Rs.		
Cost price	15,000		
Invoice Price	18,000	Rs. 3,000 Loading	
Sale Price	20,000	Rs. 2,000 Profit Without Adjustment	Re. 5,000 Actual Profit

From Figure 12.1 it is clear that if no adjustment is made the profit will be Rs. 2,000 whereas the actual profit is Rs. 5,000 Therefore, in order to calculate the actual profit earned on any consignment all the items shown at invoice price are to be brought down to the level of cost by adj sting the amount of loading on each of them. Let us now take the items involving loading one by one and see how the necessary adjustments are made.

I **Opening Stock** : Opening stock is always shown on the debit side of Consignment Account, In case the stock is shown at invoice price, the difference between the invoice price and the cost price of the stock will he shown on the credit side of the Consignment Account by passing the following journal entry.

Stock Reserve A/c - Dr
To Consignment A/c
(Being unloading on opening stock)

2 Goods Sent on Consignment : Goods sent on Consignment are shown on the debit side of Consignment Account. In order to nullify the effect of invoice price, the difference between the invoice price and the cost price in respect of goods sent on consignment will be shown on the credit side of the Consignment Account by passing the following journal entry.

Goods Sent on Consignment A/c Dr.
To Consignment A/c
(Being unloading on goods sent on consignment)

3 **Goods** Returned by the consignee : As the return of goods is shown on the credit side of Consignment Account, the adjustment for the loading will be made on the debit side of consignment Account with the help of the following journal entry

Consignment A/c Dr.
To Goods Sent on Consignment A/c
(Being loading on goods returned)

4 **Closing Stock** : Since closing stock is shown on the credit side of Consignment Account, the adjustment for the loading will be made on the debit side with the help of the following journal entry.

Consignment A/c **Dr.**
To Stock Reserve
(Being unloading on closing stock)

Thus you will observe that the adjustment entry for loading in the Consignment Account is made on the opposite side of the original entry. For example the closing stock is shown on the credit side of the Consignment Account whereas its adjustment is shown on the debit side of the Consignment Account. This is how the effect of loading in Consignment Account is neutralised and the invoice price is brought down to the cost level. You should remember that the adjustment for loading is to be made in the books of the Consignor only. The consignee does not record any entries for the items involving loading. Therefore no adjustment is needed in his books.

Check Your Progress A

1 Indicate whether the following statements are True or False.

i) Consignor always consigns goods at invoice price ....

ii) Sending goods at invoice price shall result in less profit in the Consignment Account, if no adjustment is made for the loading. ....

iii) Invoice price is always equal to selling price. ....

iv) Consignor consigns the goods at invoice price to conceal the actual profit earned on consignment. ....

v) Loading on closing stock will be nullified by debiting Stock Reserve Account and crediting Closing Stock Account. ....

vi) All the entries of adjustment for loading are recorded in the books of consignee. ....

2 What is Loading ?

....

....

....

3 Name the items that involve loading.

....

....

....

4 Work out the following problems :

i) Cost price of a fan is Rs. 500 and loading is Rs. 100. What is the invoice price. ..
ii) Cost price of a watch is Rs. 150. It is consigned at $33\frac{1}{3}\%$ above cost. Find out the invoice price.
iii) Cost price of a bicycle is Rs. 500. It is invoiced at a profit of 20% on invoice price. What is the invoice price?
iv) A ceiling fan is consigned at an invoice price of Rs. 250. Invoice price is cost plus a profit of 10% on the invoice price. What is the cost price.
v) Invoice price of a chair is Rs. 300 which is 20% above cost. Find out its cost price.

5 Find out the loading in the fallowing cases :

i) Goods costing Rs. 1,800 are invoiced at Rs. 2,200.
ii) Cost price Rs. 600 invoiced at a profit of 20% above cost
iii) Cost price is Rs. 600 invoiced at a profit of 20% on invoice price.
iv) Invoice price is Rs. 600 involving profit of 20% on invoice price.
v) Invoice price is Rs. 600 involving profit of 20% above cost.

12.5 ACCOUNTING FOR GOODS SENT AT INVOICE PRICE

You have learnt about the concept of invoice price, the calculation of loading involved and the adjustment entries to be passed in respect of all items involving loading. As for the recording of transactions for goods consigned at invoice price, the treatment in books of the consignee is not affected at all. Even in the books of the consignor all entries remain the same. But, the amounts with which the four items involving loading (opening stock, goods sent on consignment, goods returned by the consignee, and closing stock) will reflect the invoice price. Then, at the time of working out the profit on consignment, you will have to pass the necessary adjustment entries for the loading involved in respect of all the four item as stated earlier. Look at illustrations 1 to 4 and see how various consignment transactions have been recorded when goods are invoiced at the invoice price.

Illustration 1

Ages Cycle Co., Delhi sent 100 bicycles on January 1,1987 to Murugan Enterprises, Madras. The cost of each bicycle was Rs. 500 and it was invoiced at Rs. 600. Ages Cycle Co. incurred Rs. 2,000 on freight and insurance and received Rs. 30,000 as advance from Murugan Enterprises. Murugan Enterprises paid Rs. 1,000 as octroi and carriage, Rs. 800 as rent and Rs. 600 as insurance. By June 30, 1987 they had sold 100 bicycles for Rs. 62,500. Murugan Enterprises are entitled to a commission @ 10% on the proforma invoice price and 20% of any surplus realised over and above the invoice price. Murugan Enterprises remitted the amount due from them by a bank draft.

You are required to prepare ledger accounts in the books of both parties

Solution :

Books of Ages Cycle Co.

Consignment to Madras Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1987		Rs.	1987		Rs.
Jan. 1	To Goods Sent on Consignment A/c (IP)	60,000	Jan.30	By Murugan Enterprises (Sales)	62,500
" 1	To Bank (Expenses)	2,000	" 30	By Goods Send on Consignment A/c (Loading)	10,000
" 30	To Murugan Enterprises (Consignee's expenses)	2,400			
" 30	To Murugan Enterprises (Commission)	6,500			
" 30	To Profit & Loss A/c (Profit transferred)	1,600			
		72,500			72,500

Murugan Enterprise's Account

Dr.					Cr.
1987		Rs.	1987		Rs.
Jan.30	To Consignment to Madras A/c (Sales)	62,500	Jan.1	By Bank A/c (Advance)	30,000
			Jan.30	By Consignment to Madras A/c (Expenses)	2,400
			"	By Consignment to Madras A/c (Com.)	6.500
			"	By Bank A/c (Balance)	23.600
		62,500			62,500

Goods Sent on Consignment Account

1987			1987		Rs.
June 30	To Consignment to Madras A/c (Loading)		Jan.1	By Consignment to Madras A/c (IP)	60,000
" 30	To Trading A/c	50,000			
		60,000			60,000

Books of Murugan Enterprises

Ages Cycle Co. Account

Dr.					Cr.
1987		Rs.	1987		Rs.
Jan. 1	To Bank A/c (Advance)	30,000	June30	By Bank A/c (Sales)	62.500
" 1	To Bank A/c (Expenses)	2,400			
June 30	To Commission A/c	6,500			
" 30	To Bank A/c (Balance)	23,600			
		62,500			62,500

Commission Account

1987		Rs.	1987		Rs.
June30	To Profit and Loss A/c	6,500	June30	By Ages Cycle Co.	6,500

Working Notes

1	**Loading on** Goods Sent on Consignment	Rs.
	Total cost of 100 bicycles (500 x 100)	50,000
	Total Invoice price of 100 bicycles (600 x 100)	60,000
	Loading involved (IP—CP)	10,000
2	Commission	Rs.
	10% on Proforma Invoice Price of Rs. 60,000	6,000
	20% on Surplus realised (Rs. 2,500)	500
		6,500

3 Since there are no opening and closing stocks and the goods returned by the consignee, the adjustment for loading has been made only in respect of the goods sent on consignment.

Illustration 2

Raj Traders of Ludhiana consigned 100 computers costing Rs. 20,000 each to Bahadur of Gauhati at 10% above cost. Raj Traders incurred Rs. 500 for packing and other charges on each computer. The consignee received the consignment by paying Rs. 1,500 for railway charges, Rs. 1,300 for 'insurance and Rs. 200 for carriage. He submitted an Account Sales as follows:

20 Computers sold at Rs. 25,000 each for cash
50 Computers sold on credit at Rs. 30,000 each
10 taken for his own stock at Rs. 25,000 each

Consignee remitted the balance after deducting his commission at 10% on sales. Assuming that original entries are made at invoice price and consignment stock is valued at invoice price, write necessary accounts in the books of Raj Traders.

Solution:

Books of Raj Traders

Consignment to Gauhati Account

Dr. Cr.

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Goods Sent on Consignment A/c (IP)	22,00,000	By Bahadur (Sales)	22,50,000
To Bank A/c (Consignor's expenses)	50,000	By Consignment Stock A/c (IP)	4,50,600
To Bahadur (Consignee's expenses)	3,000	By Goods Sent on Consignment A/c 'Loading on goods sent)	2,00,000
To Bahndur (Commission)	2,25,000		
To Stock Reserve A/c (Loading on closing stock)	40,000		
To Profit & Loss A/c (Profit transferred)	3,82,600		
	29,00,600		29,00,600

Goods Sent on Consignment Account

	Rs.		Rs.
To Consignment A/c (Loading)	2,00,000	By Consignment A/c (IP)	22,00,000
To Trading A/c	20,00,000		
	22,00,000		22,00,000

Bahadur of Gnuhnti Account

	Rs.		Rs.
To Consignment A/c (Sales proceeds)	22,50,000	By Consignment A/c (Expenses)	3,000
		By Consignment A/c (Commission)	2,25,000
		By Balance c/d	20,22,000
	22,50,000		22,50,000

Stack Reserve Account

	Rs.		Rs.
To Balance c/d	40,000	By Consignment A/c (Loading)	40,000

Working Notes

1 **Calculation of Invoice Price per computer**

Cost price of each computer Rs. 20,000

Invoice price 10% above the cost price

Invoice price = Cost price + 10% of cost price

$$= 20,000 + \frac{10}{100} \times 20,000$$

$$= 20,000 + 2000$$

$$= \text{Rs. } 22,000$$

2 **Calculation of closing stock** While calculating closing stock proportionate nun-recurring expenses are added, as you learnt in the previous unit.

		Rs.
Total invoice price of 20 computers (Rs. 22,000 x 20)		4,40,000
Add: proportionate non-recurring expenses by the		
Consignor	50,000	
Consignee	3,000	
	53,000	
proportionate expenses (Rs. 53,000 x 20/100)		10,600
		4,50,600

3 **Calculation of loading:**

Invoice price per computer	22,000
Cost price per computer	20,000
Loading (IP–CP) per computer	2,000

a) Total loading on goods sent on consignment of 100 computers (2,000 x 100) = Rs. 2,00,000

b) Total loading on closing stock of 20 computers (200 × 20) = Rs. 40,000

Illustration 3

Ram Das of Hyderabad consigned goods costing Rs. 72,000 to Prakash of Cochin at a pro-forma invoice price which is cost plus a profit of 1/6th on invoice price. The consignor paid Rs. 1,800 as insurance and other charges. Prakash received the goods and paid Rs. 3,000 for freight and other charges. He was allowed 3% commission on gross sales. Three fourths of the goods were sold at $33\frac{1}{3}$% profit on cost, half of which were credit sales. Half of the balance was stolen, but the stock being insured, a claim was lodged for Rs. 8,000 and was settled for Rs. 7,000. Balance of stock was valued at proforma invoice price. Write up the Consignment and the Abnormal Loss Accounts.

Solution :

Consignment to Cochin Account

Dr. Cr.

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Goods Sent on Consignment A/c	86,400	By Prakash (Sales)	72,000
To Bank A/c (Consignor's expenses)	1,800	By Abnormal Loss A/c	9,600
To Prakash [Freight and other charges)	3 000	By Consignment Stock A/c (Unsold stock)	11,400
To Prakash (Commission on Sales)	2,160		
To Stock Reserve A/c (Loading on closing stock)	1,800	To Goods Sent on Consignment A/c (Loading)	14,400
To Profit & Loss A/c (Profit transferred)	12,240		
	1,07,400		1,07,400

Abnormal Loss Account

	Rs.		Rs.
To Consignment to Cochin A/c	9.600	By Bank A/c (Insurance)	
		By Profit & Loss A/c (Balance transferred)	2.600
	9,600		9,600

Working Notes

1 **Invoice Price of the Goods Sent:**

Cost price (CP) of the Goods: Rs. 72,000

IP = CP + Profit

Let IP be X

$$X = 72,000 + \frac{1}{6}X$$

$$X - \frac{1}{6}X = 72,000$$

$$\frac{6X - X}{6} = 72,000$$

$$\frac{5X}{6} = 72,000$$

$$X = 72,000 \times \frac{6}{5} = \text{Rs. } 86,400$$

2 **Sale of price of 3/4 of the goods:** $\left(\frac{3}{4}\text{th of the goods sold at a profit of } 33\frac{1}{3}\% \text{ on cost}\right)$

CP of 3/4th goods (72,000 × 3/4) = Rs. 54,000

Add $33\frac{1}{3}\%$ of cost as profit = Rs. $\frac{18,000}{72,000}$

$\left(54,000 \times \frac{100}{300}\right)$

Sales = Rs. 72,000

3 . Value of **closing stock:**

Invoice Prince of Goods Consigned	Rs. 86,400
IP of stock left unsold (86,400 × 1/14)	Rs. 21,600
Less IP of the goods a lost in transit (21,600 × 1/2)	Rs. 10,800
IP of stock with the consignee after the loss (21,600 – 10,800) .	Rs. 10,800
Add proportionate expenses (1/8 x 4.800)	600
Value of closing stock	11,400

4 ***Cost* of Goods Lost** (Abnormal Loss) Goods lost is half of the goods unsold i.e.,

1/2 × 1/4 = 1/8th of goods consigned

CP of abnormal loss (1/8 × 72,000)	0,000
Add proportionate non-recurring expenses (1/8 × 4,800)	600
Cost of Abnormal Loss	9,600

5 **Loading on Closing Stock :**

	Rs.
IP (1/8 of 86,400)	10,800
CP (1/8 of 72,000)	9,000
Loading	1,800

Illustration 4

Verma Bros. of Bombay consigned goods at the invoice price of Rs. 1,00,000 which is 25% above cost price, to their agent Kabir Agency, Ahmedabad. The consignor incurred Rs. 5,000 for carriage and freight and Rs. 3,500 for insurance. Verma Bros. received Rs. 25,000 as advance against the consignment.

The consignee is allowed 3% commission on **all** sales. Any goods taken by the consignee himself or lost through consignee's negligence shall he valued at cost plus $12\frac{1}{2}\%$ and no commission would be allowed on them. The consignee sold 4/5th of the goods consigned for Rs. 1,40,000. Goods of the invoice price of Rs. 10,000 were taken by the consignee and the remaining goods were lust through his negligence. The consignee paid Rs. 2,500 for advertisement and selling expenses. Prepare necessary accounts in the books of the consignor.

Solution:

Consignment to Ahmedabad Account

Dr. Particulars	Rs.	Particulars	Cr. Amount Rs.
To Goods Sent on Consignment A/c	1,00,000	By Kabir Agency (Sales)	1,40,000
To Bank A/c (Expenses)	8,500	By Kabir Agency	9,000
To Kabir Agency (Consignee's expenses)	2,500		
To Kabir Agency (Commission)	4,200	By Kabir Agency (Stock lost).	9,000
To Profit & Loss A/c (Profit transferred)	62,800	By Goods sent on Consignment A/c (Loading)	20,000
	1,78,000		1,78,000

Kabir's Account

	Rs.		Rs.
		By Bank A/c (Advance)	25,000
To Consignment to Ahmedabad A/c (Sales)	1,40,000	By Consignment to Ahmedabad A/c (Expenses)	2,500
To Consignment to Ahmedabad A/c	9,000	By Consignment to Ahmedabad A/c (Commission)	4,200
To Consignment to Ahmedabad A/c (Balance)	9,000	By Balance c/d	1,26,300
	1,58,000		1,58,000

Working Notes

1 **Calculation of CP of Goods Consigned** IP of the Goods Sent is Rs. 1,00,000 which is *25%* above cost.

The CP shall be calculated as follows.

$IP = CP + P\ (25\% \text{ on } CP)$

Let CP be X

$$1,00,000 = X + \frac{25}{100}X$$

$$1,00,000 = X + \frac{1}{4}X$$

$$1,00,000 = \frac{4X + X}{4}$$

$$1,00,000 = \frac{5X}{4}$$

$$\text{or } \frac{5X}{4} = 1,00,000$$

$$5X = 1,00,000 \times 4$$

$$X = \frac{1,00,000 \times 4}{5}$$

$$X = 80,000$$

$$CP = \text{Rs. } 80,000$$

2 **Value of goods taken by the consignee**

IP of goods taken = Rs. 10,000

CP of goods taken

$$= \text{Rs. } 8,000\left(10,000 \times \frac{4}{5}\right)$$

These are to be valued at cost plus $12\frac{1}{2}\%$ on cost. Hence, its value will be

= 8000 + 1000
= Rs. 9,000

3 Value of goods lost due to Consignee's negligence It will be worked in the same manner as the value of goods taken by the consignee.

12.6 LET US SUM UP

Sometimes, in order to conceal the actual profit earned on consignment the consignor invoices the goods to the consignee at a price which is higher than the cost. This is called invoice price (IP). The difference between the invoice price (IP) and the cost price (CP) is called loading. This affects four items shown in the Consignment Account viz, (i) goods sent on consignment (ii) goods returned by the consignee (iii) opening consignment stock, and (iv) closing consignment stock. In order to work out the actual profit, the effect of loading on all these items has to be nullified, otherwise the Consignment Account will show profit which is less than the profit actually earned.

Loading can be found out by subtracting CP from IP. The calculation of loading is simple when both CP and IP are given. But it needs special attention when the loading is given as a percentage of CP or IP and only the figure of IP or CP is given. In such a situation, the formula IP = CP+P is used for the calculation of loading or the cost price, invoice price whichever is not given. For the adjustment of loading involved in different items, we have to pass the necessary journal entries in the books of the consignor. However, the books of the consignee are not affected by loading because his books do not include any entry in respect of the four items involved.

12.7 KEY WORDS

Invoice Price : The price at which the consignor invoices the goods to the consignee. It is usually higher than cost.

Loading: Difference between the invoice price and the cost price.

12.8 SOME USEFUL BOOKS

Maheshwari, S.N. 1986. *Introduction to Accounting,* Vikas publishing House: New Delhi: (Chapter 1 Section II)

Patil, V.A. and J.S. Korlahalli, 1986. *Principles and Practice of Accounting,* R. Chand & Co. New Delhi. (Chapter 2)

William Pickles. 1982. *Accountancy,* E.L.B.S. and Pitman: London. (Chapter 17)

Gupta R.L. and M. Radhaswamy. 1986. *Advanced Accountancy,* Sultan Chand & Sons: New Delhi. (Chapter 15)

12.9 ANSWERS TO CHECK YOUR PROGRESS

1 i) False ii) True iii) False iv) True v) False vi) False

2 Difference between IP and CP

3 i) goods sent on consignment
ii) goods returned by the consignee
iii) opening consignment stock
iv) closing consignment stock

4 i) Rs. 600
ii) Rs. 200

iii) Rs. 625
iv) Rs. 225
v) Rs. 250

5 i) Rs. 400
ii) Rs. 120
iii) Rs. 150
iv) Rs. 120
v) Rs. 100

12.110 TERMINAL QUESTIONS/EXERCISES

Questions

1 What do you understand by invoice price? Give reasons for consigning the goods at the invoice price.

2 What is loading? How do you compute it? Give examples.

3 Name items which are recorded at the invoice price in the Consignment Account. Give journal entries passed for the adjustment of loading in respect of each item.

Exercises

1 Vijay & Co. of Kolhapur consigned 2,000 bicycles on July 18.1988 to Chaudhari of Madras for sale on the following conditions.

a) Cycles may be sold at invoice price or above.
b) Chaudhari is entitled to a commission of $7\frac{1}{2}\%$ on invoice price of goods sold and 20% on any excess over the invoice price.

The cost of each cycle was Rs. 300 and it was invoiced at cost plus $33\frac{1}{3}\%$ at cost. Vijay & Co. incurred Rs. 20,000 on freight and insurance. Chaudhari received the consignment on July 14, and accepted a 3 months bill drawn on him by Vijay & Co. for Rs. 2,00,000. Chaudhari paid Rs. 8,000 as custom duty and Rs. 5,000 as insurance and rent for the godown. They sold 1,600 cycles at Rs. 500 each; Give ledger accounts as they would appear in the books of Vijay & Co. and Chaudhari.

(Answer: Profit Rs. 2,12,600; Stock at invoice price Rs. 1,65,600 Amount due from Shri Chaudhary Rs. 5,07,000)

2 On June 10,1987, Raj & Co. of Bombay consigned 100 cases of Red Wine to Singham Bros. of Ceylon. The cost of the consignment amounted to Rs. 7,500 but the goods were charged at proforma invoice price so as to show a profit of 25% on invoice price. On the same date, the consignors paid Ks. 600 for freight and insurance. On July 1, the consignees paid Rs. 1,000 for import duty, Rs. 200 for dock dues, and remitted a bank draft for Rs. 4,000 as an advance against the consignment. On July 15, they sold 80 cases for Rs. 10,500. Singham Bros. are entitled to a commission of 5% on gross proceeds of sales as their remuneration. Show the entries in the books of the consignor and the consignee, assuming that the consignee has remitted the balance due from them by draft.

(Answer : Profit Rs. 2,535; Value of stock Rs. 2,360)

3 Modi Textiles, Delhi consigned to Vinod Enterprises, Calcutta 100 cotton bales. The invoice price of each bale was Rs. 1,500 which includes 20% profit on invoice price. The consignor paid Rs. 2,500 for insurance and Rs. 4,000 for carriage and freight. The consignee received cotton bales and sold 75 bales for cash and realised Rs. 1,12,500. He incurred Rs. 1,800 on godown rent and was allowed 10% commission on sales. 5 cotton bales were spoiled in godown and they are to be valued at 50% depreciation. Show Consignment Account in the books of Modi Textiles.

Hint: The damaged goods are also to be included in stock and they will be valued at 50% of the invoice price and the proportionate expenses.

(Answers: Profit Rs. 1412; Value of stock Rs. 35,212 (including Rs. 3,912 for damaged goods); Amount due from the consignee Rs. 99,450)

4 On January 1, 1988 the Consignment to Ceylon A/c in the books of Unique Clock Makers showed a debit balance of Rs. 3,750. This is represented by the invoice value of 50 clocks which is 25% above cost.

On January 7, they sent another consignment of 2,500 clocks at the invoice price of Rs. 75 each which was 25% above cost. They paid Rs. 1,000 for packing, Rs. 500 for insurance and Rs. 3,000 for carriage and freight. Rama watch Co., the consignee received the clocks on January 21 and paid Rs. 3,000 for custom duty, clearing, etc. They also sent a bank draft for 50% of the invoice price of the goods received. On June 15, they returned 50 clocks which were found defective.

By December 31, 1988 they sold the opening stock of 50 clocks at Rs. 85 each on credit and 2,400 clocks of the new consignment at Rs. 90 each. Their expenses were: advertising Rs. 2,000 salaries Rs. 2,000 and service charges Rs. 250.

The consignee is entitled to a commission of 8% on sales. The consignee could not recover Rs. 250 on account of credit sales. Show the necessary ledger accounts in the books of both the parties.

(Answer: Profit Rs. 43,780; Value of closing stock Rs. 3,900; Amount due from consignees Rs. 1,01,630)

5 A of Agra consigned 100 units of a commodity to D of Delhi. The goods were invoiced at Rs. 150 per unit so as to yield a profit 50% on cost. A incurred Rs. 1,000 on freight and insurance D incurred Rs. 500 on freight and Rs. 800 on rent. Before December 31, 1988 he sold 50 units for cash at Rs. 160 per unit and 20 units on credit for Rs. 175 per unit. He retained his commissions at 5% and 1% del credre on all sales and remitted the balance on December 31, 1988. D noticed that 10 units were damaged on account of bad packing and could sell them only for Rs. 80 per unit. A debtor for Rs. 1,000 to whom goods were sold on credit became insolvent and only 50 paise in a rupee could be recovered. Prepare necessary ledger accounts in the books of A and D.

(Answer: Profit Rs. 1,960; Abnormal Loss Rs. 398; Value of stock Rs. 3,300)

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 13 JOINT VENTURE ACCOUNTS

Structure

13.0 OBJECTIVES

After studying this unit you should be able to:

- explain the meaning and importance of a joint venture
- distinguish joint venture from partnership and consignment
- record joint venture transactions in the books of one venturer
- record joint venture transactions in the books of all venturers
- prepare Memorandum Joint Venture Account
- prepare separate set of books for the joint venture business

13.1 INTRODUCTION

In Unit 10, 11 and 12 you have studied how various transactions related to the consignments are recorded in the books of the concerned parties. The basic objective of preparing the Consignment Account is to ascertain the profit or loss on each consignment. Similarly, when some persons join hands to carry out a specific job or a project (called joint venture), each person (called co-venturer) would like to ascertain his share of profit or loss from the joint venture business. For this purpose they record the transactions related to the joint venture business in their own books or prepare a separate set of hooks altogether. In this unit you will learn how various transactions related to the joint venture business are recorded when separate set of books are prepared and when the co-venturers decide to record them in their own books without preparing a separate set.

13.2 WHAT IS A JOINT VENTURE?

When two or more persons join together to carry out a specific business venture and share the profits on an agreed basis it is called a 'joint venture'. Each one of them who join as a party to the joint venture is called 'Co-venturer'. No firm name is normally used for the joint venture business because its duration is limited to a short period. During this period, the co-venturers are free to carry on their own business as usual, unless agreed otherwise. The business relationship amongst the co-venturer comes to an end as soon as the venture is completed. **Thus a joint venture is some kind of a temporary partnership between two or more persons who have agreed to jointly carry out a specific venture.** The joint ventures are quite common in construction business, consignment, sale and purchase of property, underwriting of shares and debentures, etc. For example, A and B agreed to construct a college building for which they pooled their resources and skill. A provided Rs. 6 lakh and B Rs. 4 lakh as capital. They completed the building and shared the profits in the ratio of their contributions to capital. In this example, joining hands by A and B to construct a building is a joint venture. A and B are co-venturers. They will share the profits in the ratio of 6 and 4 (same as the ratio of their capitals).

From the above discussion thk essential features of a joint venture can be listed as follows:

1 It is formed by two or more persons.

2 The purpose is to execute a particular venture or project.

3 No specific firm name is used for the joint venture business.

4 It is of a temporary nature. Hence, the agreement regarding the venture automatically stands terminated as soon as the venture is completed.

5 The co-venturers share profit and loss in the agreed ratio. However, in the absence of any other agreement between the co-venturers, the profits and losses are to be shared equally.

6 During the tenure of joint venture, the co-venturers are free to continue with their own business unless agreed otherwise.

The main advantages of a joint venture are:

1 **Sufficient Resources:** Since two or more persons pool their resources, there is sufficient capital available.

2 **Ability and Experience:** In joint venture the different venturers may be having different skills and experience. The benefit of their common wisdom will be available to the venture.

3 **Spreading of Risk:** The co-venturers agree to share the profits and losses in a particular ratio. This implies that the risk is also borne by them in that ratio.

13.3 JOINT VENTLTRE AND CONSIGNMENT

Even though both consignment and joint venture are in the nature of an agreement between different parties, there arc many points of difference between the two. The main points of difference are as follows:

Consignment	Joint Venture
1 Normally two persons are involved, the consignor and the consignee.	Number of co-venturers is usually two, but it may also be more than two.
2 The relationship between the consignor and the consignee is that of principal and agent.	The relationship between co-venturers is that of partnership.
3 The arrangement may continue for a long time.	The relationship comes to an end as soon as the venture is completed.
4 The funds are provided by the consignor.	All the co-venturers contribute to a common pool.
5 The consignee acts merely as an agent and he has to follow the instructions of the consignor.	The co-venturers have equal authority to take decisions.
6 Consignment is generally concerned with the sale of movable goods.	Joint Venture may be for sale of goods or for carrying on any other activity like construction of building, investment in shares, etc.

7	The profit belongs to the consignor only. The consignee is entitled only to his commission.	The profit is shared by all the co-venturers.
8	The consignor owns the goods.	There is joint ownership.
9	There is only one method of maintaining the accounts for consignment transactions.	There are four methods of maintaining accounts for the joint venture.

13.4 JOINT VENTURE AND PARTNERSHIP

Though joint venture is in the nature of a temporary partnership but in the strict legal sense it is not a partnership. Both in joint venture and partnership some business is carried on by two or more persons and the profits are shared by all of them. But, there are some basic differences between the two. They are as follows:

	Partnership	Joint Venture
1	A partnership firm always has a name.	There is no need for firm name.
2	It is of a continuous nature.	It comes to an end as soon as the work is completed.
3	Separate set of books have to be maintained.	There is no need for a separate set of books, the accounts can be maintained even in one of the co-venturer's books only.
4	No partner can carry an a similar business.	The co-venturers are free to carry on the business of a similar nature.
5	Though the registration of partnership is not compulsory but it is considered desirable.	There is no need for registration at all.
6	A minor can also be admitted to the benefits of the firm.	A minor cannot be a co-venturer as he is incompetent to enter into a contract.

Check Your Progress-A

1 A & B enter into a joint venture for the construction of a building. They contributed Rs. 2,00,000 and Rs. 3,00,000 respectively. They agreed to share the profits or losses in the ratio of their contribution to capital. The profit for the joint venture is Rs. 45,000. State (i) the names of the co-venturers, and (ii) each co-venturer's share of profit.

i) ....

ii) ....

2 . State whether each of the following statements is True or False.

i) A joint venture is a partnership formed under the Indian Partnership Act ....
ii) A Joint venture has a definite life. ....
iii) Joint venture is the same thing as consignment ....
iv) Joint venture agreement must be registered ....
v) Co-venturers share the profits in the agreed ratio. ....

13.5 ACCOUNTING TREATMENT

Broadly speaking, accounts of a joint venture business can be kept in any one of the following four ways:

1 **In the books of one co-venturer:** In case the business is not very large, only one of the venturers may be entrusted with the task of recording the transactions in his books. In

that case all other co-venturers will send their contributions to such venturer and he will open a Joint Venture Account and the personal accounts of other co-venturers in his books.

2 In the books of ail the co-venturers: When all co-venturers are working actively, each one of them shall open a Joint Venture Account and the personal accounts of other co-venturers in his books. In such a situation, each co-venturer informs others about the transactions undertaken by him so that they can incorporate them in their books.

3 Memorandum Joint Venture Account: Sometimes each co-venturer records only such transactions as are directly concerned with him. In that case he cannot work out the profit or loss because his books do not include all transactions of the joint venture. Hence, for calculating the profit or loss of the joint venture, a Memorandum Joint Venture Account has to be prepared by incorporating all transactions related to the joint venture. Thereafter the Joint Venture Account is completed and closed.

4 Separate Set of Books: Sometimes, for the sake of convenience, a separate set of books are maintained for the joint venture. Under this system a Joint Bank Account, a Joint Venture Account and the personal accounts of all the co-venturers are to be opened in 'the independent set of books of account.

Let us now study these methods one by one in detail.

13.5.1 Recording in the Books of one Co-venturer

If the joint venture business is not very large, the task of recording transactions can very well he entrusted to one of the co-venturers. He will prepare a Joint Venture Account and the personal accounts of other co-venturers. The Joint Venture Account is prepared for ascertaining the profit or loss of the joint venture. The personal account of other co-venturers are prepared to find out the amount due from them. As stated earlier, each co-venturer is also entitled to carry on his own business and these transactions will be in addition to what he records in respect of his own business. The following journal entries are passed in his books before preparing the necessary accounts of the joint venture.

1 When the co-venturers send their contribution:

Cash/Bank A/c	Dr.
To Co-venturer's Personal A/c	

2 When the goods are purchased for the joint venture:

Joint Venture A/c	Dr.
To Cash/Bank A/c	

3 When the goods are supplied from his own stock by the co-venturer who is recording the transactions:

Joint Venture A/c	Dr.
To Purchases A/c	

Here we are crediting Purchases Account because he is supplying the goods from his own stock at cost. But if the goods are supplied by him at n price other than the cost price, we shall credit the Sales Account instead of the Purchases Account.

4 When the goods are supplied by other co-venturers:

Joint Venture A/c	Dr.
To Co-venturer's Personal A/c	

5 When some expenditure is incurred on account of the joint venture:

Joint Venture A/c	Dr.
To Cash/Bank A/c	

But, if expenses are paid by a co-venturer other than the one who is recording the transactions, then the entry will be:

Joint Venture A/c	Dr.
To Co-venturer's Personal A/c	

Here we have debited the Joint Venture Account because it is an expenditure on account of the joint venture business.

6 When the co-venturer recording the transactions sells the goods:

a) For cash sales:

Cash/Bank A/c Dr.
To Joint Venture A/c

b) For credit sales:

Debtor's Personal A/c Dr.
To Joint Venture A/c

7 When cash is received from debtors:

Cash/Bank A/c Dr.
To Debtor's Personal A/c

8 When some cash discount is allowed to the debtor making payment, or some bad debts are incurred:

Joint Venture A/c Dr.
To Debtor's Personal A/c

9. When sales are made by other co-venturers:

Co-venturer's Personal A/c Dr.
To Joint Venture A/c

10 When some cash or bills receivable are received from other co-venturers on account of sales made by them:

Cash/Bank/Bills Receivable A/c Dr.
To Co-venturer's Personal A/c

11 When the co-venturers recording the transactions is entitled to some commission or salary:

Joint Venture A/c Dr
To Commission/Salary A/c

Joint Venture Account is debited as it is an expenditure related to the joint venture business.

12 When the unsold stock of joint venture is taken over by the co-venturer recording the transactions:

Purchases A/c Dr.
To Joint Venture A/c

If the unsold stock is taken over by some other co-venturer, the journal entry will be:

Co-venturer's Personal A/c Dr.
To Joint Venture A/c

After passing the above entries, the Joint Venture Account is prepared. The balance of this account will show either profit or loss which is to be shared by all the co-venturers in their profit sharing ratio. This will require the following further entries:

a) If it shows profit:

Joint Venture A/c Dr.
To Profit & Loss A/c
(his own share)
To Co-venturers' Personal A/cs
(individually for their shares)

b) If it results in loss:

Profit & Loss A/c Dr.
(his own share of loss)
Co-venturers' Personal A/cs Dr.
(individually for their shares)
To Joint Venture A/c

After closing the Joint Venture Account, we have to find out the ainount due to other co-venturers. When this amount is sent to them, we record the following entry.

Co-venturers' Personal A/cs Dr.
To Cash/Bank A/c

Look at Illustration 1. It shows the journal entries as well as the different accounts in the ledger of the co-venturer who is recording the transactions relating to the joint venture business in his books.

Illustration 1

Rajesh and Suresh entered into a contract to construct a building for Rs. 4,00,000. Rajesh and Suresh contributed Rs. 2,00,000 and Rs. 1,50,000 respectively. They agreed to share profits and losses in the ratio of 4:3. It was decided that the work will be looked after by Rajesh who will be paid 5% commission on contract price in addition to his share of profits. Rajesh purchased the necessary materials for Rs. 3,20,000 and paid Rs. 9.000 for expenses. Rajesh also contributed building materials from his own stock worth Rs. 20,000. Rs. 5,000 remained to be paid for wages.

Suresh took over the stock of materials for an agreed valuation of Rs. 16,000. The building was completed and the contract money was duly received.

Record the above transactions in the books of Rajesh and show the Joint Venture Account and Suresh's Account assuming that the outstanding wages were paid by Rajesh.

In the Books of Rajesh

Journal Entries

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
				Rs.	Rs.
	Cash A/c	Dr.		1,50,000	
	To Suresh				1,50,000
	(Being cash received from Suresh)				
	Joint Venture A/c	Dr.		3,20,000	
	To Cash A/c				3,20,000
	(Being materials purchased)				
	Joint Venture A/c	Dr.		9,000	
	To Cash A/c				9,000
	(Being expenses paid)				
	Joint Venture A/c	Dr.		20,000	
	To Purchases A/c				20,000
	(Being material supplied from personal stock)				
	Joint Venture A/c	Dr.		5,000	
	To Outstanding Wages A/c				5,000
	(Being outstanding wages)				
	Joint Venture A/c	Dr.		20,000	
	To Commission A/c				20,000
	(Being Commission @ 5%)				
	Cash Account	Dr.		4,00,000	
	To Joint Venture				4,00,000
	(Being the contract price received)				
	Suresh	Dr.		16,000	
	To Joint Venture A/c				16,000
	(Being goods taken over by Suresh)				
	Joint Venture A/c	Dr.		42,000	
	To Profit & Loss A/c				
	To Suresh				
	(Being the profit shared)				
	Outstanding Wages A/c	Dr.		5,000	
	To Cush A/c				5,000
	(Being wages paid by Rajesh)				
	Suresh	Dr.		1,52,000	
	To Cash A/c				1,52,000
	(Being the nmount due paid)				

Joint Venture Account

Dr. Particulars		Amount	Particulars	Amount Cr.
		Rs.		Rs.
To Cash A/c (Purchases)		3,20,000	By Cash A/c	4,00,000
To Cash A/c (Expenses)		9,000	By Suresh	16,000
To Purchases A/c (Material Supplied)		20.000		
To Outstanding Wages A/c		5,000		
To Commission A/c		20,000		
To Profit transferred to:				
Profit & Loss A/c	24.000			
Suresh	18.000	42.000		
		4,16,000		4,16,000

Suresh's Account

	Rs.		Rs.
To Joint Venture A/c	16,000	By Cash A/c	1,50,000
To Cash A/c	1,52,000	By Joint Venture A/c	18.000
	1,68,000		1,68,000

Illustration 2

Anand and Prakash entered into a joint venture agreement to share the profits and losses in the ratio of 2:1. Anand supplied goods worth Rs. 60,000 to Prakash and incurred expenses amounting *to* Rs. 2,000 for freight and insurance. During transit the goods costing Rs. 5,000 were damaged and a sum of Rs. 3,000 was received from the insurance company. Prakash reported that 90% of the remaining goods were sold at a profit of 30% of their original cost. Towards the end of the venture, a fire damaged the balance stock lying unsold with Prakash. The goods were not insured and Prakash agreed to compensate Anand by paying in cash 80% of the aggregate of the original cost of such goods, plus proportionate expenses incurred by Anand. Apart from the joint venture share of profit, Prakash was also entitled to a commission @ 5% on net profits of the joint venture after charging such commission. Selling expenses incurred by Prakash totalled Rs. 1,000. Prakash had earlier remitted an advance of Rs. 10,000. Prakash paid the balance due to Anand by a bank draft. You are required to prepare the Joint Venture Account, and Prakash's Account in Anand's books.

Solution:

In the Ledger of Anand

Joint Venture Account

Dr. Particulars		Amount	Particulars	Amount Cr.
		Rs.		Rs.
To Purchase A/c (Goods supplied)		60,000	By Bank A/c (Insurance)	3,000
To Bank A/c (Expenses)		2,000	By Prakash (Sales)	64,350
To Prakash (Expenses)		1,000	By Prakash (Agreed value of damaged goods)	4,546
To Prakash (Commission -1/21 of Rs. 8,896)		424		
To Profit transferred to:				
Profit & Loss A/c	5,648			
Prakash	2,824	8,472		
		71,896		71,896

Prakash's Account

	Rs.		Rs.
To Joint Venture A/c (Sales)	64,350	By Bank A/c (Advance)	10,000
To Joint Venture A/c (Claim for damaged goods)	4,546	By Joint Venture A/c (Expenses)	1,000
		By Joint Venture A/c (Commission)	424
		By Joint Venture A/c (Profit)	2,824
		By Bank A/c (Balance received by draft)	54,648
	68,896		68,896

Working Notes:

	Rs.
1 Calculation of Sales:	
Cost of goods sent	60,000
Less Damage in transit	5,000
Cost of remaining goods	55,000
Cost of goods sold (90% of Rs. 55,000)	49,500
Add Profit 30% of Rs. 49,500	14,850
Sales	64,350

2 Loss by fire borne by Prakash:

	Rs.
Cost of goods in stock (10% of 55,000)	5,500
Add Proportionate Expenses $\frac{2,000 \times 5,500}{60,000}$	183
Total Loss	5,683
80% of this loss	4,546

3 Abnormal loss on account of damage in transit relates to the joint venture. Hence no calculation is needed.

13.5.2 Recording in the Books of all Co-venturers

Under the second method, all transactions relating to the joint venture are recorded in the books of all the co-venturers. In order to complete the Joint Venture Account in the books of all co-venturers, each co-venturer sends the necessary information about his dealings to the other co-venturers. There is not much of a difference in the recording of transactions berween the first and the second method. We will be having similar entries in the joint venture accounts in each co-venturer's books who shall all open the personal accounts of other co-venturers. Look at Illustration 3 to clearly understand the recording of transactions under the second method.

Illustration 3

Arvind and Babloo entered into a joint venture agreeing to share profits and losses equally. The following transactions took place during the course of venture:

	Rs.
Arvind bought goods for cash	2,550
Babloo bought goods for cash	7,000
Arvind paid storage charges	500
Babloo paid freight and insurance	800
Babloo sold goods for cash	7,000

Babloo received 3% commission on sales	210
Sales made by Arvind	5,000
Commission payable to Arvind	150
Babloo took over the unsold stock	560

Prepare the necessary ledger; accounts in the book of Arvind and Babloo assuming that the accounts are finally settled between them.

Solution

Ledger of Arvind

Joint Venture Account

Dr. Particulars		Amount	Particulars	Amount Cr.
		Rs.		Rs.
To Cash A/c (goods purchased)		2,500	By Babloo (sales)	7,000
To Babloo (goods purchased)		7,000	By Cash (sales)	5,000
To Cash A/c (expenses)		500	By Babloo (stock taken over)	560
To Babloo (expenses)		800		
To Babloo (commission)		210		
To Commission A/c		150		
To Profit transferred to:				
Babloo	700			
Profit & Loss A/c	700	1,400		
		12,560		12,560

Babloo's Account

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Joint Venture A/c (sales)	7,000	By Joint Venture A/c (goods purchased)	7,000
To Joint Venture A/c (stock taken over)	560	By Joint Venture A/c (expenses)	800
To Cnsh A/c (balance due paid)	1,150	By Joint Venture A/c (commission)	210
		By Joint Venture A/c (share of profit)	700
	8,710		8,710

Ledger of Babloo

Joint Venture Account

Dr. Particulars		Amount	Particulars	Amount Cr.
		Rs.		Rs.
To Arvind (Goods purchased)		2,500	By Cash A/c (Sales)	7,000
To Cash A/c (Goods purchased)		7,000	By Arvind (Sales)	5,000
To Arvind (Expenses)		500	By Purchases A/c (Stock taken over)	560
To Cash A/c (Expenses)		800		
To Commission A/c		210		
To Arvind (Commission)		150		
To Profit transferred to:				
Arvind	790			
Profit & Loss A/c	700	1,400		
		12,560		12,560

Arvind's Account

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Joint Venture A/c (Sales)	5,000	By Joint Venture A/c (Goods purchased)	2.500
		By Joint Venture A/c (Expenses)	500
		By Joint Venture A/c (Commission)	150
		By Joint Venture A/c (Share of profit)	700
		By Cash A/c (Balance due recieved)	1,150
	5,000		5,000

13.5.3 Memorandum Joint Venture Account Method

In the method discussed above each co-venturer records all transactions relating to the joint venture in the Joint Venture Account opened in his books, But. unde: the Memorandum Joint Venture Account Method each co-venturer will record only those transactions relating to the joint venture which are directly concerned with him, and not those of others. Under this method each co-venturer opens a Joint Venture Account including the name of the other co-venturer. For example, if A and B are partners in a joint venture, then in the books of A it will be termed as 'Joint Venture with B Account' and in the books of B it will be termed its 'Joint Venture with A Account': Each co-venturer will record only such transactions which are actually effected by him. For example, if goods are purchased by A for the joint venture, it will be recorded only by A and not by other co-venturers. Similarly, if goods are sold by B, it will be recorded in the books of B only. This account is in the nature of a personal account and, therefore, will not disclose the profit or loss of the venture. For that purpose. we prepre an additional account called 'Memorandum Joint Venture Account'. This is like Profit and Loss A/c.

Let us say A and B enter into a joint venture and certain transactions have taken place for which the following entries will be passed in each co-venturer's books.

1 **A purchases goods for cash:**
This transaction shall be recorded in the books of A only. The entry will be:

Joint Venture with B A/c	Dr.
To Cash A/c	

2 **A incurs some expenditure on account of the joint venture:**
It shall be recorded in A's books only. The entry will be:

Joint Venture with B A/c	Dr.
To Cash A/c	

3 **B sells goods for cash:**
No entry will be made in A's books. But the following entry will be made in B's books:

Cash Account	Dr.
To Joint Venture with A A/c	

4 **B sends money to A:**
a) It shall be recorded in B's books as follows:

Joint Venture with A A/c	Dr.
To Cash/Bank A/c	

b) It shall be recorded in A's books as follows:

Cash/Bank/ A/c	Dr
To Joint Venture with B A/c	

As stated earlier, for ascertaining the profit or loss on the joint venture, we prepare a Memorandum Joint Venture Account. This account is prepared exactly on the pattern of Profit & Loss Account. Since this account does not form part of the double entry system, the word 'Memorandum' is prefixed.

The method of preparing this account is very simple. It is prepared on the basis of information supplied by all the co-venturers. The debit entries appearing in the personal accounts of all co-venturers are written on the debit side of the Memorandum Account and the entries appearing on the credit side of those accounts are shown on the credit side of the Memorandum Joint Venture Account. However, **you should remember that the transactions which do not relate to an item of expense or income are to be excluded from this Memorandum Account.** The difference in the totals of the debit side and the credit side represents profit or loss. The profit or loss thus calculated is then shared by the co-venturers in the agreed profit sharing ratio.

Each co-venturer will record only his share of profit or loss. In the event of **profit,** the entries shall be:

In the books of A

Joint Venture with B A/c	Dr.
To Profit & Loss A/c	

In the books of B

Joint Venture with A A/c	Dr.
To Profit & Loss A/c	

In the event of Loss the entries shall be reversed as follows:

In the books of A

Profit and Loss A/c Dr.
To Joint Venture with B A/c

In the books of B

Profit and Loss A/c Dr.
To Joint Venture with A A/c

In the end each venturer balances the 'Joint Venture with ....Account' in his books and settles the account by paying or receiving cash. Look at Illustration 4 carefully to understand the Memorandum Joint Venture Account Method.

Illustration 4

Prem of Delhi and Satish of Calcutta entered into a joint venture for the purchase and sale of goods. The profits and losses are to be shared in the ratio of 2:1.

Prem purchased goods for Rs. 40,000 and sent them to Satish paying Rs. 3,000 for freight and insurance. Prem also incurre sundry expenses amounting to Rs. 400. Satish sold goods for Rs. 55,000 and incurred Rs. 6,000 as expenses. Unsold stock valued at Rs. 7,000 was taken over by Satish. Satish remitted the balance due to Prem by a bank draft.

Each party's ledger contains a record of his own transactions in the Joint Venture Account. Prepare (a) Memorandum Joint Venture Account, (b) Joint Venture with Satish's Account in Prem's ledger, and (c) Joint Venture with Prem's Account in Satish's ledger.

Solution:

Ledger of Prcm

Joint Venture with Satish Account

Dr. Particulars	Amount	Particulars	Cr. Amount
	Rs.		Rs.
To Bank A/c (Purchases)	40,000	By Bank A/c (In Final Settlement)	51,800
To Bank A/c (Freight & Ins.)	3,000		
To Bank A/c Sundry Exp.)	400		
To Profit & Loss A/c (Share of profit)	8,400		
	51,800		51,800

Ledger of Setish

Joint Venture with Prem Account

Dr.			Cr.
	Rs.		Rs.
To Bank A/c (expenses)	6,000	By Bank A/c (sales)	55,000
To Profit & Loss A/c	4,200	By Purchases A/c (stock taken over)	7,000
To Bank A/c (final settlement)	51,800		
	62,000		62,000

Memorandum Joint Venture Account

		Rs.			Rs.
To Prem:			By Satish		
Goods	40,000		Sale Proceeds	55,000	
Freight Insurance	3,000		Stock taken over	7,000	62,000
Sundry Expenses	400				
		43,400			
To Satish (expenses)		6,000			
To Profit trnnsferred to					
Prem	8,400				
Satish	4.200	12.600			
		62,000			62.000

Interest in **Joint** Venture Transactions: When the co-venturers invest money in joint venture business and receive back the amounts on different dates, ir is quite usual for them to agree to calculate interest at a certain rate. Each co-venturer is entitled to receive interest on the amounts invested by him and pay interest on thk amounts received by him. You should remember that only the net interest receivable from, or payable to, the co-venturer is recorded in the Joint Venture Account. Thus, the net amount of interest is also taken into account before ascertaining the profit or loss on joint venture. For clarification look at Illustration 5.

Illustration 5

Anand and Bimal enter into a joint venture sharing profits and losses equally. Anand purchased goods for Rs. 5,000 for cash and Bimal spent Rs. 1,000 on freight, etc., on January 1, 1988. On the same day, Bimal bought goods for Rs. 10,000 on credit. Further expenses were incurred as follows:

On 1-2-1988	Rs! 1,000 by Bimal
On 1-3-1988	Ks. 500 by Anand

Sales were made by each one of them as follows:

15-1-1988	Rs. 3,000 by Anand
31-1-1988	Rs. 6,000 by Bimal
15-2-1988	Rs. 3,000 by Anand
1-3-1988	Rs. 4,000 by Bimal

Creditors for goods were paid as follows:

1-2-1988	Rs. 5,000 by Anand
1-3-1988	Rs. 5,000 by Bimal

On March 31, 1988 the balance of stock was taken over by Bimal at Rs. 9,000. The accounts between the co-venturers were settled by cash payment on this date. The co-venturers are entitled to interest at 12% per annum. Prepare necessary ledger accounts in the books of venturers as per Memorandum Joint Venture Account Method.

Solution:

Memorandum Joint Venture Account

Dr. Cr.

Particulars		Amount	Particulars	Amount
		Rs.		Rs.
To Anand (Cost of goods)		5,000	By Anund (Sales)	6,000
To Bimal (Cost of goods)		[redacted]	By Bimal (Sales)	10,000
			By Bimal (Interest)	50
To Bimul (Freight etc.)		1,000	By Bimal (Stock taken)	9,000
To Anand (Expenses)		500		
To Bimal (Expenses)		1,500		
To Anand (Interest)		135		
To Profit transferred to				
Anand	3,457			
Birnal	3,458	6,915		
		25,050		25,050

Anand's Ledger

Joint Venture with Bimal Account

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1988		Rs.	1988		Rs.
Jan. 1	To Bank A/c (Purchases)	5,000	Jan.15	By Bank A/c (Sales)	3,000
Feb. 1	To Bank A/c (Creditors)	5,000	Feb.15	By Bank A/c (Sales)	3,000
Mas. 1	To Bank A/c (Expenses)	500	Mar.15	By Bank A/c (Final settlement)	8,092
" 31	To Interest A/c	135			
" 31	To Profit & Loss A/c	3,457			
		14,092			14,092

Bimal's Ledger

Joint Venture with Anand Account

Dr.					Cr.
Date	Particulars	Amount	Date	Particulars	Amount
1988		Rs.	1988		Rs.
Jan. 1	To Bank A/c (freight)	1,000	Jan.31	By Bank (sales)	6,000
			Mar.		
Feb. 1	To Sank A/c (expenses)	1,500	" 31	By Bank (sales)	4,000
Mar. 1	To Bank A/c (creditors)	5,000			
Mar.31	To Profit & Loss A/c	3,458	" 31	By Goods A/c (stock taken over)	9,000
" 31	To Bank A/c (Amount paid in final settlement)	8,092	" 31	By Interest A/c	50
		19,050			19,050

Calculation of Interest.

Payments by Anand

Date	Amount	Months	Product	
1-1-88	Rs. 5,000	3	15,000	(5.000 x 3)
1-3-88	Rs. 500	1	500	(500 x 1)
1-2-88	Rs. 5,000	2	10,000	(5.000× 2)
			25,500	

$$\text{Interest} = 25,500 \times \frac{12}{100} \times \frac{1}{12} = \text{Rs. } 255$$

Receipts by Anand

15-1-88	Rs. 3,000	$2\frac{1}{2}$	7 0	$\left(3.000 \times 2\frac{1}{2}\right)$
15-2-88	Rs. 3,000	$1\frac{1}{2}$	4,500	$\left(3,000 \times 1\frac{1}{2}\right)$
			12,000	

$$\text{Interest} = 12,000 \times \frac{12}{100} \times \frac{1}{12} = \text{Rs. } 120$$

Net Interest due to Anand = 255 − 120 = Ks. 135

Payments by Bimal

1-1-88	Rs. 1,000	3	3,000
1-2-88	Rs. 1.500	2	3.000
1-3-88	Us. 5,000	1	5.000
			11.000

$$\text{Interest} = 11,000 \times \frac{12}{100} \times \frac{1}{12} = \text{Rs. } 110$$

Receipts by Bimal

31-1-88	Rs. 6,000	2	12,000
1-3-88	Rs. 4,000	1	4,000
			16,000

$$\text{Interest} = 16,000 \times \frac{12}{100} \times \frac{1}{12} = \text{Rs. } 160$$

Net Interest due from Bimal

= 160 − 110 = Rs. 50

Check Your Progress-R

1 Put a tick (√) in the box for the right answer.

a) The goods supplied from his stock at cost by the co-venturer maintaining the accounts. are debited to

i) Sales Account ☐

ii) Purchases Account ☐

iii) Stock Account ☐

b) In Memorandum Joint Venture Account Method, the co-venturer records
i) His transactions only. ☐
ii) Other co-venturers' transactions only ☐
iii) All the transactions of the Joint venture ☐

c) Memorandum Joint Venture Account is prepared to find out
i) Amount due from the co-venturers ☐
ii) Profit or loss on the joint venture ☐
iii) None of the above ☐

d) The share of profit of the co-venturer maintaining the records is credited to
i) Profit and Loss Account ☐
ii) His personal account ☐
iii) None of the above ☐

e) Any bad debts incurred on account of joint venture are debited to
i) Bad Debts Account ☐
ii) Debtor's Personal Account ☐
iii) Joint Venture Account ☐

13.5.4 Separate Set of Books

So far you have studied the methods of recording joint venture trairsactions where no separate set of books were maintained. Now we shall study another method where co-venturers agree to keep separate set of books for recording the joint venture transactions. When separate set of books are maintained, the joint venture transactions ere recorded as a separate accounting entity on the basis of double entry principles. Under this method the following accounts are opened:

1 Joint Bank Account
2 Joint Venture Account
3 Personal accounts of each co-venturer

Joint Bank Account is a real account like the ordinary Rank Account. All the co-venturers pay or deposit their contribution in this account, **The Joint Venture Account is like a profit and loss account which shows all the expenses and incomes of the joint venture.** The personal accounts of the co-venturers simply show their contributions in the form of goods, cash or expenses and the amounts received by them.

Let us now see the various journal entries which are normally recorded under this method.

1 **When co-venturers contribute their share of capital:**

Joint Bank A/c Dr.
To Co-venturers' Personal A/cs

2 **When a co-venturer contributed in the form of goods:**

Joint Venture A/c Dr.
To Co-venturer's Personal A/c

3 **When purchases are made for joint venture:**

a) If on cash:

Joint Venture A/c Dr.
To Joint Bank A/c

b) If on credit:

Joint Venture A/c Dr.
To Creditor's Personal A/c

Note that when goods are purchased for the joint venture business, you will debit the joint venture Account not the Purchases Account,

4 **When expenses are incurred on account of joint venture:**

a) If paid out of Joint Bank Account

Joint Venture A/c Dr.
To Joint Bank A/c

b) If paid by a co-venturer

Joint Venture A/c Dr.
To Co-venturer's Personal A/c

5 When goods are sold:

a) For cash sales:

Joint Bank A/c Dr.
To Joint Venture A/c

b) For credit sales:

Debtor's Personal A/c Dr.
To Joint Venture A/c

6 When creditors are paid:

Creditors' Personal A/c Dr.
To Joint Bank Account

7 When amounts are received from debtors:

Joint Bank A/c Dr.
To Debtor's Personal A/c

8 Any commission, interest, etc. payable to a co-venturer:

Joint Venture A/c Dr.
To Co-venturer's Personal A/c

9 Unsold stock taken over by a co-venturer:

Co-venturer's Personal A/c Dr.
To Joint Venture A/c

Now if we balance the Joint Venture Account, it will disclose the amount of profit or loss made on the joint venture which is to be shared by the co-venturers in their profit sharing ratio, The entries for the distribution of profit and loss will be as follows:

a) In ease of profit:

Joint Venture A/c ... Dr.
To Co-venturers' Personal A/cs

b) In case of loss:

Co-venturers' Personal A/cs Dr.
To Joint Venture A/c

This closes the Joint Venture Account. After transferring the amount of profit or loss to the co-venturer's personal accounts, you can find out the amount payable to each one of them. When the payment is made, the journal entry will be as follows:

Co-venturers' Personal A/cs **Dr.**
To Joint Bank A/c

Your will notice that the balance in the Joint Bank Account will be sufficient to pay-off all the co-venturers, and when the above entries are passed all the accounts will be closed.

Treatment of cash discount : When some cash discount is allowed by the creditors it will be an item of gain for the joint venture. Hence it is credited to the Joint Venture Account. The journal entry will be:

Creditor's Personal A/c Dr.
To Joint Venture A/c

Similarly, when some cash discount is allowed to the debtors it will be an item of loss for the joint venture and, therefore, is debited, to the Joint Venture Account. The journal entry will be:

Joint Venture A/c Dr.
To Debtor's Personal A/c

The same entry is passed in case of bad debts. Look at Illustration 6 and see how the concerned accounts are prepared when separate set of books are maintained for the joint venture business.

Illustration 6

Vikas and Salil entered into a joint venture to construct a building for a joint stock company. The contract price was settled at Rs. 25 lakh, payable Rs. 20 lakh in cash and the balance in the form of fully paid equity shares of the company. They opened a Joint Bank Account wherein Vikas deposited Rs. 6 lakh and Salil paid in Rs. 3 lakh. They agreed to share the profits and losses in the ratio of 2:1.

They purchased materials for Rs. 3 lakh for cash and Rs. 10 lakh worth on credit from Anil. They paid Rs. 4,50,000 for wages, etc., and Rs. 70,000 for other expenses. Vikas and Salil supplied materials worth Rs. 2,00,000 and Rs. 80,000 respectively. Architect's fees of Rs. 10,000 was paid by Vikas. The contract was duly completed and the price received as stipulated. Anil was paid Rs. 9,80,000 in full settlement. Vikas agreed to take up the shares of the company at a valuation of Rs. 4,40,000. Salil took over the remaining material at an agreed value of Rs. 70,000.

Separate books are maintained for joint venture business. Prepare the necessary ledger accounts.

Solution:

Joint Venture Account

Dr. Cr.

Particulars		Amount	Particulars	Amount
		Rs.		Rs.
To Joint Bank A/c (Material)		3,00,000	By Joint Bank A/c	20,00,000
To Anil (Credit purchases)		10,00,000	By Equity shares A/c	5,00,000
To Joint Bank A/c (Wages)		4,50,000	By Anil (Discount)	20,000
To Joint Bank A/c (Expenses)		70,000	By Salil (Material taken over)	70,000
To Vikas (Material)		2,00,000		
To Salil (Material)		80,000		
To Vikas (Architects fee)		10,000		
To Equity Shares A/c (Loss)		60,000		
To Rrofit transferred to:				
Vikas	2,80,000			
Salil	1,40,000	4,20,000		
		25,90,000		25,90,000

Joint Bank Account

	Rs.		Rs.
To Vikas	6,00,000	By Joint Venture A/c (Material)	3,00,000
To Salil	3,00,000	By Joint Venture A/c (Wages)	4,50,000
To Joint Venture A/c	20,00,000	By Joint Venture A/c (Expenses)	
		By Anil (creditor paid)	9,80,000
		By Vikas	6,50,000
		By Salil	4,50,000
	29,00,000		29,00,000

Vikas's Account

	Rs.		Rs.
To Equity Shares A/c	4,40,000	By Joint Bank A/c	6,00,000
To Joint Bank A/c	6,50,000	By Joint Venture (Material)	2,00,000
		By Joint Venture (Architect fees)	10,000
		By Joint Venture (Profit)	2,80,000
	10,90,000		10,90,000

Salil's Account

	Rs.		Rs.
To Joint Venture (Material)	70,000	By Joint Bank A/c	3,00,000
To Joint Bank A/c	4,50,000	By Joint Venture A/c (Material)	80,000
		By Joint Venture (Profit)	1,40,000
	5,20,000		5,20,000

Equity Shares Account

Dr.			Cr.
	Rs.		Rs.
To Joint Venture A/c	5,00,000	By Vikes	4,40,000
		By Joint Venture A/c (Loss transferred)	60.000
	5,00,000		5,00,000

Anil's Account

	Rs.		Rs.
To Joint Bank A/c	9,80,000	By Joint Venture A/c (Materials)	10,00,000
To Joint Venture A/c (Discount)	20,000		
	10,00,000		10,00,000

Underwriting of Shares: Let us now take an illustration where the co-venturers agreed to underwrite the shares or debentures of a limited company. Underwriting means agreeing to buy shares that are not subscribed by the public. For this service they receive some commission which may be paid partly in the fonn of shares of the company and partly in cash. The shares thus received are sold to the public or taken over by the co-venturers at an agreed price. Look at Illustration 7 and see how accounts are prepared for the joint **venture** of underwriting the shares when separate set of books are maintained.

Illustration 7

A and B enter into a joint venture to guarantee the subscription at par of 1,00,000 shares of Rs. 10 each of a limited company, and sharing profits and losses in the ratio of 2:3. The terms with the company are : $4\frac{1}{2}\%$ commission payable in cash and 6.000 fully paid shares of the company. They agreed to pay expenses in connection with the issue of shares. The expenses incurred are advertisement Rs. *5,000;* printing and stationery Rs. 1,000 and postage Rs. 600. All expenses are paid by **A.** The public subscribed to 88,000 shares only. The remaining shares under the agreement were duly taken up by A and B who provicled the necessary cash equally. The commission is received in cash and is shared by the co-venturers in the ratio 4:5. The entire holding of the joint venture is then sold in the market through brokers as follows: *25%* at a price of Rs. 9 per share; 50% at a price of Rs. 8.75 per share. 15% at a price of Rs. 8.50 per share, and the remaining 10% is taken over by **A** and B equally at an agreed price of Rs. 8 per share. Prepare the Joint Venture Account. Joint Bank Account, Shares Account. and the accounls of A and B showing the final settlement.

Solution

Joint Venture Account

Dr. Particulars		Amount	Particulars	Cr. Amount
		Rs.		Rs.
To A			By Joint Bank A/c (commission)	45.000
Advertisement	5,000		By Shares A/c (commission)	60,000
Printing	2.000			
Postage	600	7.600		
To Shares A/c (loss on sale)		23.400		
To Profit transferred to:				
A	29,600			
B	44,400	74.000		
		1,05,000		1,05,000

Joint Bank Account

		Rs.		Rs.
To A (contribution)		60,000	By Shares A/c	1,20,000
To B. (contribution)		60,000	By A (commission)	20,000
To Joint Venture A/c (commission)		45,000	By B (commission)	25,000
To Shares A/c (sale For cash)			By A (final settlement)	70,000
25%	40.500		By 5 (final settlement)	72,200
50%	78,750			
15%	22,950	1,42,200		
		3,07,200		3,07,200

Shares Account

Dr. Particulars	Amount	Particulars	Cr. Amount
	Rs.		Rs.
To Joint Bank A/c	1,20,000	By Joint Bank A/c (Sale of shares)	40,500
So Joint Venture (Commission)	60,000	By Joint Rank A/c (Sale of shares)	78,750
		By Joint Bank A/c (Sale of shares)	22,950
		By A (shares taken over)	7,200
		By B (Shares taken over)	7,200
		By Joint Venture A/c (Loss)	23,400
	1,80,000		1,80,000

A's Account

Particulars	Amount	Particulars	Amount
	Rs.		
To Joint Rank A/c (Commission)	20,000	By Joint Venture A/c (Expenses)	7,600
To Shares A/c	7,200	By Joint Bank A/c (Contribution)	60,000
To Joint Bank A/c (Final settlement)	70,000	By Joint Venture A/c (Profit)	29,600
	97,200		97,200

B's Account

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Joint Bank A/c (Commission)	25,000	By Joint Rank A/c (Contribution)	60,000
To Shares A/c	7,200	By Joint Venture A/c (Profit)	44,400
To Joint Bank A/c (Final settlement)	72,200		
	1,04,400		1,04,400

Working Notes

1 **Distribution of commission received in cash**

$4\frac{1}{2}$% of 10,00,000 = Rs. 45,000

A's share 4/9 x 45,000 = Rs. 20,000

B's share 5/9 x 45,000 = Rs. 25,000

2 **Treatment of shares received :**

Shares received by way of commission	6,000
Shares not subscribed by public	12,000
Total number of shares received	18,000

a) **Sold for cash**

	Rs.
25% of 18,000 i.e., 4.500 shares sold @ Rs. 9 per share	40,500
50% of 18,000 i.e., 9.000 shares sold @ Rs. 8.75 per share	78,750
15% of 18,000 i.e., 2,700 shares sold @ Rs. 8.50 per share	22,950

b) **Divided amongst A and B**

10% of the remaining shares i.e, 1,800 shares are raken over equally by A & B at an agreed price of Rs. 8 per share.

A: 900 shares @ Rs. 8 per share Rs. 7.200

B: 900 shares @ Rs. 8 per share Rs. 7,200

Check Your Progress-C

1 What is the need for maintaining separate set of books for the joint venture?

....

....

....

....

2 Fill in the blanks:

i) Joint Bank Account is like a .... Account.

ii) When co-venturers' contribution is in the form of goods.................... Account is debited.

iii) All the amounts paid out of joint bank are credited to .... Account.

iv) Co-Venturers' contribution in cash is debited to Joint Bank Account and credited to .... Account.

v) In underwriting of shares, the ....shares are taken over by the underwriters.

13.5 LET US SUM UP

Joint Venture is a temporary partnership between two or more persons who have agreed to undertake jointly a specific project or a job. On the completion of the project or the job, the joint venture will automatically come to an end. The joint venture differs from consignment and partnership in many ways.

The accounts for the joint venture business can be kept in four ways : (i) all recording be done in the books of one co-venturer only, (ii) the accounting records be maintained by each one of them in their own books, (iii) each co-venturer records his own transactions relating to the joint venture and on the completion of the project a Memorandum Joint Venture Account is prepared to find out the profit or loss, or (iv) separate set of books of accounts may be maintained for the joint business and a joint account be opened in the bank.

Under the first method only one co-venturer records the joint venture transactions who opens a Joint Venture Account and the personal accounts of other co-venturers. Under the second method each co-venturer opens a Joint Venture Account and the personal accounts of other co-venlurers. The Joint Venture Account serves the purpose of Profit and Loss Account. Under the third method, no Joint Venture Account is maintained. Eacn co-venturer simply opens the personal accounts of other co-venturers and for ascertaining the profit or loss of the venture, a Memorandum Joint Venture Account is prepared.

When any of the above three methods is followed no separate books are maintained for the Joint Venture business. All transactions are recorded in the books of the co-venturers themselves. Under the fourth method a separate set of books are prepared for the joint venture business treating it as a separate accounting entity, and all transactions are recorded strictly according to the double entry system, The main accounts prepared under this method are (i) Joint Venture Account (ii) Joint Banking Account, and (iii) the personal accounts of the co-venturers. In this case also the Joint Venture Account serves the purpose of a Profit and Loss Account.

13.9 KEY WORDS

Co-venturer : Persons who are parties to the agreement for carrying out the joint venture business.

Joint Venture : A temporary partnership between two or more persons who agree to carry out a specific job or a project.

Memorandum Joint Venture **Account :** An account prepared for ascertaining the profit or loss of a joint venture where no Joint Venture Account is prepared by co-venturers.

Shares : A unit of the share capital of a company.

Underwriting : An undertaking to take up the shares which are not subscribed by the public.

13.8 SOME USEFUL BOOKS

Maheshwari, S.N. 1986. *Introduction to Accounting*, Vikas Publishing House: New Delhi. (Chapter 2 Section II)

Patil, V.A. and J.S. Korlahalli, 1986. *Principles and Practice of Accounting, R.* Chand & Co., New Delhi. (Chapter 3 Vol. II)

William Pickles. 1932. *Accountancy*, E.L.S.S. and Pitman, London. (Chapter 16).

Gupta, R.L. and M. Radhaswamy. 1986. *Advanced Accountancy* Sultan Chand & Sons, New Delhi (Chapter 16)

13.9 ANSWERS TO CHECK YOUR PROGRESS

A 1 i) A and B ii) A's share Rs. 18,000 and B's share Rs. 27,000

2 i) False ii) True iii) False iv) False v) True

B 1 a) ii b) i c) ii d) i e) iii

C 2 i) Bank ii) Joint Venture iii) Joint Bank iv) Co-venturers' Personal Accounts v) unsubscribed

13.10 TERMINAL QUESTIONS/EXERCISES

Questions

1 State the salient features of joint venture. Distinguish it from consignment.

2 "Joint Venture is a temporary partnership". Comment and explain how it differs from the partnership.

3 ~ ~ p l abriefly various methods of recording the joint venlure transaclions without maintaining separate set of books.

4 Explain the separate set of books method for maintaining joint venture accounts.

Exercises

1 Mohan and Sohan were partners in a joint venture sharing profits and losses in the ratio of 3:2. Mohan supplied goods of the value of Rs. 6,000 and incurred an expenditure of Rs. 200. Sohan supplied goods of the value of Rs. 5,000 and his expenses were Rs. 300 Sohan sold all the goods for a sum of Rs. 18,000. Sohan is entitled to a commission of 4% on sales and he settled his account by sending a bank draft to Mohan. Pass necessary journal entries in the books of both the parties

(Answer: Profit on joint venture Rs. 5,780 Commission Rs. 720)

2 A of Banglore enter into a joint venture with B of Bombay to ship cotton bales to C in Japan. A sends cotton of the value of Rs. 30,000, pays railway freight etc. Rs. 1,500 and sundry expenses Rs. 1,575. B sends goods valued at Rs. 20,750 and pays freight and insurance Rs. 1,200, dock dues Rs. 200, customer charges Rs. 500 and other sundry expenses Rs. 500. A advances to B Rs. 6,000 on account of the venture. B receives Account sale and remittance of 'the net proceeds from C for the whole of the goods amounting to Rs. 80,000.

Show the Joint Venture Account and the personal accounts of the co-ventures in the books of A and B

(Answer: Prof t on joint venture Rs. 23,775; Balance due to-A Rs. 50,962.50)

3 Sundar, Bindia and Gora entered into a contract with Mohindra Ltd. for the consturction of a building at a cost of Rs. 5,00,000 payable Rs. 4,00,000 in cash and Rs. 1,00,000 in debentures. They share profits and losses equally.

Sundar, Bindia and Gora contributed Rs. 60,000, Rs. 75,000 and Rs. 40,000 respectively. All these amounts were deposited in a Joint Bank Account. Sundar paid Rs. 7,000 to the architect. Bindia purchased concrete mixture for Rs. 25,000 and Gora brought a motor truck for Rs. 20,000 for joint venture work. They purchased plant for Rs. 24,000, materials for Rs. 2,40,000 in cash and paid Rs. 1,95,000 as wages. After construction of the building Sundar took over the remianing material for Rs. 14,000 and

Bindia took over mixture for Rs. 12,000, Cora took over the motor truck for Rs. 8,000. The plant. was sold for Rs. 6,000. When full price was received from the contractee, Sundar took over the debentures for Rs. 80,000. Prepare Joint Venture Account, Joint Bank Account and the co-venturer's personal accounts.

(Answer: Profit Rs. 9,000. Sundar will bring in Rs. 14,000 and Bindia will get Rs. 91,000 and Gora Rs. 55.000. Joint bank total Rs. 605,000)

4 Ajay and Banwari doing business separately as building contractors undertake jointly to construct a building for a newly set up company with Ks. 1,00,000 payable, Rs.80,000 in cash and Rs. 20,000 in fully paid shares of the company. A Joint Bank Account is opened in their names, Ajay paying in Rs. 25,000 and Banwari Rs. 15,000. They are to share profits and losses in the proportion of 2:1 Their transactions were as follows :

	Rs.
Paid wages	30,000
Bought material	70,000
Materials supplied by Ajay	5,000
Materials supplied by Banwari	4,000
Architect's fee paid by Ajay	2,000

The contract was completed and the price (cash and shares) duly received. The joint venture was closed by Ajay taking up all tlie shares of the company at an agreed value of Rs. 16,000 and Banwari taking up the stock of materials at an agreed value of Rs. 3,000. Show the necessary ledger accounts.

(Answer : Loss Rs. 12,000; Payments to Ajay Rs. 8,000 and Banwari Rs. 12,000)

5 A, B and Center into a Joint Venture for the construction of a building for a joint stock company. The contract price is Rs. 2,00,000.

Incidental expenses paid by the co-venturers will be reimbursed to the extent of actual expenditure or Rs. 10,000 whichever is less. A spends Rs. 8,000, B Rs. 10,000 and C Rs. 12.000. The profits and losses are to be shared equally, but C, being a technical person, is entitled to a commission of 10% on the profit of the venture after charging such commission. A Joint Bank Account is opened wherein A deposits Rs. 40,000, B Rs. 30,000 and C Rs. 30.000. B gives his own plant to the venture for Rs. 16,000. Materials worth Rs. 40,000 and wages, of Rs. 60,000 are paid out of the Joint Bank Account.

On completion of the contract, the company paid the agreed contract price (keeping Rs. 20,000 as retention money). The contract price was paid Rs. 60,000 in cash and the balance in equity shares of the company of Rs. 10 each at an agreed value of Rs. 12 per share. The shares were subsequently sold in the market @ Rs. 13 per share. A took over the unused materials at Rs. 2,000. B took over the plant at an agreed value of Rs. 4,000 and the retention money was taken over by C at Rs. 14,000. Show necessary ledger accounts in the books of the joint venture.

Hint: Contract price received is Rs. 1,80,000
Rs. 60,000 in Cash and Rs. 1,20,000 worth of shares @ Rs. 12 per share
So, the number of shares received = 1,20,000/12 = 10,000

(Answer: Profit Rs. 60,000: Final settlement A Rs. 66,000, B Rs. 72,000; and C Rs. 52,000)

6 Devendra and Revindra entered into a joint venture involving the buying and selling of old railway materials, the profit or loss to be shared equally. The cost of the goods purchased was Ks. 42,500 which was paid by Devendra who drew a bill on Ravindra at two months for Rs. 30,000. The bill was discounted by Devendra at a cost of Rs. 240.

The transactions relating lo the joint venture were (a) Devendra paid Rs. 300 for carriage, Rs. 500 for commission on sales and Rs. 200 travelling expenses, (b) Ravindra paid Rs. 100 for travelling expenses and Rs. 150 for sundry expenses, (c) hales made by Devendra amounted to Rs. 20,000, and (d) sales made by Ravindra were Rs. 30,000.

Goods costing Rs. 1,000 and Rs. 1.500 (being unsold stock) were retained by Devendra and Ravindra respectively, and these were charged to them at prices so as to show the same gross profits as made on the total sales. Devendra was credited with a sum of Rs. 400 to cover the cost of warehousing and insurance. The expenses in connection with the bills were to be treated as a charge against the joint venture.

Show the necessary accounts in the books of each party and prepare the Memorandum Join; Venture Account.

(**Answer**: Profit on Joint Venture Rs. 8,735; Payment by Devendra to Ravindra Rs. 2,742.50; Rate of Gross profit 25%; Stock taken over by Devendra valued at Rs. 1,250; and Ravindra at Rs. 1.875)

7 Akash and Vijay enter into a joint venture on January 1, 1987. Akash bought goods costing Rs. 3,000 and on the same day he received a cheque from Vijay for Rs. 1,500. Akash and Vijay incurred expenses as follows:

		Akash	Vijay
		Rs.	Rs.
February	1	300	—
April	1	300	—
March	1		400
May	31		1400

Vijay sold the goods, in two months, namely, on April 1 Rs. 4,800 and on June 30 Rs. 2,400. They share profits and losses equally and interest was to be allowed at 5% p a annum. On June 1 Vijay gives Akash a three months bill for Rs. 2,500 and on June *30* the venture was completed and the accounts settled by cheque between the parties. Calculate interest in months and show the necessary accounts.

(**Answer:** Profit: Akash Rs. 368.70 and Vijay Rs. 368.70; Akash will charge Rs. 100 as interest and Vijay will pay Rs. 47.50 as interest)

Note : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answer to the University. These are for your practice only.

UNIT 14 SELF-BALANCING SYSTEM

Structure

14.0 OBJECTIVES

After studying. this unit you should be able to:

- name the ledgers commonlyused in business and explain the types of accounts contained in each ledger
- define self-balancing system
- describe how each ledger is self-balanced
- prepare various adjustment accounts
- explain sectidnal balancing and prepare the total debtors and total creditors accounts.

14.1 INTRODUCTION

You have learnt that all business transactions are recorded first in journal or its sub-division and then posted into the concerned accounts in the ledger. A statement called Trial Balance is also prepared at the end of the accounting period primarily to check the arithmetical accuracy of the entries in the ledger, Normally the firms maintain one ledger for all the accounts involved. So long as the volume of transactions is small and the number of accounts is limited, this works fairly well. But, as the business expands and the number of accounts increases, especially those of the debtors and creditors, maintaining all accounts in a single ledger becomes impractical. The ledger becomes too bulky and location of errors involves more time. Hence many firms decide to introduce multiple ledger system whereby separate ledgers are kept for debtors and creditors and the entries are recorded in each ledger in such a way that a separate Trial Balance can be prepared for each ledger. This is called 'Self-balancing System'. Some times the firms, while maintaining more than one ledger, do not adopt the self-balancing system. In such a situation, though separate Trial Balance cannot be prepared for each ledger but the arithmetical accuracy can be duly verified by preparing certain control accounts. This is called 'Sectional Balancing'. In this unit you will learn about both the self-balancing and the sectional balancing systems: You will also study how they help in locating the errors more quickly and ensure the accuracy of postings into different ledgers.

14.2 SUB-DIVISION OF LEDGER

For the purpose of self-balancing and sectional balancing the ledger is usually divided into three parts. They are:

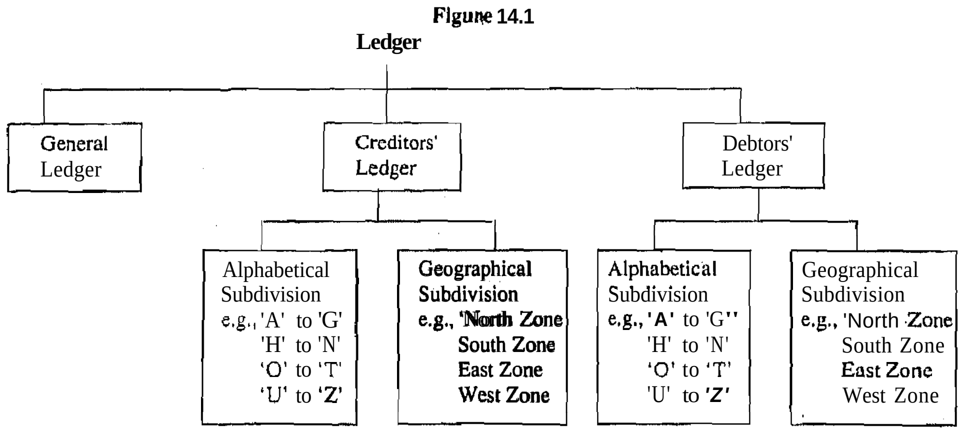
1 General Ledger: It contains all the real and nominal accounts as well as the personal accounts other than trade debtors and trade creditors. Thus accounts like furniture, machinery, goodwill, interest, salaries, capital, loan, salary outstanding etc. are maintained in this ledger.

2 Debtors Ledger: This is also known as 'Sales Ledger' or 'Sold Ledger'. It contains the accounts of trade debtors i.e., the customers to whom goods are sold on credit. The accounts of persons/firms who are not the buyers of goods from the business, are maintained in General Ledger.

3 Creditors Ledger: This is also known as 'Purchase Ledger' or 'Bought Ledger'. It contains the accounts of trade creditors only i.e., persons or firms who have supplied goods on credit to the business. The accounts of persons/firms who are not suppliers of goods or raw-materials are maintained in the General Ledger.

In case the number of trade debtors and trade creditors is fairly large, Debtors Ledger and Creditors Ledger can be further subdivided. For this, any suitable criteria may be adopted, Normally, the firms sub-divide them on alphabetical basis, say, A to F, G to K, L to P, and Q to Z or on geographical basis, say, district-wise, state-wise or nation-wise. Look at Figure 14.1 for sub-division of ledger.

Figure 14.1



14.3 HOW LEDGERS ARE MADE SELF-BALANCING

When separate ledgers are maintained for trade debtors and trade creditors, the debit and credit aspects of certain transactions will not appear in the same ledger. For example, in case of credit sales, the credit aspect (Sales Account) will appear in General Ledger whereas the debit aspect (personal account of the debtor) will appear in Debtors Ledger. Take another example like cash discount allowed by a creditor. The credit aspect (Discount Received Account) will be recorded in General Ledger whereas the debit aspect (personal account of the creditor) will appear in Creditors Ledger. Thus, no ledger is self-balancing and it is not possible to prepare a separate Trial Balance for each ledger, Hence, in order to make each ledger self-balancing it is necessary that the corresponding debit and credit aspects are fully provided in each ledger. This is done by opening some additional accounts called 'Adjustment Accounts' in each ledger. The Adjustment Account helps in completing the double entry in each ledger and making it self-balancing. The Adjustment Accounts opened in various ledgers are:

1 General Ledger Adjustment Account (in Debtors Ledger): It is opened in Debtors Ledger to provide the corresponding debits and credits for all entries related to trade debtors which appear in the General Ledger. Examples of such entries are: credit sales, sales returns, discount allowed, cash received from debtors, bad debts, etc.

2 General Ledger Adjustment Account (in Creditors Ledger): It is opened in Creditors Ledger to provide the corresponding debits and credits for all entries related to trade creditors which appear in the General Ledger. Examples of such entries are: credit purchases, purchases returns, discount received, cash paid to creditors, etc.

3 Debtors Ledger Adjustment Account (in General Ledger): It is opened in the General Ledger to provide the corresponding debits and credits for entries related to trade debtors which appear in Debtors Ledger.

4 Creditors-Ledger Adjustment Account (in General Ledger): It is opened in the

General Ledger to provide the corresponding debits and credits for entries related to trade creditors which appear in Creditors Ledger.

Thus, tlie accounts which appear in three ledgers are as follows:

Debtors Ledger	Creditors Ledger	General Ledger
i) Personal accounts of all trade debtors	i) Personal accounts of all trade creditors	i) All personal accounts other than those of trade debtors and trade creditors
ii) General Ledger Adjustment Account for Sales Ledger	ii) General Ledger Adjustment Account for Purchases Ledger	ii) All real account
		iii) All nominal accounts
		iv) Debtors Ledger Adjustment Account
		v) Creditors Ledger Adjustment Account

14.3.1 Self-balancing the Debtors Ledger

You know tlie Debtors Ledger contains tlie personal accounts of trade debtors only. The General Ledger Adjustment Account is inserted at the end in Debtors Ledger for purposes of making it self-balancing by providing the necessary corresponding debits and credits for all entries related to trade debtors. Let us therefore identify first the items which usually appear on the debit and the credit sides of a trade debtor. They are as follows:

A Trade Debtor's Account

Dr.	Rs.		Cr. Rs.
To Balance b/d		By Cash/Bank A/c (cash and cheques received)	
To Sales A/c (credit sales)		By Sales Returns A/c	
To Bank A/c (cheques dishonoured)		By Bills Receivable A/c (B/R received)	
To Bills Receivuble A/c (B/R dishonoured)		By Discount Allowed A/c	
		By Bad debts A/c	
		By Allowances A/c	
		By Balance c/d	

For self-balancitig, all items appearing on the debit side of the personal accounts of trade debtors should be recorded on tlie credit side of the General Ledgcr Adjustment Account in Debtors Leclger and those appearing on their credit side should be recorded on its debit side. For this purpose, we take only tlic totals of such items for the period as a whole and pass the necessary journal entries as follows:

1 **For total credif sales, cheques dishonoured and bills receivable dishonoured**

Sales Ledger Adjustment A/c Dr.
(in General Ledger)
To General Ledger Adjustment A/c
(in Debtors Ledger)

2 **For total cash and cheques received from debtors, sales returns, bills receivable received, discount allowed, other allowances and bad debts:**

General Ledger Adjustment A/c Dr.
(in Debtors Ledger)
To Debtors Ledger Adjustment A/c
(in General Ledger)

After passing the above two journal entries, the General Ledger Adjustment Account in Debtors Ledger will appear as given in Figure 14.2.

Figure 14.2
General Ledger Adjustment Account
(in Debtors Ledger)

Dr.	Rs.		Cr. Rs.
To Debtor's Ledger		By Balance b/d	
Adjustment A/c:		By Debtor's Ledger	
Cash Received (incl. cheques)		Adjustment A/c:	
Sales Returns		Credit Sales	
B/R Received		Cheques Dishonoured	
Discount Allowed		B/R Dishonoured	
Bad Debt			
Allowances			
To Balance c/d			

To total figures for various items can, be extracted from the concerned subsidiary books. For example, 'credit sales' can be taken from the Sales Book, 'cash received from debtors' from the Cash Book, and so on. If necessary, additional columns can be provided in the subsidiary books for the purpose. This is explained later in sub-section 14.4.

Look at Illustration 1 and see how General Ledger Adjustment Account in Debtors Ledger is prepared.

Illustration 1

From the following particulars draw up a General Ledger Adjustment Account in the Debtors Ledger.

	Rs.
Opening balance	1,220
Credit Sales	3,720
Cash received from Debtors	2,005
Sales returns	317
Discount allowed	130
Bad Debts written off	371
Allowances	42
Bill Receivable received	130
Bills Receivable dishonoured	50

Solution

General Ledger Adjustment Account
(in Debtors Ledger)

Dr.	Rs.		Cr. Rs.
To Debtors Ledger Adjustment A/c :		By Balance b/d	1,220
Cash Received	2,005	By Debtors Lcdger	
Sales Returns	317	Adjustment A/c :	
Discount Allowed	130	Credit Sales	3,720
Bad Debts	371	B/R Dishonoured	50
Allowances	42		
B/R Received	130		
To Balance c/d	1.995		
	4,990		4,990

You will notice that the General Ledger Adjustment Account in Debtors Ledger has the necessary corresponding debits and credits for all entries related to trade debtors. This makes it self-balancing and now a Trial Balance can be prepared separately for the Debtors Ledger.

14.3.2 Self-balancing the Creditors Ledger

You know the Creditors Ledger contains the personal accounts of trade creditors only. As in case of Debtors Ledger, a General Ledger Adjustment Account is inserted in Creditors Ledger for purposes of making it self-balancing. This account provides the necessary corresponding debits and credits for all entries related to trade creditors. Let us now identify the items which usually appear on the debit and the credit sides of the trade creditor. They are as follows:

A Trade Creditor's Account

Dr.	Rs.		Cr. Rs.
To Cash/Bank A/c (cash and cheques)		By Balance b/d	
To Purchases Returns A/c		By Purchases A/c (credit purchases)	
To Bills Payable A/c (bills accepted)		By Bank A/c (cheques dishonoured)	
To Discount Received A/c		By Dills Payable A/c (B/P dishonored)	
To Allowances A/c			
To Balance c/d			

For self-balancing, all items appearing on the debit side of the personal accounts of trade creditors should be recorded on the credit side of the General Ledger Adjustment in Creditors Ledger and those appearing on their credit side should be recorded on its debit side. For this purpose, taking the total figures of such items the following journal entries will be passed:

1 **For total credit purchases, cheques dishonoured and the bills payable dishonoured:**

General Ledger Adjustment Account Dr.
(in Creditors Ledger)
To Creditors Ledger Adjustment A/c
(in General Ledger)

2 **For total cash and cheques paid to creditors, purchases returns, bill payable accepted, discount received, other allowances:**

Creditors Ledger Adjustment A/c Dr.
(in General Ledger)
To General Ledger Adjustment A/c
(in Creditors Ledger)

After passing the above two journal entries the General Ledger Adjustment Account in Creditors Ledger will appear as given in Figure 14.3.

Figure 14.3
General Ledger Adjustment Account In Creditors Ledger

Dr.	Rs.		Cr. Rs.
To Balance b/d		By Creditor's Ledger Adjustment A/c:	
To Creditor's Ledger Adjustment A/c:		Cash Paid (incl. cheques)	
Credit Purchases		Purchases Returns	
Cheques Dishonoured		Bills Accepted	
B/P Dishonoured		Discount Received	
		Allowances	
		By Balance c/d	

The figures for various items can be extracted from the concerned subsidiary books. For example, 'credit purchases' can be taken from the Purchase Book, cash paid to creditors from Cash Book, and so on. Look at Illustration 2 and see how General Ledger Adjustment in Creditors Ledger is prepared.

Illustration 2

From the following information prepare the General Ledger Adjustment Account in Creditors Ledger.

	Rs.
Opening Balance of Sundry Creditors	**28,010**
Credit Purchases	**27,600**
Payment to Creditors	**26,500**
Discount Allowed by Creditors	**1,450**
Returns Outwards	**2,240**
Bills Payable Accepted	**5,300**
Allowances	**400**
Bills Payable Dishonoured	**500**

Solution:

General Ledger Adjustment Account
(in Creditors Ledger)

Dr.	Rs.		Cr. Rs.
To Balance b/d	28,010	By Creditors Ledger Adjustment A/c:	
To Creditors Ledger Adjustment A/c:		Cash Paid	26,500
Credit Purchases	27,600	Purchases Returns	2,240
B/P Dishonoured	500	Rills Accepted	5,300
		Discount Received	1,450
		Allowances	400
		By Balance c/d	20,220
	56,110		56,110

You will notice that the General Ledger Adjustment Account in Creditors Ledger has the necessary comsponding debits and credits for all the entries related to trade creditors, This makes it self-balancing and now a separate Trial Balance can be prepared also for the Creditors Ledger.

14.3.3 Self-balancing the General Ledger

You know the General Ledger contains all real and nominal accounts. In case of mast of the transactions recorded in General Ledger both the debit and credit aspects would appear in this ledger itself. Take for example, depreciation on machinery. This involves Depreciation Account (a nominal account) and the Machinery Account (a real account), Both the accounts appear in the General Ledger and so both debit and credit aspects arc recorded in this ledger itself. But, in case of transactions which involve the personal accounts of trade debtors or trade creditors, the situation is different. One aspect of such transactions appears in the General' Ledger and the other in Debtors Ledger or Creditors Ledger. Hence, for Self-balancing the General Ledger it becomes necessary to provide the corresponding debits and credits for all entries related to trade debtors and trade creditors. For this purpose, we open the Debtors Ledger Adjustment Account and the Creditors Ledger Adjustment Account in the General Ledger. In fact these two accounts will automatically, be opened when journal entries are passed for opening the General Ledger Adjustment Accounts in the Debtors and the Creditors Ledgers as stated in sub-sections 14.3.1 and 14.3.2. Thus, the Debtors Ledger Adjustment Account and the Creditors Ledger Adjustment Account in General Ledger will be just the reverse of the General Ledger Adjustment Account in Debtors Ledger and the General Ledger Adjustment Account in the Creditors Ledger respectively. Let us now prepare these two accounts from the information given in Illustrations 1 and 2.

Debtors Ledger Adjustment Account (in General Ledger)

Dr.	Rs.		Cr. Rs.
To Balance b/d	1,220	By General Ledger Adjustment A/c:	
To General Ledger Adjustment A/c :		Cash received	2,005
		Sales Returns	317
Sales	3,720	Discount Allowed	130
B/R Dishonoured	50	Bad Debts	371
		Allowances	42
		B/R Received	130
		By Balance c/d	1,995
	4,990		4,990

Creditors Ledger Adjustment Account (in General Ledger)

Dr.	Rs.		Cr. Rs.
To General Ledger		By Balance b/d	28,010
Adjustment A/c:		By General Ledger	
Cash Paid	26,500	Adjustment A/c:	
Purchases Returns	2,240	Credit Purchases	27,600
Bills Accepted	5,300	B/P Dishonoured	500
Discount Received'	1,450		
Allownnces	400		
To Balance c/d	20,220		
	56,110		56,110

Now let us take a comprehensive illustration and prepare all Adjustment Accounts.

Illustration 3

A firm has three ledgers in use viz., Debtors Ledger, Creditors Ledger and General Ledger. These are all kept on the self-balancing system, From the following transaction, prepare the Adjustment Accounts as they would appear in each ledger.

Balances of Trade Debtors on 1-3-1988	28,500
Balances of Trade Creditors on 1-3-1988	47,800
Transactions during tho month were:	
Credit Sales	43,800
Cash received from Trade Debtors	30,950
Discount allowed to Trade Debtors	2,600
Bills Receivable received from Debtors	5,000
Bad Debts Written off	200
Credit Purchases	68,800
Purchases Returns	2,000
Cash paid to Trade Creditors	59,000
Discount allowed now disallowed	100
Interest and Charges debited to Debtors.	200

Solution:

Debtors Ledger Adjustment Account (In General Ledger)

Dr.	Rs.		Cr. Rs.
To Balance b/d	28,500	By General Ledger	
To General Ledger		Adjustment A/c:	
Adjustment A/c:			
Credit Sales	43,800	Cash received	30,950
Discount Disallowed	100	Discount Allowed	2,600
Interest and Charges	200	Bills receivable	5,000
		Bad Debts	200
		By Balance c/d	33,850
	72,600		72,600

Creditors Ledger Adjustment Account
(in General Ledger)

Dr.	Rs.		Cr. Rs.
		By Balance b/d	47,800
To General Ledger Adjustment A/c:		By General Ledger Adjustment A/c:	
Cash Paid	59,000	Credit Purchases	68,800
Purchases Returns	2,000		
To Balance c/d	55,600		
	1,16,600		1,16,600

General Ledger Adjustment Account
(in Debtors Ledger)

	Rs.		Rs.
		By Balance b/d	28,500
To Sales Ledger Adjustment A/c:		By Sales Ledger Adjustment A/c:	
Cash Received	30,950	Credit Sales	43,800
Discount Allowed	2,600	Discount Disallowed	100
Bills Receivable	5,000	Interest and Charges	200
Bad debts	200		
To Balance c/d	33,850		
	72,600		72,600

General Ledger Adjustment Account
(In Creditors Ledger)

	Rs.		Rs.
To Balance b/d	47,800		
To Bought Ledger Adjustment A/c:		By Bought Ledger Adjustment A/c:	
Credit Purchases	68,800	Cash Paid	59,000
		Purchases Returns	2,000
		By Balance c/d	55,600
	1,16,600		1,16,600

Note : 1 **Discount Disallowed :** Any amount of discount allowed to debtors, if disallowed later, is debited to the concerned debtor's personal account. Hence, it has been shown on the debit side of Debtors Ledger Adjustment Account in General Ledger and the credit side of the General Ledger Adjustment Account in Debtors Ledger.

2 **Interest and Charges** debited to Debtors : It is an amount charged to debtors on account of late payment or some errors. It has also been shown on the debit side of Debtors Ledger Adjustment Account in General Ledger and the credit side of General Ledger Adjustment Account in Debtors Ledger.

14.4 SOME PECULIAR POINTS

Contra Balances : Normally the personal accounts of debtors show a debit balance and the personal accounts of creditors a credit balance, Sometimes, a debtor's account may show a credit balance and a creditor's account a debit balance. It usually happens on account of over-payments. In such a situation, both the debit and the credit balances are shown separately in the Adjustment Accounts. For **example,** the total of debit balances of various debtors is Rs. 60,000 and the total of credit balances Rs. 800. These will be shown in the respective Adjustment Accounts as follows:

Debtors Ledger Adjustment Account
(in General Ledger)

Dr.	Rs.		Rs. Cr.
To Balance b/d	60,000	By Balance bid	800

General Ledger Adjustment Account
(in Debtors Ledger)

To Balance b/d	800	By Balance b/d	60,000

If the creditors accounts also show both types of balances, they will appear in the concerned Adjustments Accounts separately.

Transfers : Sometimes goods are bought from the person who is also a customer to the business. In such a situation, his personal account will appear in both the Debtors Ledger and the Creditors Ledger. The settlement of such accounts is made by paying or receiving the net amount. Hence, it becomes necessary to transfer his account from the ledger where it shows a lower balance to the other where his account shows a higher balance. For example, Ganesh's personal account in Debtors Ledger shows a debit balance of Rs. 10,800 and his personal account in Creditors Ledger shows a credit balance of Rs. 1,000. In such a situation, the credit balance of Rs. 1,000 in Ganesh's Account will be transferred from Creditors Ledger to his account in Debtors Ledger. Such transfer should also be recorded in the Adjustment Accounts. **Whether the transfer tnkes place from creditors Ledger to Debtors Ledger or from Debtors Ledger to Creditors Ledger, it shall be reflected in various Adjustment Accounts as follows :**

In Debtors Ledger Adjustment Account	Credit side
In Creditors Ledger Adjustment Account	Debit side
In General Ledger Adjustment Account in Debtors Ledger	Debit side
In General Ledger Adjustment Account in Creditors Ledger	Credit side

Provision for Bad Debts : Sometimes you may find an item of provision for bad debts in the information from which the Adjustment Accounts are to be prepared. You know that this provision does not appear anywhere in the personal accounts of debtors. Hence it will not be included in the Adjustment Accounts. You may simply ignore it. **The same thing is true of items like cash sales, bills discounted, old bad debts recovered, etc.**

Look at illustration 4 and see how the above items have been treated.

Illustration 4

From the following details prepare General Ledger Adjustment Accounts and the Debtors Ledger and Creditors Ledger Adjustment Accounts as on 31 December 1988 :

		Rs.		Rs.
Debtors (1-1-1988)	Dr.	17,425	Discount Allowed to Debtors but disallowed later	100
Debtors -do-	Cr.	320		
Creditors -do-	Cr.	27,408		
Creditors -do-	Dr.	204		
Purchases		25,200	Cash received from Debtors	8,700
Sales		28,209		
Sales Returns		208	Cash paid to Debtors	25
Purchases Returns		714	Transfer from Debtors to Creditors Ledger	1,242
Cash paid to Creditors		12,700	Cnsh Purchases	4,320
Bills received from Debtors		9,300	Cash Sales	7,400
Bills dishonoured		200	Bad Debts written off	215
Bills accepted		7,400		
Discount allowed hy Creditors		1,020	Discount allowed to Debtors	215

Solution :

Creditors Ledger **Adjustment Account**
(In General Ledger)

Dr.	Rs.		Cr. Rs.
To Balance b/d	204	By Balance b/d	27.408
To General Ledger		By General Ledger	
Adjustment A/c (in Creditors Ledger)		Adjustment A/c (in Purchases Ledger):	
Cash Paid	12,700	Purchases	25.200
Purchases Returns	714		
Bills Accepted	7,400		
Discount	1,020		
Transfer	1,242		
To Balance cld	29,328		
	52,608		52,608

Debtors Ledger Adjustment Account
(**in** General Ledger)

	Rs.		Rs.
To Balance bld	17,425	By Balance b/d	320
To General Ledger		By General Ledger	
Adjustment A/c (in Debtors Ledger):		Adjustment A/c (in Debtors Ledger):	
		Cash Received	8,700
Sales	28.209	Sales Returns	208
Cash Paid	25	Discount Allowed	215
B/R Dishonoured	200	B/R Received	9,300
Discount Disallowed	100	Bad Debts	215
		Transfers	1,242
		By Balance c/d	25,759
	45,959		45,959

General Ledger **Adjustment** Account
(In Creditors Ledger)

	Rs.		Rs.
To Balance b/d	27,408	By Balance b/d	204
To Creditors Ledger Adjustment A/c:		By Creditors Ledger Adjustment A/c:	
Purchases	25,200	Cash Paid	12,700
		Purchases Return	714
		Bills Accepted	7,400
		Discount Received	1,020
		Transfers	1,242
		By Balance cld	29,328
	52,608		52,608

General Ledger **Adjustment** Account
(In Debtors Ledger)

	Rs.		Rs.
To Balance b/d	320	By Balance b/d	17,425
To Debtors Ledger Adjustment A/c:		By Debtors Ledger Adjustment A/c:	
Cash Received	8,700		
Sales Returns	208	Sales	28,209
Discount Allowed	215	Cash Paid	25
B/R Received	9,300	B/R Dishonoured	200
Bad Debts	215	Discount Disallowed	100
Transfers	1,242		
By Balance c/d	25,759		
	45,959		45,959

Illustration 5

From the following information prepare Debtors Ledger Adjustment Account in General Ledger.

	Rs.
Opening Credit balance of Sundry Debtors	2,000
Opening Balance of Sundry Debtors	20,000
Cash and Cheques received	80,000
Credit Sales	1,00,000
Discounts Allowed	3,000
Returns Inwards	2,000
Bad Debts	1,500
Rills Receivable received	10,000
Bills Receivnble Discounted	4,000
Provision for Bad Debts	1,000
Bad Debts Recovered	500
Closing Credit Balance in Sundry Debtors	3,000

Rs. 500 is to be transferred from Debtors Ledger to Creditors Ledger. Similarly, Rs. 600 is to be transferred from Creditors Ledger to Debtors Ledger..

Debtors' **Ledger Adjustment Account**
(in General Ledgcr)

Dr.	Rs.		Rs. Cr.
To Balance b/d	20,000	By Balance b/d	2,000
To General Ledger Adjustment Account (in Debtors Ledger):		By General Ledger Adjustment Account (in Debtors Ledger):	
Credit sales	1,00,000	Cash Received	80,000
		Returns Inwards	2,000
To Balance c/d	3,000	Discount Allowed	3,000
		Bad Debts	1,500
		B/R Received	10,000
		Transfers :	
		From Debtors Ledger to Creditors Ledger	500
		From Creditors Ledger to Debtors Ledger	600
		By Balnnce c/d	23,400
	1,23,000		1,23,000

Notes: Provision for Bad Debt, Bad Debts Recovered and Bills Receivable Discounted do not appear in the personal accounts of Debtors. Hence no entry need be made in the Adjustment Accounts.

Check Your Progress A

1 What is a self-balancing system?

....

....

....

2 Name the three ledgers usually kept under Multiple Ledger System,

....

....

....

3 Fill in the blanks

i) Debtors Ledger Adjustment Account is opened in .... Ledger.

ii) Creditors Ledger Adjustment Account is opened in .... Ledger.

iii) The Adjustment Account opened in Debtors Ledger is termed as .... .Account.
iv) General Ledger contains all real and .... accounts.
v) Creditors Ledger contains personal accounts of all ....
vi) Adjustment Accounts help to 'complete .... in each ledger to make them self-balancing,

4 Indicate the Adjustment Account given in General Ledger in which each of the following items usually appears and write within brackets whether it will be on the debit or the credit side of that account.

i)	B/P Dishonoured	....
ii)	Bad Debts	....
iii)	Transfers	....
iv)	Cash Sales	....
v)	Interest debited to a customer	....
vi)	Refunds received from a creditor	....
vii)	Discount disallowed	....
viii)	Provision for Bad Debts	....

14.5 ADVANTAGES OF SELF-BALANCING SYSTEM

The main advantages of self-balancing system are as follows:

1 It is easy to locate the errors because we prepare sepafate Trial Balance for each ledger. If the Trial Balance of a particular ledger agrees, it implies that there are no errors in that ledger. The detection work is confined only to the accounts in a ledger whose Trial Balance does not agree. For-instance, if an error is committed in the personal account of a customer neither the General Ledger nor the Creditors Ledger is affected. It is only the Debtors Ledger which is affected and its Trial Balance will not agree. Hence you will look for the errors in Debtors Ledger only. Similarly, if the Trial Balance of General Ledger does not agree you will check entries in the nominal and real accounts only. This narrows down the area of detection work and the errors can be quickly detected:

2 The maintenance of ledgers can be divided amongst many persons. This helps in quick posting and fixation of responsibility in case of errors and frauds.

3 The main ledger becomes less bulky because the personal accounts of customers and suppliers are excluded. The system is very useful when the number of customers and suppliers is large.

4 It is easy to check the accuracy of each ledger independently with the help of Adjustment Accounts.

5 It facilitates the preparation of interim accounts whenever required by including the figure of total debtors and total creditors. There is no need to go through the Debtors and Creditors Ledgers.

14.6 SECTIONAL BALANCING

The sectional balancing refers to a system under which only a section of the group of ledgers is self-balanced. If a firm which uses three ledgers viz., Debtors Ledger, Creditors Ledger and General Ledger, makes only one ledger self-balancing (normally the General Ledger) it will be called 'Sectional Balancing System'. Under this system only two Adjustment Accounts viz., Debtors Ledger Adjustment Account and Creditors Ledger Adjustment Account are prepared. They are termed as **Total** Debtors Account and **Total** Creditors Account respectively. They are also known as control accounts.

Most of the firms do not follow the self-balancing system. They simply prepare the Total Debtors and Total Creditors Accounts to check the accuracy of Debtors and Creditors Ledgers. These two accounts do not, in fact, form part of any ledger. Hence, no journal entries are passed for opening the accounts. They are prepared by extracting relevant figures from various subsidiary books. Like Debtors Ledger Adjustment Account, the Total

Debtors Account includes the total amounts of all those items which have been debited or credited to the personal accounts of the trade debtors. Similarly, the Total Creditors Account, like the Creditors Ledger Adjustment Account, includes the total amounts of all those items which have been debited or credited to the personal accounts of the trade creditors. Look at Figures 14.4 and 14.5 and note the sources of various items to be debited and credited in these control accounts.

Figure 14.4
Sources of Items for Total Debtors Account

Dr. Cr.

Item	Source	Item	Source
1. Opening balance of Debtors	Opening Entry	1. Opening Credit balance of Debtors	Opening Entry
2. Credit Sales	Sales Book	2. Cash Received from Debtors	Cash Book
3. B/R Dishonoured	Journal	3. Discount Allowed	Cash Rook
4. Interest and expenses charged to Debtors	Journal	4. B/R Received	Bills Receivable Book
5. Refund to Debtors	Cash Book	5. Sales Returns	Returns Inwards Book
		6. Bad debts	Journal
		7. Transfers	Journal
		8. Closing balance of Debtors	

Figure 14.5
Sources of Items for Total Creditors Account

Dr. Cr.

Item	Source	Item	Source
1. Opening Debit balance of Creditors	Opening Entry	1. Opening balance of Creditor:	Opening Entry
2. Payment to Creditors	Cash Bmk	2. Credit Purchases	Purchases Book
3. Discount Received	Cash Book	3. B/P Dishonoured	Journal
4. Bills Accepted	Bills Payable Book	4. Interest and expenses	Journal
5. Purchases Returns.	Purchases Returns Book	5. Refund from Creditors	Cash Book
6. Transfers	Journal		
7. Closing Balance of Creditors	—		

Look at illustration 6 and see how Total Debtors and Total Creditors Accounts are prepared.

Illustration 6

The following figures are extracted from the books of a company for the year ended March 31, 1988: Opening Balance as per Debtors Ledger was Rs. 70,420 and as per Creditors Ledger Rs. 51,360. Transactions during the year ending March 31, 1988 were as follows:

	Rs.		Rs.
Sales	4.86.430	Cash paid to Debtors	8,320
Purchases	2,92,125	Cash paid to Creditors	2.57.750
Sales Returns	23,960	Bills Receivable	19,565
Purchases Returns	15,970	B/R Dishonoured	1,200
Discount Received	5,300	Bad debts	765
Discount Allowed	3,335	Bills Payablk	2,390
Cash Received from Debtors	4,49,700		

Additional information :

i) Amount of Rs. 1,945 standing to the credit of a Supplier's Account was set off against an account for goods sold to that supplier.

ii) A balance of Rs. 450 outstanding from a debtor was adjusted against a claim from him for third party liability arising from accident.

iii) As on March 31, 1988 the balance as per Debtors and Creditors ledger amounted to Rs. 60,650 and 60,130 respectively.

You are required to prepare the Total Accounts to prove the accuracy of entries in the Debtors and Creditors Ledger.

Solution :

Total Debtors Account

Dr.					Cr.
1987		Rs.	1988		Rs.
April 1	To Balance b/d	70,420	Mar. 31	By Sales Returns	23,960
Mar. 31,88	To Sales	4,86,430		By Discount Allowed	9.335
	To Cash	8,320		By Cash	4,49,700
	To B/R	1,200		By Bills Receivable	19,565
				By Bad Debts	765
				By Allowances	450
				By Transfer	1,945
				By Balance c/d	60,650
		5,66,370			5,66,370

Total Creditors Account

		Rs.			Rs.
March 31, 1988	To Cash	2,57,750	April 1, 87	By Balance b/d	51,360
	To Purchases Returns	15,970	March 31, 1988	By Purchases	2,92,125
	To Discount Received	5,300			
	To Bills Payable	2,390			
	To Transfer	1,945			
	To Balance c/d	60,130			
		3,43,485			3,43,485

Check Your Progress B

1 What is the main purpose of Sectional Balancing?

....

....

....

2 Name the two control accounts opened under Sectional Balancing System.

....

....

....

3 Name the source of relevant data in case of each of the following items.

i) Credit Sales

ii) Discount Allowed

iii) Interest Charged by a creditor

iv) Payment to creditors

v) Rill Accepted

vi) B/R Dishonoured

vii) Refund to a debtor

viii) Purchases Returns

14.7 RULING OF SUBSIDIARY BOOKS

You have learnt that for the preparation of Adjustment Accounts or Control Accounts you have to extract relevant figures from various subsidiary books. For this purpose some adjustment in the rulings of subsidiary books becomes necessary. For example, .if there is only one Debtors' Ledger and one Creditors Ledger you may add one, extra column on the debit side of the Cash Book to record receipts from trade debtors and another column on the credit side to record payments to trade creditors. These columns will readily provide the figures of total amounts received from trade debtors and total payments to trade creditors at the end of the accounting period. No change will, however, be required in other subsidiary books. But if there are several Debtors and Creditors Ledgers maintained on alphabetical or regional basis, many additional columns will have to be provided in almost all the subsidiary books. These additional columns will analyse all transactions to provide the total Figures for each Debtors Ledger and each Creditors Ledger separately. Look at figure 14.6 and study how rulings in Sales Book will be arranged to provide the relevant periodic totals.

Figure 14.6
Sales Book

Date	Particulars (Names of Customer)	Inv. No.	L.F.	Total Amount	Debtors Ledgers		
					A-G	G-K	L-P

14.8 LET US SUM UP

It is a common practice with firms having a large number of customers and supplier to adopt multiple ledger system. Under this system the ledger is usually divided in General Ledger, Debtors Ledgers and Creditors Ledger,'

When ledgers are maintained in such a way that a separate Trial Balance can be prepared for each ledger, it is called self-balancing system. Under this system each ledger contains certain Adjustment Accounts to provide the corresponding debits and credits. These accounts are opened through proper journal entries.

Most of the firms do not follow self-balancing system. They sub-divide the ledger but do not prepare separate Trial Balance for each ledger. However, in order to check the accuracy of Debtors and Creditors ledger they simply prepare two control accounts known as Total Debtors Account and Total Creditors Account. This system is known as sectional balancing and it is equally helpful in preparing the interim final accounts as and when required.

14.9 KEY WORDS

Adjustment Account: An account which helps to complete the double entry in each ledger and make it self-balancing.

Creditors Ledger: A ledger containing the personal accounts of all trade creditors.

Debtors Ledger: A ledger containing the personal accounts of all trade debtors.

General Ledger: A ledger containing all accounts other than the personal accounts of trade debtors and trade creditors.

Multiple Ledger System: A system of maintaining more than one ledger.

Sectional-Balancing System: A system of checking the accuracy of Debtors and Creditors Ledgers by p eparing the Total Debtors and Total Creditors Accounts.

Self-Balancing System: A system whereby each ledger can be self-balanced i.e., a separate Trial Balance can be prepared for each ledger.

Total Creditors Account: An account reflecting the total debits and credits for all entries related to trade creditors.

Total Debtor Account: An account reflecting the total debits and credits for all entries related to trade debtors.

Transfers: Transfer of the lower balance in a particular personal account in one ledger to his personal account showing a higher balance in another ledger.

14.10 SOME USEFUL BOOKS

Maheshwari, S.N., 1986. *Introduction to Accounting,* Vikas Publishing I-louse: New Delhi. (Chapter 18).

Patil, V.A. and J.S. Korlahalli, 1986. ***Principles and Practice of Accounting*, R.** Chand & Co.: New Delhi. (Chapter 20 Part 11).

William Pickles, 1982. *Accountancy,* E.L.B.S. and Pitman, London. (Chapter 10).

Gupta, R.L. and M. Radhaswamy. 1986. *Advanced Accountancy*, Sultan Chand & Sons: New Delhi. (Part Six).

Shukla, M.C and T.S. Grewal, 1987. *Advanced Account,* Chand & Co. (Pvt.) Ltd.: New Delhi. (Chapter 5).

14.11 ANSWERS TO CHECK YOUR PROGRESS

A **3** i) General Ledger ii) General Ledger iii) General Ledger Adjustment Account (in Debtors Ledger) iv) nominal v) trade creditors vi) double entry

4 i) Creditors Ledger Adjustment Account (credit)
ii) Debtors Ledger Adjustment Account (credit)
iii) Debtors Ledger Adjustment Account (credit) and Creditors Ledger Adjustment Account (debit)
iv) None
v) Debtors Ledger Adjustment Account (debit)
vi) Creditors Ledger Adjustment Account (credit)
vii) Debtors Ledger Adjustment Account (debit)
viii) None

B 3 i) Sales Book ii) Cash Rook iii) Journal Proper
iv) Cash Book v) Bills Payable Book vi) Journal Proper vii) Cash Book
viii) Returns Outwards Book

14.12 TERMINAL QUESTIONS/EXERCISES

Questions

1 What do you understand by Self-Balancing System? State its advantages.

2 Explain briefly how Debtors Ledger is made Self-balancing. How do you deal with a transfer entry from one personal ledger to another?

3 What are Adjustment Accounts? Give journal entries necessnry for self-balancing the General Ledger.

4 What is Sectional Balancing? How does it differ from Self-balancing? Give proforma of a Total Debtors Account.

Exercises

1 A firm has three ledgers in use viz., Debtors Ledger, Creditors Ledger, and General Ledger. They are all kept on the self-balancing system. From the following

transactions prepare the necessary Adjustment Accounts as they would appear in each of the ledgers.

1988		Rs.
Jan. 1	Balance of Sundry Debtors	16.000
	Balance of Sundry Creditors	18,500
Jan. 31	Credit Purchases	4,500
	Credit Sales	9.800
	Paid to Creditors	9,875
	Discount allowed by them	325
	Received cash from Debtors	7,800
	Allowed them discount	200
	Accepted Bills Payable	1.500
	Received Bills Receivable	3,000
	Returns Inwards	875
	Returns Outwards	600
	Allowances to Debtors	275
	Allowances from Creditors	150
	Bad Debts	450
	Bills Receivable Dishonoured	375

(Answers Sales ledger Adjustment Account Rs. 13,575;
Creditors Ledger Adjustment Account Rs. 10,550)

2 From the following particulars as extracted from the books of Bordia & Co., who keep Debtors Ledger, Creditors' Ledger and General Ledger on the self-balancing system, show how the Debtor's Ledger and Creditors' Ledger Adjustment Accounts will appear in the General Ledger for the year 1988.

	Rs.
Debtors' Balance as on 1.1.88	45,750
Creditors' Balance as on 1.1.88	54,900
Transactions during the year:	
Credit Purchases	20,500
Credit Sales	22,700
Returns Inwards	400
Returns Outwards	600
Cash received from Customers	25,500
Discount allowed to Customers	450
Cash paid to Cretlitors	30,700
Discount received from Creditors	670
Acceptances received from Debtors	8,500
Creditors Bills accepted	12,000
Bills receivable returned dishonoured	1,200
Bills payable dishonouretl	3,000
Bad Debts written off	2,500
Miscellaneous Expenses wrongly debited to Customers' Account	345
Allowances from Creditors	275

(Answer: Closing Balances of Debtors Ledger Adj. A/c Rs. 31,955 and of Creditors Ledger Adj. A/c Rs. 34, 155)

3 From the following particulars extracted from the books of M/s. Balance Minded Ltd., which keeps accounts on self-balancing system, prepare the General Ledger Adjustment Account in the Sales Ledger and the Bought Ledger respectively

	Rs.		Rs.
Debtors as on January 1, 1988	4,575	Cash paid to Supplier	3,070
Creditors as on January 1, 1988	5,490	Discount received	67
Transactions for the year:		Acceptances received from Debtors	850
Credit Purchases	2,050	Accbpfances given to Creditors	1,200
Credit Sales	2,270	B/R dishonoured	120
Returns Inwards	40	B/P dishonoured	300
Returns Outwards	60	Bad Debts written off	250
Cash received from Customers	2,550	Sundry Charges debited to Customers	35
Discount allowed	45	Allowances from Creditors	28

(Answer: Closing balances of General Ledger Adjustment Account in the Sales Ledger and Bought Ledger Rs. 3,265 and Rs. 3,415 respeclively),

4 From the following details prepare General Ledger Adjustment Accounts and the Debtors and Creditors Ledger Adjustment Accounts as on December 31, 1988.

Debtors (January 1, 1988)	Dr.	17,425
Debtors (- do -)	Cr.	320
Creditors (- do -)	Cr.	27,408
Creditors (- do -)	Dr.	204
Purchases		25,200
Sates		28,209
Sales Retums		208
Purchases Returns		714
Cash paid to Creditors		12,700
Bills received from Debtors		9,300
Bills dishonoured		200
Bills accepted for Creditors		7,400
Discount allowed to Debtors		215
Discount allowed to Debtors but later on disallowed		100
Cash received from Debtors		8,700
Discount allowed by Creditors		1,020
Cash paid to Debtors		25
Transfer from Debtors to Creditors Ledger		1,242
Cash Purchases		4,320
Cash Sales		7,400
Bad Debts writtenoff		215

(Answer: Creditors Ledger Adjustment Account Rs. 29,328; Debtors Ledger Adjustment Account Rs. 25,759).

5 From the following balances extracted from the books of Jackson and Co., prepare the Total Creditors Account.

Jan. 1, 1988	Creditors-Credit Balance	1,59,260
	Balance of Debtors-Credit Balance	13,820
Dec. 31,1988	Sales	15,86,980
	Purchases	10,47,713
	Cash paid to Creditors	9,87,280
	Discount Allowed by Creditors	7,980
	Purchase Returns	6,300
	Creditors-Debit Balance (closing)	185

(Answer: Balance Rs. 2,05,590)

6 From the following details extracted from the books of Y Ltd. for the year ended 31.3.1988 prepare a Debtors Ledger Adjustment Account as it would appear in the General Ledger.
Opening Balance on 1.4.1987: Sales Ledger Dr. 45,256, Cr. 156, Provision for Bad and Doubtful Debts 5,000
Sales during the period: Cash 15,200, Credit 1,25,656
Amount received from Customers Rs. 1,56,215
Bills accepted by the Customers Rs. 1,250
Cheques dishonoured Rs. 1,270: Bad Debts written off Rs. 256, Interest on overdue account Rs. 82
Cash discount allowed Rs. 1,527
Bad debts previously written off recovered Rs. 456
Retums from customers 726

(Answer: Sales Ledger Adjustment Account Rs. 12,134).

7 Prepare Total Debtors Account and Total Creditors Account for the year ended December 31, 1988 from the following figures:

Debtors on January 1. 1988	36,400
Creditors on January 1, 1988	26,900
Sales (including cash sales Rs. 18,500)	3,01,600
Sales Returns	2,100
Purchases	2,19,000
Purchases Returns	5,000
Cash received from Debtors (including Rs. 2,000 against a debt previously written off).	2,49,500
Discount allowed to Debtors	4,050
B/R received from Debtors	42,000
Bad Debts	2,500
Cash paid to Creditors	1,44,600
Transfer from Bought Ledger to Sales Ledger	3,200
Discount received from Creditors	8,500

Bills Receivable endorsed to Creditors	25,000
Bills Payable given to Creditors	48,000
Endorsed bills dishonoured	5,000
Credit balance in Sales Ledger December 31, 1988	2.100
Debit balance in Bought Ledger, December 31, 1988.	1,600

(Answer: Total Debtors Account debit balance Rs. 25,250; Total Creditors Account credit balance Rs. 18,200)

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 15 ACCOUNTS FROM INCOMPLETE RECORDS-I

15.0 OBJECTIVES

After studying this unit you should He able to:

- explain the single entry system of accounting
- describe the salient features of incomplete records and their limitations
- numerate the two methods of ascertaining profit from incomplete records
- prepare statement of affairs to ascertain the opening and closing capitals
- ascertain profit or loss from incomplete records

15.1 INTRODUCTION

In Unit 1 you learnt about the two systems of accounting viz., the double entry system and the single entry system. Most firms follow the double entry system of accounting about which you have learnt in detail. The single entry system of accounting is usually followed by small traders and the professionals who cannot afford to employ qualified persons for the accounting work. Under this system they maintain only a cash book and the personal accounts of customers and suppliers. Thus, they keep partial and incomplete record of their transactions. This creates problem in ascertaining the profit or loss of their business and prepare proper final accounts. In such a situation there are two methods that can be adopted for ascertaining the profit or loss: (i) net worth method, and (ii) conversion method. In this unit you will learn about the net worth method of ascertaining the profit of a business owned by a sole proprietor or a partnership firm.

15.2 WHAT IS SINGLE ENTRY SYSTEM

The primary aim of every business, be it a trading concern or manufacturing establishment, is to earn profits. For this purpose every firm must keep proper records of transactions so that at the end of an accounting period the final accounts can be prepared and profits ascertained. The big business concerns usually have a separate Accounts Department and employ qualified and expert accountants for this purpose. But small traders, petty shop-keepers and persons in the profession cannot afford to employ qualified persons for the accounting work. Such persons usually keep the accounting records themselves which are often incomplete. Some of them keep only personal accounts of customers and suppliers, some keep only a Cash Book while others may keep personal accounts of customers' and suppliers' as well as the Cash Book. Thus, they maintain partial and incomplete records without fully following the principles of Double Entry System of Book Keeping. Such partial and incomplete recordirig of transactions is known as 'Single Entry System'.

The term Single Entry System is quite misleading. It gives an impression that under this system only one aspect of a transaction is recorded in books. This is not true. Single Entry System actually refers to incomplete **records** or the defective Double Entry System. Under this system, for certain transactions both the aspects are recorded while for others only one aspect is recorded. Some transactions may simply be ignored, they are not recorded at all. Take the case of a firm which maintains a Cash Eook and personal accounts of customers and suppliers. When cash is paid to a creditor, it will be recorded on the payment side (credit) of the Cash Book and also debited to the personal account of the creditor. Thus you find that both the aspects of this transaction have been duly recorded and the double entry is complete. The same thing applies to cash received from a debtor. But, when rent is paid, it will be recorded in the Cash Book but no entry is made in the Rent Account because the nominal accounts are not maintained. Thus, in this case only one aspect has been recorded in books, the other is simply ignored. For items like depreciation such firms do not make any entry because no fixed assets accounts are maintained. The single entry system is thus a mixture of double entry, single entry and no entry. The accounts maintained under this system are incomplete and unsystematic. Kohler in his 'Dictionary for Accountants' has defined it as '*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 the circumstances*'. Some people prefer to call it a 'Quasi Single Entry System' or simply 'Incomplete Records'. This system is generally adopted by small traders, petty shop-keepers, doctors, advocates, and other professionals. The system can be adopted by sole proprietory concerns and partnership firms. The limited companies, however, cannot adopt it because they have to maintain complete records of all transactions as well as those of assets and liabilities as per the requirements of the Indian companies Act, 1956.

15.3 SALIENT FEATURES OF INCOMPLETE RECORDS

1 Maintenance of Cash **Rook:** A Cash Book is usually maintained. But the business transactions and the personal transactions of the proprietor are usually mixed up.

2 Maintenance of Personal Accounts: If there are credit sales and credit purchases the Personal Accounts of customers (debtors) and suppliers (creditors) are maintained. Rut the Real and Nominal Accounts are avoided. In other words, the accounts of fixed assets, liabilities, expenses and incomes are not maintained.

3 No Uniformity: The adoption of this system is not uniform. It differs from firm to firm as per their individual requirements and convenience.

4 **Dependence on** original vouchers: To ascertain profit or loss or to collect information for any other purpose, necessary figures can be collected only from the original vouchers such as purchase invoice, sales invoice, etc. Thus, dependence on original vouchers is inevitable.

5 Preparation **of** Final Accounts: The final accounts cannot be prepared easily. It is possible to prepare the Trading and Profit & Loss Account only after the available information has been converted into double entry records and the missing figures have been found out. The figures of assets and liabilities computed from incomplete records ore not very reliable as they are based on mere estimates. Hence the statement of assets and liabilities prepared at the end of the accounting period under this system is called as 'Statement of Affairs' instead of "Balance Sheet".

15.4 LIMITATIONS

Single Entry System signifies the incompleteness and insufficiency of information. Hence, it suffers from certain limitations which can be summarised as follows:

1 The arithmetical accuracy of the hooks of accounts cannot be checked as it is not possible to prepare a Trial Balance in the absence of real and nominal accounts.

2 Any information obtained under this system will not be free from doubt and so is unreliable.

3 It is not possible to prepare a Trading Account and find out the rate of gross profit earned by the firm. In the absence of gross profit margin, the performance of the firm cannot be compared with that of other firms or with the past. This also affects proper planning and sound decision-making.

4 True profit or loss and information about assets and liabilities, cannot be obtained with certainty. Hence, it is not possible to assess financial soundness of the firm.

5 In the absence of proper and reliable balance sheet, the firm may not be able to avail itself of the various financial facilities from banks such as overdraft facilities or loan facilities.

6 The system generates a spirit of laxity on the part of the employees which may result in frauds.

Check Your Progress A

1 State whether the following statements are True of False:

i) Partnership firms of professionals cannot keep their books of account on single entry system. ....

ii) Profits can be easily and quickly calculated if the books are kept on single entry system. ....

iii) Sole traders prefer to keep their books on single entry system. ....

iv) It is not possible to prepare Trial Balance if the account books are kept on single entry system. ....

v) As it is easier to keep accounts under single entry system, most of the limited companies adopt this system of accounting. ....

2 Fill in the blanks with appropriate word or words :

i) Trading and Profit & Loss Account .... be easily prepared to find out profit if the books are kept under single entry system of accounting.

ii) .... and .... usually keep their books on single entry system.

iii) Only .... and .... are maintained under single entry system ofaccounting.

iv) As per legal requirements .... cannot keep their accounts on single entry system.

v) .... accounts and ....accounts are not prepared when books are kept under single entry system.

3 Tick the correct answer.

a) Records under single entry system are maintained by:

i) big business houses

ii) small traders

iii) public limited companies

iv) government companies

b) Under single entry system the main account book kept is:

i) Purchases Book

ii) Sales Book

iii) Cash Book

iv) Returns Inwards Book

c) Under single entry system the type of accounts usually maintained are;

i) personal accounts

ii) property accounts

iii) expense accounts

iv) income accounts

15.5 METHODS OF ASCERTAINING PROFITS

You know that in every business the profit or loss must be worked out at the end of an accounting period, whether proper books of account have been kept or not and whether the records maintained are complete or not. This is necessary not only for the proprietors of the business but also for income tax purposes. It is all the more essential if the business happens to be a partnership firm, because the partners have to share the profits of the firm at the end of each accounting period. Now the question arises as to how to ascertain the profits when the accounting records are incomplete. In such a situation there are two methods which can be used for ascertaining.the profits. They are:

1 **Net Worth Method:**
Under this method profits are computed by comparing the net worth or capital at the beginning of the accounting period with the net worth or capital at the end of the accounting period. This method does not involve the preparation of Trading and Profit and Loss Account. It is considered most suitable when the information available is too limited.

2 **Conversion Method:**
Under single Entry System the Debtors' Ledger and Creditors' Ledger are usually maintained along with the Cash Book. Thus, though the records are incomplete, they provide sufficient information for preparation of the Trading and Profit & Loss Account. Hence the Conversion Method is employed for ascertaining the profits which involve the preparation of proper final accounts after working out the missing figures. This method will be discussed in detail in Unit 16.

15.6 NET WORTH METHOD

Many small business firms simply maintain the personal accounts of Debtors and Creditors or only the Cash Book. In such a situation it is not possible to prepare the Trading and Profit and Loss Account. Hence, we have to use the net worth method for finding out the profit or loss at the end of an accounting period. This method is also known as 'Net Assets Method' or 'Statement of Affairs Method'.

The net worth method is based on a simple fact that any increase or decrease in the net worth (capital) of a business takes place as a result of the profit earned or the loss incurred during the year. For example, a person started his business with a capital of Rs. 20,000 on January 1, 1987. On December 31, 1987 when he analyses his assets and liabilities he finds that his capital had increased to Rs. 28,000. This would mean that he earned a profit of Rs. 8,000 (Rs. 28,000 - Rs. 20,000) during 1987. If however, his capital on December 31. 1987 worked out as Rs. 16,000 it would mean he incurred a loss of Rs. 4,000 (Rs. 20,000 - Rs. 16,000).

Thus under net worth method the profit can be ascertained by comparing the net worth (or capital) of the business as at the beginning of the accounting period (opening capital) with the net worth (or capital) as at the end of the period (closing capital). If, the net worth at the end is more as compared to the net worth at the beginning, the difference is treated as the profit earned during the period. If, on the other hand, the net worth at the end is less than the net worth at the beginning, it means the firm has incurred a loss during the period. Let us study first how the net worth at the beginning and the net worth at the end are to be worked out.

15.6.1 Computation of Net Worth

The net worth or capital on a particular date can be found out by adding all assets and deducting therefrom the total of all external liabilities. Thus opening capital can be calculated by adding all assets at the beginning of the year and deducting therefrom the total of all external liabilities on that date. Similarly, the closing capital can be calculated by adding the value of all assets on the last day of the year and deducting therefrom the total of all external liabilities on that date. This is done by preparing two separate statements of assets and external liabilities one as at the beginning and the other as at the end. These, statements are called 'Statement of Affairs' which are virtually the Balance Sheets of the business.

Under double Entry System you get all the figures of assets arid liabilities from the books of accounts. But under Single Entry System, you may get some figures from books but fc others you will have to rely on vouchers or other documents and physical assessment. Foi example, cash and bank balances can be taken from Cash Book. The lists of debtors and creditors can be compiled from personal accounts. But, the value of fixed assets like furniture, machinery. buildings, etc. shall be ascertained from vouchers and other documents available. Similarly, the closing stock will be worked out by actual stock takii and their values ascertained on the basis of the invoices received from the suppliers.

15.6.2 Computation of Profits

You have learnt that under the net worth method the profit or loss of the business is ascertained by comparing its net worth at the beginning (opening capital) with its not worth at the end (closing capital). You know if the closing capital is more than the openir capital the difference is treated as profit because the increase in capital is primarily the result of the profit earned during the period. But we must also bear in mind that capital ca be affected by two other factors (i) drawings made during the year, and (ii) additional capital introduced during the year. Hence, while calculating the profit by net worth method, these two aspects should also be taken into account.

Adjustment in respect of drawings: The proprietors always withdraw certain amount from the business for personal expenses. This decreases the closing capital. In other words if there were no drawings, the closing capital would have been a higher figure. Hence, to find out the true closing capital it becomes necessary to add back the amount of drawings made during the year.

Adjustment in respect of additional capital: Any additional capital brought in by the proprietors increase the closing capital of the business. Thus, such increase in capital is nc the result of profits but it is on account of the additional capital introduced during the yeai Hence, to find out the true profits, it becomes necessary to reduce the closing capital by th amount of additional capital introduced by the proprietors during the year.

For ascertaining the profit or loss by net worth method, we usually prepare a statement called 'Statement of Profit' which clearly shows the comparison of opening and closing capitals with due adjustment of drawings and the additional capital. Look at Figure 15.1. I shows the form in which the Statement of Profit is to be prepared.

Figure 15.1
Statement of Profit
for the year ending ....

Look at Illustration 1 and study how opening and closing capitals are worked out with the heip of Statements of Affairs and how profit is ascertained after making necessary adjustments for drawings and the additional capital.

Illustration 1

Rajeev keeps his books on single entry system. His position on March 31, 1987 was as follows:

Cash in hand Rs. 2,400; Cash at bank Rs. 25,500; Debtors Rs. 18,400; Stock Rs. 28,600; Furniture Rs. 5,000; Creditors Rs. 18,700: Expenses Outstanding Rs. 2,000.

On October 1, 1987 Rajeev introduced Rs. 10,000 as additional capital in the business nut of which a machine costing Rs. 5,000 was purchased for the business. His drawings during the year totalled Rs. 2,000.

On March 31, 1988 his position was as follows:

Cash in hand Rs, 2,600; Cash at bank Rs. 27,500; Stock Rs. 31,500; Debtors Rs. 24,200; Furniture Rs. 4,500; Creditors Rs. 20,200; Prepaid Insurance Rs. 200.

Prepare the necessary Statement of Affairs and the Statement of Profit for the year ending March 31, 1988 and ascertain the profit or loss.

Solution

Statement of Affairs of Rajeev
as ut March 31,1987

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Creditors	18,700	Cash in hand	2,400
Expenses Outstanding	2,000	Cash at Bank	25.500
		Debtors	18,400
Capital (balancing figure)	59.200	Stock	28,600
		Furniture	5,000
	79,900		79,900

Statement of Affairs of Rajeev
as at March 31, 1988

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Creditors	20,200	Cash in hand	3,600
Capital (balancing figure)	76,300	Cash at Dank	27,500
		Stock	31,500
		Debtors	24,200
		Prepaid Insurance	200
		Furniture	4,500
		Machinery	5,000
	96,500		96,500

Statement of Profits of Rajeev
for the year ended March 31, 1988

	Rs.
Capital as on March 31, 1988	76,300
Add Drawings	2,000
	78,300
Less Further Capital introduced	10,000
	68,300
Less Capital as on March 31, 1987	59,200
Profit made during the year	9,100

Adjustment for Depreciation and Provision for Bad Debts: You know the purpose of providing depreciation and making a provision far bad debts at tha time of preparing3 the final accounts. Such items are equally relevant for ascertaining the profit or loss from incomplete records. They may be given In the farm of additional information and must be duly taken into account while preparing the Statement of Affairs for working out the closing capital. The depreciation will be deducted from the value of the concerned fixed asset and the provision for bad debts from Sundry Debtors. Look at Illustration 2 and study how these adjustments are made under the net worth method,

Illustration 2

A trader has not kept proper books of account on double entry system. The following balances have been supplied to you by the trader. You are required to prepare a Statement of Profit for the' year ended December 31, 1987 and a Statement of Affairs as on that date:

	as on 1.1.88	as on 31.12.88
	Rs.	Rs.
Cash in hand	10,000	12,000
Bank Overdraft	30,000	40,000
Stock in Trade	60,000	80,000
Sundry Creditors	35,000	40,000
Sundry Debtors	40,000	45,000
Bills Receivable	20,000	15,000
Land and Buildings	80,000	80,000
Furniture & Fittings	8,000	8,000
Bills Payable	30,000	26,000
Outstanding Expenses	3,000	2,000

Drawings during the year amounted to Rs, 16,000. Depreciation is to be provided on land and buildings @ 2% and on furniture & fittings @ 10%. Also provide for doubtful debts at 5% on debtors.

Solution:

Statement of Affairs as on January 1,1988

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Bank overdraft	30,000	Cash in hand	10,000
Sundry Creditors	35,000	Stock in Trade	60,000
Bills Payable	30.000	Sundry Debtors	40,000
Outstanding Expenses	3,000	Bills Receivable	20,000
Capital (balancing figure)	1,20,000	Land & Buildings	80,000
		Furniture & Fittings	8,000
	2,18,000		2,18,000

Statement of Affairs as on December 31,1988

Liabilities	Amount	Assets		Amount
	Rs.			Rs.
Bank Overdraft	40,000	Cash in hand		12,000
Sundry Creditors	40,000	Stock in trade		80,000
Bills Payable	26,000	Sundry Debtors	45.000	
		Less Provision		42,750
Outstanding Expenses	2,000	for Bad Debts	2,250	
Capital	1,27,350	Bills Receivable		15,000
(balancing figure)		Land & Building	80,000	
		Less Depreciation	1,600	78,400
		Furniture	8,000	
		Less Depreciation	800	7,200
	2,35,350			2,35,350

Statement of Profit for the year ending December 31,1988

	Rs.
Capital at the end	1,27,350
Add Drawings during the year	16,000
	1,43,350
Less Capital at the beginning	1,20,000
Profit earned during the year	23,350

15.6.3 Partnership Firms

In case of a partnership firm, all partners will have some balance in their capital accounts and the profit of the business will havk to be distributed amongst all the partners in the agreed profit sharing ratio (or equally if no ratio is given). The Statement of Affairs however reveals only the combined capital of all partners. Hence, the Statement of Profit will be prepared with the help of combined capitals and in order to work out the individual capital of each partner we may have to prepare the capital accounts of all the partners. It is also possible that the partnership deed provides for allowing interest on capital, interest on drawings, etc. In that case, we should prepare of Profit and Loss Appropriation Account to show the distribution of profit amongst the partners wherein the entries for interest on capital, interest on drawings etc. may also be made. Look at Illustration 3 which deals with a partnership firm keeping books on single entry system.

Illustration 3

A, B and C are partners sharing profits and losses in the ratio of 5:3:2 respectively. They keep their books on single entry system. Their Statement of Affairs as on December 31, 1987 was as follows :

Statement of Affairs as on December 31, 1987

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Creditors	5,000	Cash in hand	1,800
Bills Payable	2,000	Debtors	6,000
Capital Account!		Stock	4,000
A - 10,000		Furniture	3,000
B - 5,000		Machinery	12,000
C - 5,000	20,000	Prepaid Expenses	200
	27.000		27,000

The withdrawals by the partners during the year **1988** were A : Rs. 2,400 ; B : Rs. 1,800 and C : Rs. 1,800. B brought in **additional** capital of **Rs.** 5,000 **on** July **1,** 1987. On December 31, **1987** Cash in hand was **Rs.** 3,400 ; Debtors **Rs.** 10,000; Stock in trade Rs. 7,500 ; Creditors Rs. 6,000; Bills Payable Rs. 2,500; Bills Receivable Rs. 4,000 ; Outstanding Expenses Rs. **500.** Machinery is to be depreciated by 10% and Furniture by 20% per annum.

Provision for doubtful debts is to be made @ 5% on debtors. Interest is to be allowed on capitals @ 16% per annum but no interest is to be charged on drawings.

You are required to calculate profits earned by the firm during the year 1988 and its division amongst the partners. Also prepare the Balance Sheet **of** the firm **as** on December **31,** 1988,

Solution

Statement of Affairs as on December 31,1988

Liabilities	Amount	Assets		Amount
	Rs.			Rs.
Creditors	6,000	Cash in hand		3,400
Bills Payable	2.500	Debtors	10,000	
		Less Provision for Bad Debts	500	9,500
Outstanding Expenses	500			
Combined Capital (balancing figure)	28.600	Stock in trade		7.500
		Bills Receivable		4,000
		Furniture	3,000	
		Less Depreciation	600	2,400
		Machinery	12.000	
		Less Depreciation	1,200	10,800
	37,600			37.600

Statement of Profit for the yenr ending December 31, 1988

		Rs.
Combined Capital as at the end		28,600
Add Drawings by the partners	A 2,400 B 1,800 C 1,800	6,000
		34,600
Less Additional Capital by B		5,000
		29,600
Less Combined Capital as at the beginning		20,000
Profit earned during the year		9,600

Profit & Loss Appropriation Account

Dr.	Rs.		Cr. Rs.
To Interest on Capital A 1,600 B 1,200 C 800	3,600	By Profit	9,600
To Share of Profit A 3,000 B 1,800 C 1,200	6,000		
	9,600		9,600

A's Capital Account

	Rs.		Rs.
To Drawings	2,400	By Balance b/d	10,000
To Balance c/d	12,200	By Interest on Capital	1,600
		By Share of Profit	3,000
	14,600		14,600

B's Capital Account

	Rs.		Rs.
To Drawings	1,800	By Balance b/d	5,000
To Balance c/d	11,200	By Cash A/c	5,000
		By Interest on Capital	1,200
		By Share of Profit	1,800
	13,000		13,000

C's Capital Account

	Rs.		Rs.
To Drawings	1,800	By Balance b/d	5,000
To Balance c/d	5,200	By Interest on Capital	800
		By Share of Profit	1,200
	7,000		7,000

Balance Sheet as on December 31, 1988

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Creditors	6,000	Cash in hand	3,400

Liabilities	Rs.	Assets	Rs.	Rs.
Bills Payable	2,500	Debtors	10,000	
		Less Provision for Bad Debts	500	
Outstanding Expenses	500			9,500
		Stock in trade		7,500
		Bills Receivable		4,000
		Furniture	3,000	
		Less Depreciation	600	2,400
Capital:		Machinery	12,000	
A 12,200		Less Depreciation	1,200	10,800
B 11,200				
C 5,200	28,600			
	37,600			37.600

Check Your Progress B

1 Select the correct answer.

a) Under net worth method, the profit can be ascertained by preparing
   i) Profit and Loss Account
   ii) Cash Account
   iii) Statement of Affairs
   iv) Statement of Profit

b) The closing capital can be ascertained by preparing
   i) Cash Account
   ii) Statement of Affairs
   iii) Trial Balance
   iv) Profit and Loss Account

c) Profit under net worth method, when there are no drawings and no additional capital is the difference between:
   i) Assets and Liabilities
   ii) Capital and Liabilities
   iii) Assets and Capital
   iv) Closing Capital and Opening Capital.

d) To ascertain the real profit, the difference between the closing capital and opening capital is adjusted by:
   i) deducting the drawings and adding the additional capital introduced
   ii) adding the drawings and deducting the additional capital introduced
   iii) deducting both the drawings and the additional capital.
   iv) adding both the drawings and the additional capital

2 The amounts of opening assets and closing assets of a firm are Rs. 80,000 and Rs. 1,30,000 respectively, and the amounts of opening and closing external liabilities are Rs. 50,000 and Rs. 80,000 respectively. Calculate the profit earned during the yaar under the following circumstances :

i) if there are no dmwinga made and no additional capital brought In by the proprietors;
ii) if there are no drawings but Rs. 10.000 was introduced as additional capital by one of the partners;
iii) if drawings by the partners amounted to Rs. 8,000 but no additional capital was introduced;
iv) if drawing by partners amounted to Rs. 8,000 and one of the partners had introduced Rs. 10,000 as additional capital during the year.

15.7 LET US SUM UP

The system of keeping partial or incomplete records is popularly known as Single Entry System. It is usually employed by small traders or professionals. Limited companies cannot adopt this system of accounting.

Under this system only Cash Book and the personal accounts of customers and suppliers are maintained. No real and nominal accounts are maintained. One has to depend mainly on original vouchers and other documents to collect necessary data for ascertaining the assets and liabilities. Proper final accounts cannot be prepared. Hence, the profit or loss of the business is ascertained in an indirect manner by following eithet the net worth method or the conversion method.

Under net worth method, the profit or loss is calculated by comparing the opening capital with closing capital. Any increase in capital over the year is regarded as profit and the decrease as loss. To find out the opening and closing capitals we have to make use of the Accounting Equation (Capital = Assets – External Liabilities) and prepare the necessary Statement of Affairs.

To ascertain the true profit, adjustments have to be made in the closing capital in respect of additional capital introduced, drawings made and other items affecting the profits such as depreciation, etc. If it is the case of a partnership, items like interest on capital and interest on drawings may also be invqlved. The net profit or net loss will have to be distributed amongst the partners according to their profit-sharing ratio and the individual capitals of partners found out by preparing their capital accounts,

15.8 KEY WORDS

Net Worth : The difference between the total assets and the total external liabilities. It is equal to capital.

Profit and Loss Appropriation Account : An account prepared to show the distribution of profits amongst the partners.

Statement of **Affairs : A** statement of assets and liabilities based on incomplete records. It is prepared for ascertaining the opening or closing capitals.

15.9 SOME USEFUL BOOKS

Gupta R.L. and M. Radhaswamy, 1986. *Advanced Accountancy,* Sultan Chand & Sons: New Delhi. (Chapter 15 Section II).

Maheshwari S.N., 1986. *Introduction to Accounting,* Vikas ,Publishing House: New Delhi. (Chapter 16).

Patil, V.A. and J.S. Korlahalli, 1986. *Principles and Practice of Accounting,* R. Chand & Co., New Delhi. (Chapter 6, Section II).

Shukla, M.C. and T.S. Grewal, 1987. *Advanced Accounts,* S. Chand & Co: New Delhi (Chapter 8).

William Pickles, 1982. *Accountancy,* E.L.B.S. and Pitman, London. (Chapter 2).

15.10 ANSWERS TO CHECK YOUR PROGRESS

A 1 i) False ii) False iii) True iv) True v) False

2 i) can not ii) small traders; professionals iii) personal accounts; Cash Book iv) limited companies v) Real; nominal

3 a) ii b) iii c) i

B 1 a) iv b) ii c) iv d) ii

2 i) Rs. 20,000
ii) Rs. 10,000
iii) Rs. 28,000
iv) Rs. 18,000

15.11 TERMINAL QUESTIONS/EXERCISES

Questions

1 What is a Single Entry System? Distinguish it from Double Entry System.

2 Why do some persons prefer to keep their accounts in the form of incotnplete records? State the salient features of such records:

3 Discuss the drawbacks of Single Entry System of accounting. Briefly explain the two methods of ascertaining profit when accounting records are incomplete.

Exercises

1 Calculate the profit or loss from the following data: Withdrawals by the proprietor during the year Rs. 15,000. Capital at the beginning of the year Rs. 60,000. Capital at the end of the year Rs. 1,00,000. Capital brought in by the proprietor during the year Rs. 25,000.

(Answer : Profit Rs. 20,000)

2 Calculate the net profit from the following information: Capital in the beginning of the year Rs. 40,000. Drawings during the year. Rs: 10,750. Capital at the end of the Year Rs. 90,000. Capital introduced by the proprietor on July 1 Rd. 35,000. Interest allowed on capital @ 10% per annum.

(Answer : Profit after allowing interest on Capital of Rs. 5,750 is Rs. 20,000).

3 From the following information, prepare a Statement of Affairs and Calculate profits earned during the year ending December 31, 1988.

	as on 1.1.88	as on 31.12.88
	Rs.	Rs.
Cash in hand	8,000	10,000
Bank Overdraft	28,000	18,000
Stock in trade	37,000	43,000
Sundry Creditors	26,000	22,000
Sundry Debtors	32.000	30,000
Bills Receivable	8,000	5,000
Furniture & Fittings	5,000	4,000
Machinery	40,000	36,000
Buildings	50,000	49,000
Bills Payable	4,000	6,000
Motor Vehicle	—	24,000
Unpaid Expenses	800	600

(Answer : Opening Capital Rs. 1,21,200; Closing Capital Rs. 1,54,400; Profit Rs. 33,200)

4 Jai Prakash has not kept proper books of accounts. His position on December 31, 1987 was as follows:

Cash in hand Rs. 2,000; Cash at Bank Rs. 5,000; Stock in trade Rs. 36,000; Sundry Debtors Rs. 24,000; Fixtures and Fittings Rs. 12,000; Machinery Rs. 40,000; Sundry Creditors Rs, 28,000; Loan from his friend Rajesh Rs, 20,000; Prepaid Expenses Rs. 400. During the year Jai Prakash introduced additional capital on October 1, 1988 amounting to Rs. 20,000 and his drawings during the year were Rs. 500 per month.

On December 31, 1988 his position was as follows;

Cash in hand Rs. 15,000; Bank Overdraft Rs, 25,000;

Machinery Rs. 40,000;

Stock in trade Rs. 44,000: Sundry Debtors Rs. 32,000; Furniture and Fittings Rs. 20,000; Sundry Creditors Rs. 34,000; Outstanding Expenses Rs. 1.000.

He has purchased additional furniture worth Rs. 8,000 on May 1, 1988 and the loan from his friend still remains unpaid. Calculate profit earned during the year after allowing interest on capital @ 10% per annum and charging depreciation on Machinery @ 10% and on Furniture & Fittings @ 15% per annum.

(Answer: Opening Capital Rs. 71,400; Closing Capital Rs. 64,400; Loss for the year Rs, 28,640; Interest on Capital Rs. 7,640)

5. The following is the Statement of Affairs of A, B and C as on December 31, 1988 :

Statement of Affairs as on 31.12.88

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Sundry Creditors	18,000	Cash in hand	2.400
Bills Payable	5,000	Sundry Debtors	24,000
Capital Accounts		Stock in trade	26,000
A - 30,000		Furniture	10,000
B - 20,000		Machinery	50,000
C - 15,000	65,000	Buildings	35,000
Bank Lonn	60,000	Prepaid Expenses	600
	1,48,000		1,48,000

The partners share profits in the ratio of 5 : 3 : 2 after allowing interest on capital @ 10% per annum. The drawings were A - Rs. 800, B - Rs. 600 and C-Rs.500 per month. Interest charged on drawings was A - Rs. 480, B - Rs. 360 and C - Rs. 300.

On December 31, 1988 the assets and liabilities of the firm were as follows:

Cash in hand Rs. 3,600; Sundry Debtors Rs. 32,000; Stock in trade Rs. 35,000;

Furniture Rs. 16,000; Machinery Rs. 50,000; Buildings Rs. 35,000; Sundry Creditors Rs. 20,000; Bills Payable Rs. 6,000; Unpaid Expenses Rs. 800,

New furniture worth Rs. 6,000 was purchased on April 1, 1988, The Bank Loan is repaid to the extent of 40%. Depreciation has to be provided @ 20% on furniture; 10% on machinery and 2% an buildings per annum. A brought additional capital sf Rs. 10,000 on July 1, 1988, Calculate the profit and prepare the Statement of Affairs as on December 31, 1988 as it stands in the books of the firm.

(Answer: Closing Capital after providing for depreciation Rs. 1,00,200; Net Profit after accounting for interest on Capital and drawings Rs. 42,140)

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 16 ACCOUNTS FROM INCOMPLETE RECORDS-II

Structure

16.0 OBJECTIVES

After studying this unit you should be able to:

- explain full conversion method and describe how records maintained on single entry system can be converted into double entry records
- explain abridged conversion method and describe how missing items can be ascertained
- prepare Trading and Profit & Loss Account and Balance Sheet from incomplete records,

16.1 INTRODUCTION

You know there are two methods of ascertaining the profit or loss of a business which does not maintain complete accounting records. In Unit 15 you learnt in detail about the first method viz., Net Worth Method. No doubt, the Net Worth Method helps us to ascertain the profits earned during the accounting period and prepare the Statement of Affairs as at the end. But, certain vital information regarding operational aspects of the business cannot be ascertained nnd many important questions relating to the operational efficiency of the firm remain unanswered. For example, the information regarding sales, purchases and operating expenses is not available and so we cannot workout the rate of gross profit earned by the firm. Thus, neither a meaningful analysis of various aspects of business operations nor measurement of the comparative efficiency of the finn can be made. Hence, the second method viz., the Conversion Method is adopted by most of the firms. This helps in digging out the necessary information and prepare proper final accounts for the business. In this unit you will learn how such information is extracted from the incomplete records and how profit or loss is ascertained under the Conversion Method by preparing proper Profit & Loss Account and the Balance Sheet.

16.2 CONVERSION METHOD

In Unit 15 you learn that the Conversion Method involves preparation of proper Profit and Loss Account and the Balance Sheet. There are two ways of doing it: (1) preparation of final accounts after converting the single entry records into complete double entry records

Statement of Affairs as on 31.12.88

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Sundry Creditors	18.000	Cash in hand	2.400
Bills Payable	5,000	Sundry Debtors	24,000
Capital Accounts		Stock in trade	26,000
A - 30,000		Furniture	10.000
B - 20,000		Machinery	50,000
C - 15,000	65,001)	Buildings	35,000
Bank Loan	60,000	Prepaid Expenses	600
	1,48,000		1,48,000

The partners share profits in the ratio of 5 : 3 : 2 after allowing interest on capital @ 10% per annum. The drawings were A - Rs. 800, B - Rs. 600 and C-Rs. 500 per month. Interest charged on drawings was A - Rs. 480, B - Rs. 360 rind C - Rs. 300.

On December 31, 1988 the assets and liabilities of the firm were as fallows:

Cash in hand Rs. 3,600; Sundry Debtors Rs. 32,000; Stock in trade Rs. 35,000;

Furniture Rs. 16,000; Machinery Rs. 50,000; Buildings Rs. 35,000; Sundry Creditors Rs. 20,000; Bills Payable Rs. 6,000; Unpaid Expenses Rs. 800,

New furniture worth Rs. 6,000 was purchased on April 1, 1988. The Rank Loan is repaid to the extent of 40%. Depreciation has to be provided @ 20% on furniture; 10% on machinery and 2% on buildings per annum. A brought additional capital of Rs. 10,000 on July I, 1988, Calculate the profit and prepare the Statement of Affairs us on December 31, 1988 as it stands in the books of the firm.

(Answer: Closing Capital after providing for depreciation Rs. 1,00,200; Net Profit after accounting for interest on Capital and drawings Rs. 42,140)

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to rho University, These are for your practice only.

UNIT 16 ACCOUNTS FROM INCOMPLETE RECORDS-II

Structure

16.0 OBJECTIVES

After studying this unit you should be able to:

- explain full conversion method and describe how records maintained on single entry system can be converted into double entry records
- explain abridged conversion'method and describe how missing items can be ascertained
- prepare Trading and Profit & Loss Account and Balance Sheet from incomplete records.

16.1 INTRODUCTION

You know there are two methods of ascertaining the profit or loss of a business which does not maintain complete accounting records. In Unit 15 you learnt in detail about the first method viz., Net Worth Method. No doubt, the Net Worth Method helps us to ascertain the profits earned during the accounting period and prepare the Statement of Affairs as at the end. But, certain vital information regarding operational aspects of the business cannot be ascertained and many important questions relating to the operational efficiency of the firm remain unanswered, For example, the information regarding sales, purchases and operating expenses is not available and so we cnnnot workout the rate of gross profit earned by the firm, Thus, neither a meaningful analysis of various aspects of business operations nor measurement of the cumpnrative efficiency of the finn can be made. Hence, the second method viz., the Conversion Method is adopted by most of the firms. This helps in digging out the necessary information and prepare proper final accounts for the business. In this unit you will learn how such information is extracted from the incomplete records and how profit or loss is ascertained under the Conversion Method by preparing proper Profit & Loss Account and the Balance Sheet.

16.2 CONVERSION METHOD

In Unit 15 you learnt that the Conversion Method involves preparation of proper Profit and Loss Account and the Balance Sheet. There are two ways of doing it: (1) preparation of final accounts after converting the single entry records into complete double entry records including the preparation of Trial Balance, (2) preparation of final accounts simply by ascertaining certain missing figures. The first method is known as 'Full Conversion Method' and the second an 'Abridged Conversion Method'.

16.2.1 Full Conversion Method

As stated above, the full conversion method involves conversion of records maintained on single, entry system into complete double entry records. You know most of the firms which keep records on single entry system usually maintain a Cash Book along with the personal accounts of the customers and suppliers. So, in order to convert them into double entry records, you must also open all the concerned real and nominal accounts in the ledger and make proper postings therein. This involves a series of steps as follows:

1 Prepare the Statement of Affairs at the beginning and open all those real and personal accounts which do not appear in the ledger maintained under single entry system. This may involve the opening of all real accounts (other than cash and bank) and the personal accounts such as Capital, Drawings, Loan, Outstanding Expenses, Outstanding Incomes, Prepaid Expenses, etc. It can be done by passing an opening journal entry.

2 From the Cash Book, complete postings into all real and personal accounts opened above.

3 Go through the debit side of the Cash Book and open all the incomes' accounts in the ledger and make postings therein.

4 Go through the credit side of the Cash Bank and open all expenses' accounts in the ledger and make postings therein.

5 Make complete analysis of the customers accounts and complete double entry in accounts like Sales, Sales Returns, Bad Debts, Bills Receivable, etc.

6 Similarly, make a complete analysis of suppliers accounts and complete double entry in accounts like Purchases, Purchases Returns, Bills Payable, etc.

7 Go through all vouchers and documents and note whether certain other items require entry in books. For example, a piece of old furniture might have been sold which may involve some profit or loss, the same will have to be brought into books.

8 Prepare a Trial Balance and ensure that double entry is complete in every respect.

You can now prepare the Trading and Profit & Loss Account and the Balance Sheet.

16.2.2 Abridged Conversion Method

You will agree that the conversion of records maintained on single entry system into double entry records is an arduous task involving a lot of time, labour and expense. Hence, a short cut method known as 'Abridged Conversion Method' has been devised which helps us to prepare the Trading and Profit & Loss Account and the Balance Sheet without the opening of any additional accounts in the ledger. Under this method we simply prepare a summary of all Cash transactions for the entire accounting period. This is known as 'Receipt and Payments Account'. In this account we show the opening cash and bank balances and enter all receipts during the year under different heads of accounts on its debit side. All Payments during the year under various head of accounts and the closing balances of cash and bank are shown on its credit side. This enables us to work out the amounts of various incomes earned and the expenses incurred during the year. Not only that, a number of other items such as cash purchases, cash sales, cash received from debtors, cash paid to creditors, and purchase or sale of fixed assets can also be worked out from the Receipt and Payments Account. Similarly, we prepare a Total Debtors and a Total Creditors Account to find out the amounts of credit sales and credit purchases respectively. This enables us to work out most of the figures required for preparing the final accounts at the end of the accounting period. In such a situation, there is no need to open any real or nominal account in the ledger or prepare a Trial Balance. **Note that the Receipt and Payments Account** and **Total Debtors and Total Creditors Accounts do not form part of the ledger. They are prepared simply to ascertain the amounts of a few missing items.**

The Conversion Method usually refers to the abridged conversion method which implies the preparation of Trading and Profit & Loss Accnunt and the Balance Sheet from incomplete records after finding out certain missing figures with the help of Receipts and Payments Account, Total Debtors Account and Total Creditors Account.

16.3 MISSING ITEMS AND THEIR ASCERTAINMENT

As stated earlier, the conversion method usually implies the preparation of final accounts without actual conversion of single entry records into double entry records. But the kind of information which is needed for preparing the final accounts is not directly available from records maintained on single entry system. Hence, we have to prepare certain additional accounts for finding out the necessary information. Before we learn how such information can be extracted from incomplete records, we should identify the kind of information which is usually missing. In practice, the most common items are :

1 Opening Capital
2 Credit Sales
3 Credit Purchases
4 Cash and Bank Balances

Let us now take them one by one and study how the amount of each item will be worked out.

16.3.1 Opening Capital

You know capital is always equal to the total of assets minus the total of external liabilities. Hence, by preparing a statement of all assets and all external liabilities we can easily find out the opening capital. You have already learnt about the preparation of such a statement in Unit 15. It is called 'Statement of Affairs at the beginning'. Go through Sub-section 15.6.1 once again and look at Illustration 1 of Unit 15. This will help you to revise the calculation of opening capital.

16.3.2 Credit Sales

To prepare Trading Account and find out the Gross Profit you will certainly need the figure of sales. The sales include cash as well as credit sales of goods, Hence you will need both of these amounts, The amount of cash sales can be easily found out from the summary of cash transactions called the 'Receipts and Payments Acdount', But, for credit sales we should prepare an additional account called 'Total Debtors Account'. You learnt about the preparation of Total Debtors Account in Unit 14 under Sectional Balancing, You know it shows opening debtors and credit sales on the debit side, and cash received.from debtors, sales returns, discount allowed, bad debts, and closing debtors on the credit side. If the figures of all other items (opening and closing balunces of debtors, cash received from dqbtors, discount allowed, bad debts, etc.) are given, the credit sales can be easily ascertained by working out the difference between the totals of debit and credit sides of the Total Debtors Account. Look at Illustration 1 and see how credit sales have been worked out.

Illustration 1
From the following information ascertain the amount of credit sales for the year ending December 31, 1988.

	Rs.
Debtors on 1.1.88	50,000
Debtors on 31.12.88	65,000
Cash received from Debtors	80,000
Discount Allowed	2,000
Bad Debts	2,000

Solution:
The missing figure is credit sales. It will be calculated by preparing Total Debtors Account as follows:

Total Debtors Account

Dr.	Rs.		Cr. Rs.
To Balance b/d (opening debtors)	50,000	By Cash Received	80,000
To Credit Sales (balancing figure)	99,000	By Discount Allowed	2,000
		By Bad Debts	2,000
		By Balance c/d (closing debtors)	65.000
	1,49,000		1,49,000

Note that the credit sales are worked out with the help of the Total Debtors Account are the net of total credit sales and sales returns. In **fact with the help of Total Debtors Account we can find out any missing item like** cash **received from debtors, opening debtors or closing debtors provided the Figures of all other items including credit sales are given.**

16.3.3 Credit Purchases

The amount of purchases is another item which is important for the preparation of Trading Account. Like sales, purchases also include cash purchases and credit purchases of goods. The amount of cash purchases can be taken from the Receipts and Payments Account. Fur credit purchases we have to prepare Total Creditors Account about which you have already learnt in **Unit** 14. You know Total Creditors Account shows the opening creditors and the credit purchases on the credit side, and the cash paid to creditors, purchases returns, discount received and closing creditors, on the debit side. If the amounts of all other items (opening and closing creditors, cash paid to creditors, discount received, etc.) are given, the credit purchases can be ascertained simply by working out the difference between the totals of the debit and credit sides of the Total Creditors Account. Look at Illustration 2 and see how credit purchases have been worked out.

Illustration 2

From the following information find out the amount of credit purchases for the year ending December 31, 1988.

	Rs.
Creditors on 1.1.88	40,000
Creditors on 31.12.88	33,000
Cash paid to Creditors	60,000
Discount allowed by Creditors	1,000

Solution:

Total Creditors Account

Dr.	Rs.		Cr. Rs.
To Cash Paid	60,000	By Balance b/d (opening creditors)	40,000
To Discount Received	1,000	By Credit Purchases (balancing figure)	54,000
To Balance c/d (closing creditors)	33,000		
	94,000		94,000

Note that credit purchases as worked out with the help of Total Creditors Account are the net of total credit purchases and purchases returns. In **fact, with the help of Total Creditors Account we can find out any missing item like cash paid to creditors opening or closing creditors provided the figures of** all **other items including credit purchases are given,**

16.3.4 Cash and Bank Balances

Cash and Bank balances as at the beginning are usually given. But the balances at the end may have to be worked out. This can be easily done by preparing the Receipts and Payments Account which is debited with all receipts of cash and cheques and credited with all payments by cash and cheques. The closing balance in Receipts and Payments Account represents both the cash and bank balances at the end. Cash in hand is generally known and so the remaining amount may be treated as cash at bank at the end. Look at Illustration 3 and see how Receipts and Payments Account is prepared and the closing bank balance worked out.

Illustration 3

From the following cash transactions of a firm for the year ending December 31, 1988 ascertain the amount of cash at bank at'the end.

	Rs.		Rs.
Cash in hand 1.1.88	10,000	Salaries paid	36,000
Cash at bank 1.1.88	10,000	Other Expenses	13,000
Cash received from Debtors	80,000	Cash Purchases	8,000
Payments to Creditors	72,000	Cash Sales	16,000
Other Incomes	8,000	Drawings	8,000
Cash in hand 31.12.88	6,000	Furniture Purchased	6,000
		Sale of old Motor Car	16,000
		Bank Charges	1,000

Solution

Receipts & Payments Account

Dr.	Rs.		Cr. Rs.
To Balance b/d		By Cash paid to Creditors	72,000
Cash in hand	10,000	By Salaries	36,000
Cash at bank	40,000	By other Expenses	13,000
To Cash received from Debtors	80,000	By Cash Purchases	8,000
To Other Incomes	8,000	By Drawings	8,000
To Cash Sales	16,000	By Furniture	6,000
To Sale of old Motor car	16,000	By Bank Charges	1,000
		By Balance c/d	
		Cash in hand	6,000
		Cash at bank (balancing figure)	20,000
	1,70,000		1,70,000

In Illustration 3 the combined cash and bank balance' at the end works out to be Rs. 26,000. The amount of cash in hand is given and so the remaining amount of Rs. 20,000 (Rs. 26000-Rs. 6,000) has been treated as cash at bank at the end. Sometimes, you may not be provided with the figure of cash in hand. In such a situation we can use the combined figure of cash and bank balances for preparing the Balance Sheet. **The Receipts and Payments Account can also help in finding out any missing item of cash payments like cash paid to creditors, cash purchases, etc. or cash receipt like cash received from debtors, cash sales, etc., provided all other figures including opening and closing cash and bank balances are given.** It can also be used for ascertaining the opening cash and bank balances provided their closing balances are given.

Check Your Progress-A

Fill in the blanks.

1 Conversion method normally means converting accounts prepared under single entry system into .... system.
2 Normally conversion method involves the preparation of...............
3 The capital at the beginning can be ascertained by preparing opening ....
4 Total Debtors Account is prepared mainly to ascertain ....
5 Credit purchases can be ascertained by preparing............. Account.

6 Cash sales can also be ascertained by preparing .... provided all other items are given.
7 Closing balance of creditors can-bc ascertained by preparing .... Account.
8 Given the opening and closing balances of debtors and the figure of credit sales, the balancing figure of Total Debtors Account will represent ....

3164 PREPARATION OF FINAL ACCOUNTS

By now you must have followed what information is usually missing from incomplete records and how it can be ascertained with the help of some accounts or statements. Let us now take up a few comprehensive illustrations and study how complete final accounts can be prepared from incomplete records. Look at Illustration 4 and 5 and see how Trading and Profit & Loss Account and the Balance Sheet have been prepared from the limited information available in such records.

Illustration 4

Aslam did not keep proper books of accounts. However, following information is available from his records for the year ending December 31, 1988.

	as on 1-1-88	as on 31-12-88
	Rs.	Rs.
Cash in hand and at bank	4,000	7,200
Stock in hand	60,000	52,000
Sundry Debtors	50,000	58,000
Machinery	80,000	80,000
Sundry Creditors	40,000	37,000

Summary of Cash Transactions

Dr. Cr.

Receipts	Amount	Payments	Amount
	Rs.		Rs.
Balance b/d	4,000	Cash paid to Creditors	1,10,000
Cash received from Debtors	1,73,000	Wages	20,200
Cash Sales	8,400	Salaries and Expenses	13,200
Sale of old Newspaper	400	Buildings Purchased	30,000
Loan from Mrs. Aslam	4,000	Drawings	9,200
(@ 6% on 1-7-88)		Balance c/d	7,200
	1,89,800		1,89,800

Additional Information:

i) During the year Rs. 1,000 had to be written off as bad
ii) Provide depreciation @ 15% on Machinery
iii) Outstanding expenses were Rs. 1,600.

Prepare Aslam's Trading and Profit & Loss Account for the year ended December 31, 1988 and the Balance Sheet as on that date.

Solution:

Trading and Profit & Loss Account of Aslam for the year ended December 31,1988

Dr. Cr.

Particulars	Amount	Particulars		Amount
	Rs.			Rs.
To Opening Stock	60,000	By Sales		
To Purchases	1,07,000	Cash	8,400	
		Credit	1,81,000	
				1,89,400
To Wages	20,200			
To Gross Profit c/d	54,200	By Closing Stock		52,000
	2,41,400			2,41,400

To Salaries and Expenses 13,200 Add: Out standing 1,600	14,800	By Gross Profit b/d	54,200
		By Sale of Old Newspaper	400
To Bad Debts	1,000		
To Depreciation on Machinery	12,000		
To Interest on Loan (@ 6% for 6 months)	120		
To Net Profit (transfered to Capital A/c)	26,680		
	54,600		54,600

Balance Sheet of Aslam as on December 31,1988

Liabilities		Amount	Assets		Amount
		Rs.			Rs.
Sundry Creditors		37,000	Cash in hnnd and bank		7,200
Outstanding Expenses		1,600	Stock		52.000
Loan from Mrs. Aslam	4,000		Sundry Debtors	58,000	
Add Interest o/s	120	4,120	Less Bad Debts	1,000	57,000
Capital (beginning)	1,54,000		Machinery	80,000	
			Less Depreciation	12,000	68,000
Add Net Profit	26,680		Buildings		30,000
	1,80,680				
Less Drawings	9,200	1,71,480			
		2,14,200			2,14,200

Working Notes:

The items in respect of which the information is missing are:

1 Credit Sales
2 Credit purchases
3 Opening Capital

They have been worked as follows:

1 For Credit Sales

Trade Debtors Account

Dr.			Cr.
	Rs.		Rs.
To Balance b/d	50,000	By Cash Received	1,73,000
To Credit Sales (balancing figure)	1,81,000	By Balance c/d	58,000
	2,31,000		2,31,000

2 For Credit Purchases:

Trade Creditors Account

	Rs.		Rs.
To Cash Paid	1,10,000	By Balance b/d	40,000
To Balance c/d	37,000	By Credit Purchases (balancing figure)	1,07,000
	1,47,000		1,47,000

3 For Opening Capital

Statement of Affairs as at December 31,1987

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Sundry Creditors	40,000	Cash in hand and at bank	4,000
Capital as on 1-1-88 (balancing figure)	1,54,000	Stock	60,000
		Sundry Debtors	50,000
		Machinery	80,000
	1,94,000		1,94,000

Illustration 5

Francis keeps his books on single entry system. From the following information prepare his Trading and Profit & Loss Account for the year ended December 31, 1988 and the Balance Sheet as on that date.

Summary of Cash transactions;

	Rs.
Cash in hand	500
Bank Overdraft on 1-1-88	4,500
Cash received from Debtors	25,000
Interest Paid	100
Drawings	2,000
Cash Paid to Creditors	15,000
Cash Sales	15,000
Miscellaneous Expenses	7,900
Salaries	8,500
Cash in hand on 31-12-88	500

Further information available is:

	1-1-88	31-12-88
	Rs.	Rs.
Stock in hand	9,000	10,220
Furniture	1,000	1,000
Office Premises	15,000	15,000
Creditors	8,000	5,500
Debtors	22,000	?

The total sales for the year were Rs. 48,000.

Adjustments:

i) Provide interest on Capital @ 5% per annum.
ii) Provide Rs. 1,500 for bad and doubtful debts
iii) Depreciation on fixed assets to be provided @ 5% per annum
iv) Salanes outstanding are Rs. 770.

Solution:

Trading and Profit & Loss Account of Francis
for the year ended December 31,1988

Dr. Cr.

Particulars		Amount	Particulars		Amount
		Ks.			Rs.
To Opening Stock		9,000	By Sales		
To Purchases		12,500	Cash	15,000	
			Credit	33,000	48,000
To Gross Profit c/d		36,720	By Closing Stock		10,220
		58,220			58,220
To Interest		100	By Gross Profit b/d		36,720
To Miscelleneous Expenses		7,900			
To Salaries	8500				
Add Out-Standing	770	9,270			
To Interest on Capital		1.750			

To Bad & Doubtful Debts				
To Depreciation				
Furniture	50			
Office Premises	750	800		
To Net Profit (transferred to Capital A/c)		15,400		
		36,720		36,720

Balance Sheet of Francis
as on December 31,1988

Liabilities		Amount	Assets		Amount
		Rs.			Rs.
Creditors		5,500	Cash in hand		500
Outstanding Salaries		770	Cash st bank		2,000
Capital	35,000		Stock in hand		10,220
Add Interest	1,750		Debtors	30,000	
	36,750		Less Provision for bad debts	1,500	28,500
Add Net Profit	15,400		Furniture	1,000	
	52,150		Less Depreciation		950
Less Drawings	2,000	50,150	Office Premises	15,000	
			Less Depreciation	750	14,250
		56,420			56,420

Working Notes:

1 For Bank Balance

Receipts & Payments Account

Dr.			Cr.
	Rs.		Rs.
To Balance b/d		By Balance b/d	
Cash in hand	500	Bank Overdraft	4,500
To Debtors	25,000	By Interest	100
To Sales	15,000	By Drawings	2,000
		By Creditors	15,000
		By Miscellaneous Expenses	7,900
		By Salaries	8,500
		By Balance c/d	
		Cash in hand	500
		Cash at bank (balancing figure)	2,000
	40,500		40,500

2 For Opening Capital

Statement of Affairs as on December 31,1987

	Rs.		Rs.
Creditors	8,000	Cash in hand	500
Bunk Overdraft	4,500	Stock In hand	9,000
Capital (balancing figure)	35,000	Debtors	22,000
		Furniture	1,000
		Office Premises	15,000
	47,500		47,500

3 For Credit Sales

Trade Debtors Account

Dr.			Cr.
	Rs.		Rs.
To Balance b/d	22,000	By Cash Received	25,000
To Credit Sales	33,000	By Balance c/d (balancing figure)	30,000
	55,000		55,000

Note: 1. **Credit** Sales have been found out by deducting cash sales from the total sales i.e., Rs. 48,000 — Rs. 15,000 = Rs. 33,000.
2. Closing balance of Total Debtors Account represents the closing debtors.

4 For Credit Purchases:

Trade Creditors Account

	Rs.		Rs.
To Cash Paid	15,000	By Balance b/d	8,000
To Balance c/d	5,500	By Credit Purchases (balancing figure)	12,500
	20,500		20,500

16.5 LET US SUM UP

The Net Worth Method of ascertaining profits from incomplete records suffers from several drawbacks. Hence, when a trader maintains a Cash Book and the personal accounts of customers and suppliers, most of the firms adopt conversion method of ascertaining the profits which involves the preparation of proper final accounts. The final accounts can be prepared either after converting the records maintained on single entry system into double entry records or simply by ascertaining the missing figures. The first method is called Full Conversion Method and the second one Abridged Conversion Method.

Full conversion method involves a series of steps to convert the incomplete records into proper double entry records. This requires a lot of time, labour and expense. Hence the firms mostly adopt the Abridged Conversion Method which is known as the Conversion Method. Under this method, first of all a summary of all cash transactions is prepared in the form of Receipts and Payments Account, This helps in the ascertainment of all items of incomes and expenses and the closing cash and bank balances. Then the Total Debtors Account and the Total Creditors Account may be prepared for ascertaining the missing figures of credit sales and credit purchases respectively, Opening capital is another item which is usually missing. This can be ascertained by preparing the Opening Statement of Affairs. Having thus ascertained the missing figures, the Trading and Profit & Loss Account and the Balance Sheet can be prepared without much difficulty.

16.6 SOME USEFUL BOOKS

Gupta, R.L. and M. Radhaswaniy, 1986. Advanced Accountancy, Sultan Chand & Sons: New Delhi. (Chapter 15 Section II).

Maheshwari, S.N., 1986. *Introduction* to Accounting, Vikas Publishing House : New Delhi. (Chapter 16).

Patil, V.A. and J.S. Korlahalli, 1986. Principles and Practice of Accounting, R.Chand & Co.: New Delhi. (Chapter 6, Section II).

Shukla, M.C. and T.S. Grewal, 1987. *Advanced Accounts*, S.Chand & Co., New Delhi (Chapter 8 Volume I).

William Pickles, 1982. Accountancy, E.L.B.S. and Pitman. London. (Chapter 2).

16.7 ANSWERS TO CHECK YOUR PROGRESS

A 1 Double entry
2 Receipts and Payments Account
3 Statement of Affairs
4 Credit sales
5 Total Creditors Account
6 Receipts and Payments Account
7 Total Creditors Account
8 Cash received from debtors

16.8 TERMINAL QUESTIONS/EXERCISES

Questions

1 What do you mean by Conversion Method? What steps will you take to convert the accounts kept under the single entry system into double entry system?

2 What do you mean by 'Missing Items'? Name some probable missing items and state how will you ascertain them.

3 Explain the steps you will take to ascertain the profits under Conversion Method.

Exercises

1 Prepare Total Debtors Account and Total Creditors Accounts from the following information and ascertain the amounts of credit sales and credit purchases,

	Rs.		Rs.
Opening Debtors	15,500	Discount Allowed	960
Opening Creditors	10,200	Discount Received	740
Cash received from customers	33,030	Closing Debtors	16,350
		Closing Creditors	6,835
Cash paid to suppliers	21,865	Bad Debts	850

(Answer: Credit Sales Rs. 35,690; Credit Purchases Rs. 19,240)

2 Prepare Receipts and Payments Account from the following information for the year ended December 31, 1988 and calculate the closing bank balance.

	Rs.		Rs.
Bank Overdraft as on 1-1-1988	4.980	Receipt of fire claim from Insurance Co.	2,700
Cash in hand	700	Stationary	220
Interest and Bank Charges	120	Freight & Duty, etc.	625
Drawings	2,600	Carriage Inwards	1,250
Salaries	3,200	Carriage Outwards	775
Payments to Creditors	52,775	Machinery Repairs	620
Receipts from Debtors	26,025	Income Tax Refunds	625
Cash Sales	32,730	Rent	375
Insurance Charges	300	Cash in hand	450

(Answer: Bank Overdraft as on 31-12-88 Rs. 5,510)

3 Ramesh keeps his books on single entry system. From the information furnished below prepare the Trading and Profit & Loss Account for the year ended December 31, 1988 and the Balance Sheet as on that date.

Cash transactions during the year were:

	Rs.		Rs.
Cash received from Debtors	72,740	Advertising	870
		Distribution Expenses	680
Cash sales	17,725	Repairs	1,810
Cash paid to Creditor	63,960	Sundry Expenses	700
Salaries	8,750	Drawings	4,885
Rates and Taxes	1,500	Electricity Charges	1,250
Rent	6.000		

The Position of assets and liabilities was, as follows

	1-1-88	31-12-88
	Rs.	Rs.
Cash in hand	1,975	?
Machinery	1,000	1,000
Furniture	7,500	7.500
Stock	11.275	10,180
Debtors	12,750	7,475
Creditors	8,820	5,370

Adjustments:

i) Outstanding Electricity Charges were Rs.260, Advertising Rs. 130, and Sundry Expenses Rs. 200.

ii) Depreciate Furniture @ 5% and Machinery @ 20%

iii) Provide Rs. 300 for bad debts.

(Answer: Gross Profit Rs. 23,585; Net Profit Rs. 560; Balance Sheet Total 27,315; Closing Cash Balance Rs. 2,035; Credit Purchases Rs. 60,510; Credit Sales Rs. 67,465; Opening Capital Rs. 25,680).

4 Ram Prasad keeps his books on single entry system. From the information given below prepare his Trading and Profit & Loss Account for the year ending March 31, 1988 and the Balance Sheet as on that date.

On April 1, 1987 he had Stock worth Rs. 40,000, Creditors Rs. 24,000, Debtors Rs. 60,000; Land & Buildings Rs. 45,000, and Furniture Rs. 3,000.

His cash transactions for the year were as follows:

	Rs.
Received from Debtors	75,000
Cash Sales	20,000
Paid to Creditors	44,000
Cash Purchases	12,500
Salaries and Wages	9,000
Rent and Taxes	1,700
Drawings	1,000
General Expenses	750

Additional Information:

i) He allowed Rs. 4,500 as discount to his debtors and received a discount of Rs. 3,000 from his creditors.

ii) Total Purchases for the year were Rs. 55,500

iii) On March 31, 1988 his stock was valued at Rs. 40,000; Debtors 67,000; Cash in hand Rs. 14,050.

vi) Expenses Outstanding were Rs. 400

v) Create a provision of Rs. 4,800 for doubtful debts.

vi) Depreciate Furniture and Land & Buildings @ 5% per annum.

vii) 5% interest on Capital is to be given to the Proprietor

(Answer: Overdraft on April 1, 1987 Rs. 12,000; Credit Sales Rs. 86,500; Closing Creditors Rs. 20,000; Opening Capital Rs. 1,12,000; Gross Profit Rs. 51,000; Net Profit Rs. 24,850; Balance Sheet Total Rs. 1,61,850.

5 Shanker maintains his books of account on single entry system. Prepare his final accounts from the information supplied for the year ended September 30, 1988 as follows:

Cash transactions during the Year:

	Rs.
Bank Charges	150
Drawings	4,000
Carriage Inwards	2,000
Salaries and Wages	15,000
Office Expenses	15,800
Paid to Creditors	30,000
Received from Debtors	50,000
Cash Sales	20,000

His assets and liabilities in the beginning and in the end were:

	1-10-87	30-9-88
	Rs.	Rs.
Stock	18,000	20,440
Cash in hand	950	150
Cash at bank	1.000	?
Creditors	16,000	10,000
Debtors	44,000	?
Furniture	2,000	2,000
Land & Buildings	30,000	30,000

Additional Information

i) Credit sales for: the year Rs. 18,100.
ii) Discount allowed to Debtors Rs. 2,100.
iii) Returns Outwards during the year Rs. 500.
iv) Salaries Outstanding on 30-9-88 Rs. 3,000.
v) Provision for doubtful debts is to be created to the extent of Rs. 3,000.
vi) 5% depreciation is to be provided on Furniture and Land & Building.

(Answer: Cash at bank on 30-9-88 Rs. 4,850; Opening Capital Rs. 79,950; Closing Debtors Rs. 60,000; Credit Purchases Rs. 25,500; Gross Profit Rs. 63,540; Net Profit Rs. 22,890; Balance Sheet Total Rs. 1,12,840).

Note: These questions will help you to understand the unit better. **Try** to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 17 . ACCOUNTS FROM INCOMPLETE RECORDS-III

Structure

17.0 OBJECTIVES

After srudying this unit you should be able to:

- ascertain the amounts of B/R received and B/P accepted
- ascertain cash sales and cash purchases
- ascertain sales with the help of gross profit rate
- prepare memorandum trading account and ascertain the amounts of purchases, opening and closing stocks
- prepare final accounts from incomplete records.

17.1 INTRODUCTION

In Unit 16 you have learnt about the preparation of final accounts from incomplete records by finding out certain missing figures with the help of the Statement of Affairs at the beginning, the Receipts and Payments Account, the Total Debtors Account and the Total Creditors Account. In this unit you will learn about a few more missing items such as Cash Purchases, Cash Sales, B/R Received, B/P Accepted, etc., and study how they are worked out so that the final accounts can be prepared from incomplete records without much difficulty.

17.2 OTHER MISSING ITEMS AND THEIR ASCERTAINMENT

You have learnt that the items which are usually missing from the incomplete records are: opening capital, closing cash and bank balances, credit sales and credit purchases. The information about them is found out by preparing the Statement of Affairs at the beginning, the Receipts and Payments Account, the Total Debtors Account and the Total Creditors Account respectively. The preparation of these accounts may also help us to ascertain the opening or closing balanced of debtors, cash received from debtors, opening or closing balances of creditors, cash paid to creditors, etc: But, sometimes, you may have to prepare some additional accounts because certain other relevant figures such as B/R received, B/P accepted, cash sales, cash purchases, etc, may also be missing. Let us now study how these missing items will be worked out before preparing the final accounts.

17.2.1 Bills Receivable (B/R) Received

You know B/R received during the year appear on the credit side of the Total Debtors Account. If the figure of B/R received is not given the Total Debtors Account cannot be prepared correctly and, consequently, the amount of credit sales cannot be ascertained. Hence, before preparing the Total Debtors Account you must ascertain the amount of B/R received during the year, if necessary. This can be done by preparing Bills Receivable Account. Look at Figure 17.1 for the proforma of the Bills Receivable Account.

Figure 17.1
Bills Receivable Account

Dr.	Rs.		Cr. Rs.
To Balance b/d (opening balance)		By Cash Bank (B/R collected)	
To Debtors (B/R received)		By Debtors (B/R dishonoured)	
		By Balance c/d (closing balance)	

You will notice that for the preparation of Bills Receivable Account you need the figures of opening and closing balances of bills receivable, B/R received during the year, B/R collected during the year, and B/R dishonoured, etc. The opening and closing balances of bills receivable are usually given. The amount of B/R collected can be ascertained from the summary of cash transactions. The information about B/R dishonoured, may also be a given figure. But, the amount of B/R received during the year is generally missing. This can be ascertained by working out the difference between the totals of the debit and the credit sides of the Bills Receivable Account. Look at Illustration 1 and see how the amount of B/R received during the year has been worked out.

Illustration 1

Find out the missing figure of B/R received from the following particulars.

	Rs.
Bills Receivable (at the beginning)	3,500
Bills dishonoured	1,000
Bills collected during the year	7,500
Bills Receivable at the end	3,000

Solution:

Bills Receivable Account

Dr.	Rs.		Cr. Rs.
To Balance b/d (opening balance)	3,500	By Debtors (B/R dishonoured)	1,000
To Debtors B/R received (balancing figure)	8,000	By Cash (B/R collected)	7,500
		By Balance c/d (closing balance)	3,000
	11,500		11,500

The Bills Receivable Account can also help in finding out the missing items like opening or closing balance's of bill receivable, the amount of bills collected, bills dishonoured, etc., provided the figures of all other items including B/R received are given,

17.2.2 Bills Payable (B/P) Accepted

You know B/P accepted during the year appear on the debit side of the Total Creditors Account. If the figure of B/P accepted is not given, the Total Creditors Account cannot be prepared correctly and consequently, the credit purchases cannot be ascertained. Hence, before preparing the Total Creditors Account you must ascertain the amount of B/P accepted during the year, if necessary, this can be done by preparing the Bills Payable Account. Look at Figure 17.2 for the proforma of Bills Payable Account.

Figure 17.2
Bills Payable Account

Dr.	Rs.		Cr. Rs.
To Cash/Bank (bills honoured)		By Balance b/d (opening balance)	
To Credirors (bills dishonoured)		By Creditors (bill accepted)	
To Balance c/d (closing balance)			

You will notice that for the preparation of Bills Payable Account you need the figures of opening and closing bills payable, B/P accepted during the year, B/P honoured during the year and B/P dishonoured, etc. The opening and closing balances of bills payable are usually given. The amount of B/P honoured can be ascertained from the summary of cash transactions. The information about the B/P dishonoured, if any, may also be a given figure. But the amount of B/P accepted during the year is generally missing. This can be ascertained by working out the difference between the totals of the debit and the credit side of the Bills Payable Account. Look at Illustration 2 and see how the amount of B/P accepted during the year has been worked out.

Illustration 2

Calculate the missing figure of B/P accepted from the following information.

	Rs.
Opening balance of Bills Payable	7,500
Cash paid against B/P	20,100
Bills Payable dishonoured	3,000
Closing balance of Bills Payable	4,000

Solution:

Bills Payable Account

Dr.	Rs.		Cr. Rs.
To Cash/Bank (B/P honoured)	20,100	By Balance b/d (opening balance)	7,500
To Creditors (B/P dishonoured)	3,000	By Creditors (B/P accepted) (balancing figure)	19,600
To Balance c/d (closing balnnce)	4,000		
	27,100		27,100

The Bills Payable Account can also help in finding out the missing items like opening or closing balances of bills payable, the amount of B/P honoured, B/P dishonoured, etc., provided the figure of all other items including B/P accepted are given.

Illustration 3

From the following particulars prepare Trade Debtors Account, Bills Receivable Account, Trade Creditors Account and Bills Payable Account and find out the missing items.

	Rs.		Rs.
Balance January I, 1988		Cash received against B/R	28,400
Total Debtors	1,14,400	Payments made aguinst B/P	14,000
Bills Receivnble	8,000	Cash Sales	31,600
Total Creditors	52,800	Cash Purchases	14,600
Bills Payable	5,000	B/R dishonoured	2,200
Cash received from customers	2,70,800	Balance, December 31,1988	
Discount allowed	8,400	Total Debtors	1,11,200
Cash paid to Creditors	1,40,500	Bills Receivable	2,000

	Rs.		Rs.
Discount received	5,300	Total Creditors	56,800
Returns Outwards	2,660	Bills Payable	6,000
Returns Inwards	3,250		
Bad Debts Written off	7,080		
Bad Debts recovered	2,000		

Solution:

Total Debtors Account

Dr.	Rs.		Cr. Rs.
To Balance b/d	1,14,400	By Cash	2,70,800
To Bill Receivable (bills dishonoured) (2)	2,200	By Discount Allowed	8,400
		By Returns Inwards	3,250
To Credit Sales (belancing figure)	3,08,730	By Bad Debts	7,080
		By Bills Receivable (B/R received) (1)	24,600
		By Balance c/d	1,11,200
	4,25,330		4,25,330

Bills Rcceivnble Account

	Rs.		Rs.
To Balance b/d	8,000	By Cash (hills collected)	28,400
To Debtors (B/R received) (1) (balancing figure)	24,600	By Debtors (bills dishonoured) (2)	2,200
		By Balance cld	2,000
	32,600		32,600

Total Creditors Account

	Rs.		Rs.
To Cash	1,40,500	By Balance b/d	52,800
To Discount Received	5,300	By Credit Purchases (balancing figure)	1,67,460
To Returns Outwnrds	2,660		
To Bills Payable (B/P accepted)(3)	15,000		
To Balance c/d	56,800		
	2,20,260		2,20,260

Bills Payable Account

	Rs.		Rs.
To Cash	14,000	By Balance bid	5,000
To Balance c/d	6,000	By Creditors (B/P accepted) (3) balancing figure	15,000
	20,000		20,000

17.2.3 Cash Sales and Cash Purchases

Sometimes the amounts of cash sales or cash purchases ate not given. They can be found out with the help of Receipts and Payments Account, provided the opening and closing cash/bank balances are given, But, at a time you can work out only one figure, either cash sales or cash pill-chases. If cash purchases are given you can find out the amount of cash sales which will be equal lo the excess of the payments side total over the Receipts side total of Receipts and Payments Account. If, on the other hand, cash sales are given, you can find out the amount of cash purchases which will be equal to the excess of the Receipts side total over the Payement side total of Receipts and Payments Account. In case both the figures are missing and you find that the Payments side total is more than the Receipts side total, the excess is treated as cash sales and cash purchases are assumed to be nil.

Look at illustration 4 wherein you will find tnat the opening and closing balances of cash are given and the amount of cash purchases is also given. See how, by preparing the Receipts and Payments Account, the amount of cash sales has been worked out.

Illustration 4

Following are the Cash transactions of a trader who keeps his books on Single Entry System, Calculate the missing figure.

	Rs.		Rs.
Opening Cash balance	2,500	Salaries	1,500
Cash received from Debtors	7,000	Wages	2,700
Cash paid to Creditors	6,500	Rent Received	1.200
Cash Purchases	10,000	Additional Capital Introduced	2,000
Interest on Investments	600	Rent, Rates & Taxes	500
Drawings	2,000	Purchased Furniture for cash	3,000
		Closing Bnlance of Cash	1,600

Solution:

Receipts and Payments Account

Dr.	Rs.		Cr. Rs.
To Balance b/d	2,500	By Creditors	6.500
To Debtors	7,000	By Purchases (Cash)	10,000
To Interest on Investments	600	By Drawings	2,000
To Rent Received	1,200	By Salaries	1,500
To Capital	2,000	By Wages	2,700
To Sales (Cash) (balancing figure)	14,500	By Rent, Rates & Taxes	500
		By Furniture	3,000
		By Balance c/d	1,600
	27,800		27,800

Check Your Progress - A

Fill in the blanks.

1 B/R received during the year are shown on the .... side of the Total Debtors Account and .... side of the Bills Receivable Account.

2 If the total of the credit side of Bills Receivable Account is Rs. 45,500 and the opening bills receivable are Rs. 20,000, the amount of B/R received would be Rs. ....

3 B/P dishonoured are shown on the .... side of Bills Payable Account.

4 If the B/P dishonoured, B/P accepted and opening and closing balances of bills payable are given then .... will be the balancing figure of Bills Payable Account,

5 If the opening and closing balances of cash are given and the total of receipt side is in excess of the total of payment side of Receipts and Payments Account, the missing item is ....

6 If total sales are Rs. 2,80,000 and cash sales Rs. 70,800, the amount of credit sales will be ....

17.3 PREPARATION OF FINAL ACCOUNTS

Having learnt how missing information of various items can be ascertained, the preparation of final accounts from incomplete records should not now be a difficult task. All that you have to do is to go through the information provided, note down the missing items, and prepare the necessary statements and nccounts to ascertain their amounts before you prepare the Trading and Profit & Loss Account and the Balance Sheet. You will notice that the preparation of Opening Statement of Affairs, Receipts and Payments Account, Total Debtors Account and Total Creditors Account will he involved in almost all the cases. But the Bills Receivable and Bills Payable Accounts are to be made only when the amounts of bill receivable and bills payable are involved. Now let us take a comprehensive illustration and see how the amount of various missing itetns are ascertained and the final accounts prepared. Look at Illustration 5. You will find that the figures of cash sales, credit sales, B/R received, B/P accepted, opening debtors, credit purchases and opening capital are missing. Study how they are ascertained before preparing the final accounts from incomplete records.

Illustration 5

Raj Prakash has not kept proper books of account. From the following information you are required to prepare the Trading and Profit & Loss Account for the year ending December 31, 1988 and also the Balance Sheet of the firm on that date.

Assets and Liabilities	1.1.88	31.12.88
	Rs.	Rs.
Creditors	31,540	31,600
Sundry Fixed Assets	23,220	24,080
Bills Receivable	8,000	11,000
Debtors	?	35,740
Stock	16,080	32,240
Bills Payable	5,000	4,200
Cash & Bank Balance	13,920	16,160
Expenses Outstanding	1,200	660

Details of the year's transactions are as follows:

	Rs.
Bills Receivable Collected	23,200
Sales - Cash and Credit	1,43,620
Bills Receivable dishonourcd	8,800
Cash puid against Bills Payable matured	20,000
Returns from debtors	2,900
Bad debts written off	840
Discount allowed by creditors	1,400
Returns to creditors	800
Capital introduced by the proprietor (paid into bunk)	17,000
Received from debtors by cheque	1,25,000
Discount Allowed	3,000
Bills Payable dishonoured	2,000
Cash purchases	2,060
Office expenses pnid in cash	19,140
Drawings by cheque	860
Purchase of muchinery by cheque	6,360
Payment to creditors by cheque	1,20,540
Repairs to machinery paid by cheque	3,200

Additional Information: Depreciation of Rs. 5,500 is to be provided on fixed assets.

Solution:

Trading and Profit & Loss Account for the year ending December 31, 1988

Dr.		Rs.			Cr. Rs.
To Opening Stock		16,080	By Sales -		
To Purchases -			Cash	9,200	
Cash	2,060		Credit	1,34,420	
Credit	1,42,260			1,43,620	
	1,44,060		Less Returns	2,900	1,40,720
Less Returns		1,43,260			
To Gross Profit c/d		13,620	By Closing Stock		32,240
		1,72,960			1,72,960
To Discounts Allowed		3,000	By Gross Profit b/d		13,620
To Bad Debts		840	By Discount Received		1,400

	Rs.		Rs.
To Repairs	3,200	By Net Loss (transferred to Capital A/c)	16,120
To Depreciation	5,500		
To Office Expenses	18,600		
	31,140		31,140

Note: Office expenses charged to Profit & Loss Account have been worked us follows:

	Rs.
Paid during the year	19,140
Add outstanding at the end	660
	19,800
Less outstanding at the beginning	1.200
	18,600

Balance Sheet
as on December 31, 1988

Liabilities		Amount	Assets		Amount
		Rs.			Rs.
Sundry Creditors		31,600	Cash & Bank Balance		16,160
Rills Payable		4,200	Bills Receivable		11,000
Outstanding Expenses		660	Sundry Debtors		35,740
Capital account:			Stock in trade		32,240
Opening Balance	82,740		Sundry Fixed Assets		
Add Further			Opening Balance	23,220	
Capital Introduced	17,000		Add Purchases	6,360	
	99,740			29,580	
Less Drawings	860		Less Depreciation	5.500	24,080
	98,880				
Less Net Loss	16,120	82,760			
		1,19,220			1,19,220

Worklng Notes:

Recelpts and Payments Account

Dr. Cr.

Recelpts	Amount	Payments	Amount
	Rs.		Rs.
To Balance b/d	13,920	By Bills Payable	20,000
To B/R collected	23,200	By Purchases	2,060
To Capital	17,000	By Office expenses	19,140
To Debtors	1,25,000	By Drawings	860
To Sales (cash) (balancing figure)	9,200	By Machinery	6,360
		By Creditors	1,20,540
		By Repairs	3,200
		Balance c/d	16,160
	1,88,320		1,88,320

Bills Receivable Account

	Rs.		Rs.
To Balance b/d	8,000	By Cash (B/R collected)	23,200
To Debtors (balancing figure being total B/R received)(1)	35,000	By Debtors (B/R dishonoured)	8,800
		By Balance c/d	11,000
	43,000		43,000

Total Debtors Account

	Rs.		Rs.
To Balance b/d (balancing figure)	59,260	By Bank	1,25,000
To Credit Sales (1,43,620-9,200)	1,34,420	By Discount Allowed	3,000
To Bills Receivable (B/R dishonoured)	8,800	By Bills Receivable (1)	35,000
		By Sales Returns	2,900
		By Bad Dabts	840
		By Balance c/d	35,740
	2,02,480		2,02,480

Note: Credit Sales have been worked out by deducting cash sales from total sales.

Bills Payable Account

	Rs.		Rs.
To Cash	20.000	By Balance b/d	5,000
To Creditors (B/P dishonoured)	2,000	By Creditors (B/P uccepted)(2)	21,200
To Balance c/d	4,200		
	26,200		26,200

Total Creditors Account

	Rs.		Rs.
To Cash/bank	1,20,540	By Balance b/d	31,540
To Discount Received	1,400	By B/P (B/P dishonoured)	2,000
To Purchase Returns	800	By Purchases (credit) (balancing figure)	1,42,000
To B/P (accepted)(2)	21,200		
To Balance c/d	31,600		
	1,75,540		1,75,540

Statement of Affairs
as on January 1,1988

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Sundry creditors	31.540	Sundry fixed assets	23,220
Bills payable	5,000	Bills receivable	8,000
Outstanding expenses	1,200	Sundry debtors	59,260
Capital (opening)- (balancing figure)	82,740	Stock in trade	16,080
		Cash & Bank Balance	13,920
	1,20,480		1,20,480

17.4 ASCERTAINING SALES WITH GROSS PROFIT RATE

You have learnt that credit sales are normally ascertained with the help of Total Debtors Account. Sometimes the information available is not sufficient for the preparation of Total Debtors Account. In that case the credit sales can be worked out simply by deducting cash sales from the total sales, if given. If cash sales are not given, they can be worked out with the help of Receipts and Payments Account. But if the total sales are also not given, it becomes difficult to ascertain the amount of credit sales. In such a situation, you will have to work out the total sales with the help of cost of goods sold and the gross profit rate, if given. For example, if the given rate of gross profit is 20% and cost of goods sold Rs. 1,60,000 the amount of total sales will be calculated as follows:

Gross Profit	= 20% or 115th of sales
Let Sales be X	
Gross Profit	= Sales–Cost of Goods sold
1/5X	= X – 1,60,000
X - 1/5X	= 1,60,000
4/5X	= 1,60,000
X	= 1,60,000 X 5/4
	= Rs. 2,00,000

In fact, the cost of goods sold is not a given figure. It has to be worked out with the help of available information. You learnt about it in Unit 7. It is equal to opening stock plus purchases (including direct expenses) minus Closing Stock. Look at Illustration 6 and see how cost of goods sold has been computed and the total sales worked out with the help of gross profit rate.

Illustration 6

Calculate Total Sales from the information given below.

	Rs.
Opening Stock	8,000
Purchases	60,000
Wages	22,000
Closing Stock	14,000

Gross Profit is 116 on the Sales.

Solution:

Cost of Goods Sold	= Opening Stock t Purchases + Direct Expenses – Closing Stock
	= 8,000 + 60,000 t 22,000 – 14,000
	= Rs. 76,000
Gross Profit	= 1/6th of sales
Let Sales be X	
Gross Profit	= Sales – Cost of Goods Sold
1/6X	= X - 76,000
X – 1/6X	= 76,000
$\frac{6X-X}{6}$	= 76,000
5/6X	= 76,000
X	= $\frac{76.000 \text{ X } 6}{5}$
X	= 91,200

So Sales are Rs. 91,200

17.5 MEMORANDUM TRADING ACCOUNT

Sometimes you will find that the opening and closing stock are not given. The opening stock can be worked out by preparing the opening Statement of Affairs, provided all other figures including opening capital is given. But, if the opening capital is also not given, then the opening stock will have to be worked out by preparing a Memorandum Trading Account, which is just like the normal Trading Account. You know the Trading Account is prepared for ascertaining the gross profit. It is debited with opening stock, purchases, and direct expenses and credited with sales and closing stock. The gross profit is equal to the excess of the credit side total over the debit side total and is shown on the debit side of the Trading Account. The gross profit can also be worked out if the gross amount of sales are known and the rate of gross profit is given. Now if all figures other than the opening stock are available and the gross profit has been worked out with the help of goss profit rate. you can prepare a Memorandum Trading Account and find out the amount of opening stock on the basis of balancing figure. Look at Illustration 7 and see how Memorandum Trading Account helps in working out the amount of opening stock.

Illustration 7

Calculate the amount of opening stock from the following information

	Rs.
Purchases	1,80,000
Closing Stock	25,000
Direct Expenses	15.000
Sales	3,50,000
Gross Profit rate 20% on sales.	

Solution:

Memorandum Trading Account

Dr.			Cr.
	Rs.		Rs.
To Opening Stock (balancing figure)		By Sales	3,50,000
		By Closing stock	25,000
To Purchases	1,80,000		
To Direct Expenses	15,000		
To Gross Profit (20% of sales)	70,000		
	3,75,000		3,75,000

Similarly with the help of Memorandum Trading Account, you can also find out the figure of closing stock. Even the amount of purchases can be worked out provided all other information is available.

Let us now take a comprehensive illustration and prepare final accounts from incomplete records once again.

Illustration 8

Jai Prakash keeps only a cash book and a personal ledger. All receipts are banked and all payments are made by cheques. There are no cash purchases or cash sales. You obtain the following information from Jai Prakash for the year ending December 31, 1988.

	Rs.
Cash at bank (1.1.88)	44,400
Drawings	40,000
Wages paid (including Rs. 4,000 for 1987)	68,000
Payments to creditors	2,10,000
Salaries paid	24,000
Receipts form debtors	3,52,000
Payments for office establishment	30,000
Stock in trade (31.12.88)	56,000
Trade Debtors (1.1.88)	32,000
Trade Debtors (31.12.88)	60,000
Trade Creditors (1.1.88)	40,000
Trade Creditors (31.12.88)	48,000
Payment for furniture purchased	8,000
Amount spent on repairs	3,000
Furniture (1.1.88)	32,000
Furniture (31.12.88)	37,000
Plant and Machinery (1.1.88)	80,000

Wages and Salaries for December, 1988 still outstanding were Rs. 6,000 and Rs. 2,000 respectively. Included in office establishment is a sum of Rs. 500 relating to insurance prepaid for 1989. Provide Rs. 3,000 as depreciation on Furniture and 10% depreciation on Plant & Machinery.

Jai Prakash sells goods at gross profit of 25% on sales. Prepare Trading & Profit & Loss Account for the year ended December 31, 1988 and the Balance Sheet as on that date.

		Rs.		Rs.
To Opening Stock		53.000	By Sales	3,80.000
To Purchases		2,18,000	By Stock (closing)	56,000
To Wages Paid	68.000			
Add Outstanding for 1988	6,000			
	74.000			
Less Outstanding for 1987	4.000	70,000		
To Gross Profit c/d		95,000		
		4,36,000		4,36,000
To Salaries	24.000		By Gross Profit b/d	95,000
Add Outstanding	2.000	26,000		
To Office Establishment	3,000			
Less Prepaid Insurance	500			
		29,500		
To Repairs		3,000		
To Depreciation				
Furniture	3,000			
Plant & Machinery	8,000	11,000		
To Net Profit		25.500		
		95,000		95,000

Balance Sheet of Jai Prakash
as on December 31, 1988

Liabilities		Amount	Assets		Amount
		Rs.			Rs.
Sundry Creditors		48,000	Cash at Bank		13,400
Outstanding Wages		6,000	Trade Debtors		60,000
Outstanding Salaries		2.000	Stock in Trade		56.000
Capital Account			Furniture	32,000	
Opening Balance	1,97,400		Add Purchase	8,000	
				40,000	
Net Profit	25,500		Less Depreciation	3.000	37,000
	2,22,900				
Less Drawings	40.000	1,82,900	Plant & Machinery	80,000	
			Less Depreciation	8,000	72,000
			Prepaid Insurance		500
		2,38,900			2,38,900

Working Notes

Bank Account

Dr.	Rs.		Cr. Rs.
To Balance bld	44,400	By Drawings	40,000
To Debtors	3,52,000	By Wages	68,000
		By Creditors	2,10,000
		By Salaries	24,000
		By Office Establishment	30,000
		By Furniture	8,000
		By Repairs	3,000
		By Balance c/d (balancing figure)	13,400
	3,96,400		3,96,400

Total Debtors Account

	Rs.		Rs.
To Balance b/d	32.000	By Bank	3,52,000
To Sales (Credit) (balancing figure)	3,80,000	By Balance c/d	60,000
	4,12,000		4,12,000

Total Creditors Account

	Rs.		Rs.
To Dunk	2,10,000	By Balance b/d	40,000
To Balance c/d	48,000	By Purchases (credit) (balancing figure)	2,18,000
	2,58,000		2,58,000

Memorandum Trading Account

		Rs.		Rs.
To Opening Stock (balancing figure)		53,000	By Sales	3,80,000
To Purchase		2,18,000	By Stock (closing)	56,000
To Woges	68,000			
Add Outstanding for 1988	6,000			
	74,000			
Less Outstanding for 1987	4,000	70,000		
To Gross Profit (25% on sales)		95,000		
		4,36,000		4,36,000

Statement of Affairs as on 31.12.87

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Outstanding Wages	4,000	Cash at Bank	44,400
Trade Creditors	40,000	Trade Debtors	32,000
Capital (opening) (balancing figure)	1,97,400	Stock in trade	53,000
		Furniture	32,000
		Plant and Machinery	80,000
	2,41,400		2,41,400

17.6 LET US SUM UP

The preparation of final accounts from incomplete records generally involves the ascertainment of opening capital, closing cash/bank balances, credit sales and credit purchases, debtors, creditors, etc. But, sometimes items like B/R received, B/P accepted, cash sales, cash purchases etc., may also be missing. Hence, in addition to the preparation Statement of Affairs, Receipts and Payments Account, Total Debtors Account and Total Creditors Account, one may also have to prepare the Bills Receivable Account and Bills Payable Account.

When it is not possible to ascertain the credit sales with the help of Total Debtors Account, it can be worked out by deducting cash sales from the total sales. But if the total sales are also not given, the same will have to worked out with the help of cost of goods sold and the gross profitrate. Sometimes the figures of opening and closing stocks may not be available. They can be found out by preparing the Memorandum Trading Account provided the total sales and the rate of gross profit are given. Thus, conversion method which involves the preparation of final accounts from incomplete records is quite a complicated affair.

17.7 SOME USEFUL BOOKS

Gupta, R.L. and M. Radhaswamy, 1986. *Advanced Accountancy*, Sultan Chand & Sons, New Delhi. (Chapter 15 Section II).

Maheshwari, S.N. 1986. *Introduction to Accounting*, Vikas Publishing House: New Delhi. (Chapter 16).

Patil, V.A. and J.S. Korlahalli, 1986. *Principles und Practice of Accounting*, R. Chand & Co., New Delhi. (Chapter 6, Section II).

Shukla, M.C. and T.S. Grewal.,1987. *Advanced Accounts*, S. Chand & Co., New Delhi (Chapter 8 Volume I).

William Pickles, 1982. *Accountancy*, E.L.B.S. and Pitman, London. (Chapter 2).

17.8 ANSWERS TO CHECK YOUR PROGRESS

A 1 credit, debit 2 Rs. 25,500 3 debit 4 B/P honoured
5 Cash purchases 6 Rs. 2,09,200

17.9 TERMINAL QUESTIONS/EXERCISES

Questions

1 Under what circumstances would you prepare Bills Receivable Account and Bills Payable Account while preparing final accounts from incotnplete records?

2 "Credit sales can be ascertained either by preparing the Total Debtors Account or with the help of Memorandum Trading Account". Discuss.

Exercises

1 Calculate the missing item from the information supplied as follows.

	Ra.		Rs.
Balance on April 1, 1987		Returns Outwards	400
Total Debtors	48,000	Bud debts	1.100
Total Creditors	42.000	Received from Debtors	30,000
Bills Receivable	15.000	Discount Allowed	500
Bills Payable	12,000	Paid to Creditors	25,000
Bills Receivable dishonoured	14,500	Discount Received	400
		Bills Payable Dishonoured	15.00
		Balance on March 31. 1988	

	Rs.		Rs.
Cash Paid against		Total Debtors	50,000
Bills Payable	10,000	Total Creditors	45,000
Returns Inwards	600	Bills Receivable	20,000
		Bills Payable	15,000

(Answer: B/R received Rs. 19,500; Credit Sales Rs. 39,200; B/P accepted Rs. 14,500; Credit Purchases Rs. 43,300)

2 Given below are the cash transaction of Sita Ram for the year ended December 31, 1988. Find out the missing item.

	Rs.		Rs.
Opening Cash Balance	10.900	Rent Received	9,900
Cash received from Debtors	2,15,200	Drawings	15,300
Cesh Sales	50,100	Capital Introduced	20,000
Cash paid to Creditors	1,05,900	Machinery Purchased	22.000
Salaries Paid	25,200	Commission Received	14,800
Wages	30.700	Closing Cnsh Balance	3,600

(Answer: Cash Purchases Rs. 1,12,200)

3 Calculate the Total Sales and Prepare a Memorandum Trading Account from the following particulars

	Rs.
Opening Stock	12,000
Closing Stock	10,000
Purchases	48,000
Carriage Inwards	5,000
Carriage Outwards	2,000
Salaries	7,000
Wages	15,000

Gross Profit rate is 20% on Sales.

(Answer: Sales; Rs. 87,500)

4 Ramesh keeps his records on Single Entry System. From the following information prepare Trading and Profit & Loss Account for the year ended October 31, 1988 and the Balance Sheet as on that date.

Balances	**1-11-87**	**31-10-88**
	Rs.	Rs.
Bills Receivable	50,000	68,000
Debtors	78,1100	90,000
Stock	1,50,600	1,06,000
Plant & Machinery	94,000	—
Lnnd & Buildings	1,40,000	—
Creditors	72,000	76,000
Bills Payable	32,000	46,000
Cash	1,400	4,800
Bank Overdraft	10.000	
Bunk Balance		25.000

Cash trasactions during the year were as follows.

	Rs.
Received from Dehtors	5,80,000
Received against B/R	2,00,000
Salaries	24,000
Paid against B/P	2,86,000
Wages	31,600
Paid to Creditors	2,94,000
Office Expenses	16,000
Drawings	40,000
Additional Information	
B/R dishonoured	4,000
Discount Allowed	4,000
Discount Received	2,000
Returns Inwards	1,000
Returns Outwards.	500
Wages Outstanding at the end	2,500
Salaries Prepaid	1,000

Depreciation 15% to be provided on Plant & Machinery and 5% on Land & Building.

(Answer: B/R received Rs. 2,23,000; Credit Sales Rs. 8,15,000; B/P issued Rs. 3,00,000; Credit Purchases Rs. 6,00,500; Cash Purchases Rs. 50,000; Opening Capital

Rs. 4,00,000; Gross Profit Rs. 85,300; Net Profit Rs. 23,200; B/s Total Rs. 5,07,700)

5. Prakash keeps only a cash book and personal ledgers. From these books and by enquiries with the proprietor, the following information is obtained for the year ending December 31, 1988.

	Rs.
Payments to Creditors	8,40,000
Cash at Bank (1.1.88)	93,600
Wages paid (including Rs. 16.000 for 1987)	2.72.000
Drawings	1,60,000
Salaries paid	48,000
Receipts from debtors	13,60,000
Payments fur office expenses	1,20,000
Stock in trade (31.12.87)	1,28,000
Trade Debtors 1.1.88	1,20,000
Trade Debtors 31.12.88	2,32,000
Trade Creditors 1.1.88	1,40,000
Trade Creditors 31.12.88	1,52,000
Hills Receivable 1.1.88	56,000
Bills Receivable 31.12.88	40,000
Bills Payable 1.1.88	32,000
Bills Payable 31.12.88	20.000
Bills Receivable matured during the year	1,40,800
Bills receivable dishonoured	41,600
Bills Payable matured and paid cash	1,60,000
Cash paid for furniture purchased	32.000
Amount spent on repairs during the year	20.000
Furniture on 1st January, 1988	1,40,000
Furniture on 31st December, 1988	1,56,400
Plant and Machinery 1.1.88	4,80,000

Included in the office expenses is a sum of Rs. 2,800 relating to quarter ending on March 31,1989. Wages outstanding were Rs. 24,000 and salaries outstanding Rs. 10,000.

Prakash sells goods at the fixed mark-up of 25% on sales.

Depreciation on Plant and Machinery is to be charged @ 10% per annum.

Prepare a Trading and Profit & Loss Account for the year ending December 31, 1988 and also Balance Sheet of the firm as on that date.

(Answer: Total B/R received during the year Rs. 1,66,400; Total B/P accepted during the year Rs. 1,48,000; Closing Stock Rs. 2,10,400; Sales Rs. 15,96,800; Purchases Rs. 10,00,000; Opening Capital Rs. 8,29,600; Bank Overdraft (31.12.88) Rs. 57,600; Depreciation on furniture Rs. 15,600; Gross Profit Rs. 3,99,200; Net Profit Rs. 1,40,400; Balance Sheet Total Rs. 10,73,600.)

Note: These questions will help you to understand the unit better. Try to write answers far them. But do not submit your answers to the University. These are for your practice only.

ECO-02 ACCOUNTANCY-I

Course Components

BLOCK	UNIT NO.	PRINT MATERIAL
1		**Accounting Fundamentals**
	1	Basic Concepts of Accounting
	2	The Accounting Process
	3	Cash Book and Bank Reconciliation
	4	Other Subsidiary Books
	5	Bills of Exchange
2		**Final Accounts**
	6	Concepts Relating to Final Accounts
	7	Final Accounts-1
	8	Final Accounts-11
	9	Errors and their Rectification
3		**Consignments and Joint Ventures**
	10	Consignment Accounts-1
	11	Consignment Accounts-11
	12	Consignment Accounts-Ill
	13	Joint Venture Accounts
4		**Accounts from Incomplete Records**
	14	Self Balancing System
	15	Accounting from Incomplete Records-I
	16	Accounting from Incomplete Records-11
	17	Accounting from Incomplete Records-Ill
5		**Accounts of Non-trading Concerns, Depreciation, Provisions and Reserves**
	18	Accounts of Non-trading Concerns-I
	19	Accounts of Non-trading Concerns-11
	30	Depreciation-I
	31	Depreciation-II
	22	Provisions and Reserves

UNIT 18 ACCOUNTS OF NON-TRADING CONCERNS – I

Structure

18.0 OBJECTIVES

After studying this unit you should be able to :

- describe the accounting records maintained by non-trading concerns
- prepare Receipts & Payments Accaunt
- prepare Income & Expenditure Account and Balance Sheet
- explain the difference between the Receipts & Payments Account and the Income & Expenditure Account
- describe the nature of some items that are peculiar to non-trading concerns and explain their treatment in final accounts.

18.1 INTRODUCTION

The accounting systems you have studied so far relate to the organisations which are engaged in some kind of business activity. The accounting records are equally important for welfare organisations which may not be doing any business such as clubs, societies, educational institutions, hospitals etc. They are basically charitable institutions which function without any profit motive, They are usually termed as non-trading concerns. Such organisations also have to keep proper records of their receipts and payments and match their expenses with incomes. This is a legal requirement and at the same time it helps them to control their expenditure. Of course, because of the nature of their activities, the accounting system followed by them is slightly different. In this unit you will learn about the accounting records of such non-trading concerns and study how they prepare their final accounts.

18.2 ACCOUNTING RECORDS OF NON-TRADING CONCERNS

The non-trading concerns like clubs, societies etc, differ from the trading concerns in several respects. They normally do not indulge in buying and selling of goods and accepting or receiving bills of exchange. The major sources of their income usually are subscriptions from members, donations, etc.', and most of their transactions are cash transactions. Hence, they need not maintain as many books of account as the tracking concerns do. The main objective of keeping records in such concerns is to meet the statutory requirement and exercise control over the utilisation of funds. Hence, they usually maintain a Cash Book to record all receipts and'payments (or separate Cash Receipts Journal and Cash Payments Journal to provide the necessary details) and other books like Members Register., Midutes Book, Stock Register, etc. You are fully conversant with Cash Book. Let us have a brief idea about the other books.

1 Members Register : Most charitable institutions are organised as societies which are registered with the Registrar of Societies. They are required to keep full record of their subscribers (called members). Hence they maintain a Members Register which shows their names, addresses, date of admission, etc. .

2, Minutes Books : The societies function on the basis of decisions taken by the general body of members and their managing committee. They have to keep separate minutes books for recording the proceedings of the meeting of general body and that of the managing committee. Minutes book is a permanent record of of the decisions taken from time to time.

3 Stock Register : Every society possesses fixed assets like furniture, office equipment, etc. They have to keep complete record of these items in a register called 'Stock Register' which shows date of purchase, quantity purchased, the amount at which purchased, etc. Similarly, they also keep a stock register for consumable items like stationery, sports materials, etc, which, in addition to the details of purchases, will also show their consumption and balances.

The non-trading concerns also maintain a ledger containing the accounts of all incomes, expenses, assets and liabilities. This facilitates the preparation of final accounts at the end of the accounting year.

18.3 FINAL ACCOUNTS

You know the final accounts usually consist of a Profit and Loss Account and a Balance Sheet. In case of non-trading concerns, however, they include (i) Receipts & Payments Account, (ii) Income & Expenditure Account, and (iii) Balance Sheet.

You will notice that a non-trading concern has to prepare a Receipts & Payments Account in addition to the Income & Expenditure Account (it is similar to Profit and Loss Account) and the Balance Sheet. You know that the Profit & Loss Account and the Balance Sheet are usually prepared with the help of a Trial Balance. But, in case of non-trading concern the practice is to prepare the Income & Expenditure Account and the Balance Sheet straight from the Receipts & Payments Account and the additional information. Hence, the Receipts & Payments Account is very important for the non-trading concern and should be prepared very carefully. It does not mean, however, that the non-trading concerns should not prepare the Trial Balance at all. In fact, if the organisation has followed double' entry system they must prepare a Trial Balance for checking the arithmetical accuracy of postings into ledger accounts. This would also help the preparation of Receipts & Payments Account.

18.3.1 Receipts and Payments Account

While preparing the final accounts from incomplete records (Unit 16) you had some idea of the Receipts and Payments Account. So, you know that it is simply a summary of cash and bank transactions for the year. It gives full information about all receipts and payments under different heads and is prepared with the help of the Cash Book. The Cash Book contains a record of all receipts and payments in a chronological order but the Receipts & Payments Account will simply show the total amount received or paid under each head. For example, a club receives subscriptions from its members on different dates in a year. These are recorded in the Cash Book separately on those dates. But in Receipts & Payments Account, the total amount of subscriptions received during the year will appear as one item on its debit side. Similarly, salaries paid to the staff will appear in Cash Book every month whereas the Receipts &'Payments Account will simply show the total amount for salaries paid during the year on its credit side. You will recall that the opening balance in Receipts and Payments Account represents the cash and bank balances at the beginning of the year whereas the difference between the totals of the two sides reflects the closing cash and bank balances. Look at Illustration 1 and see how Receipts & Payments Account is prepared for a club.

Illustration 1

From the following information of National Club for the year ended December 31, 1987, prepare a Receipts and Payments Account.

	Rs.		Rs.
Balances on 1-1-87		Lighting and Heating	4,600
Cash in hand	600	Secretary's Honorarium	3,700
Cash at bank	6,400	General Expenses	20,150
Subscriptions	39,400	Life Membership Subscriptions	3,000
1986 – 2,400		Furniture Purchased	3,000
1987 – 36,700			
1988 – 300		Wages	34,000
		Balances on 31-12-87	
Restaurant and Bar Payments	1,00,000	Cash in hand	500
		Cash at bank	4,500
Restaurant and Bar sales	1,20,000		
Interest on Investments	1,050		

Solution :

Receipts and Payments Account
for the year ending December 31,1987

Dr. Cr.

Receipts	Amount	Payments	Amount
	Rs.		Rs.
To balance b/d		By Restaurant and Bar Payments	1,00,000
Cash in hand 600		By Wages	34,000
Cash at Bank 6,400	7,000		
To Annual subscriptions		By Lighting and Heating	4,600
1986 2,400		By Secretary's Honorarium	3,700
1987 36,700		By General Expenses	20,150
1988 300	39,400	By Furniture (purchased)	3,000
		By Balance c/d	
To Restaurant and Bar sales	1,20,000	Cash in hand 500	
		Cash at bank 4,500	5,000
To Interest on Investments	1,050		
To Life Membership Subscriptions	3,000		
	1,70,450		1,70,450

Main Features

The main features of Receipts & Payments Account can be summarised as follows :

i) It is a real account.

ii) It is a summary of Cash Book. All receipts are shown on the debit side and all payments on the credit side.

iii) No distinction is made whether the payment has been made in cash or by cheque. In other words, cash and bank items are merged except in case of opening and closing balances.

iv) It includes all receipts and payments whether they are of revenue nature or of capital nature.

v) It shows total receipt and total payment under each head irrespective of the year to which it relates. For example, in Illustration 1 subscriptions related to 1986 as well as 1988 have been included because the amount's were actually received during 1987.

vi) The closing balance represents the cash and bank balances at the end of the year.

18.3.2 Income and Expenditure Account

The Income & Expenditure Account serves the same purpose for a non-trading concern as the Profit & Loss Account for a trading concern. It is also prepared exactly in the same manner as the Profit & Loss Account i.e., all incomes are shown on the credit side and all expenses and losses on the debit side. However, in case of non-trading concerns the excess of income over expenses and losses is not termed as profit. It is called 'Excess of Income over Expenditure' or 'Surplus'. Similarly, the excess of expenses and losses over income is termed as 'Excess of Expenditure over Income' or 'Deficiency'.

As stated earlier, the Income & Expenditure Account is prepared with the help of Receipts & Payments Account and the additional information available. You know the Income & Expenditure Account will show incomes and expenses only for the period to which it relates and that too on accrual basis. Hence while taking figures from Receipts & Payments Account you will have to make the necessary adjustments. For example, if the amount of subscriptions received during 1987 includes Rs. 200 relating to 1986, it should be deducted for purposes of computing the income from subscriptions. Similarly, if certain amount of subscriptions relating to 1987 are still to be received (outstanding) it would not appear in the Receipts & Payments Account. But, it has been included in the income from subscriptions for 1987 and so added thereto. Another precaution you have to take relates to the distinction between capital and revenue items. In the Income & Expenditure Account you are to include only the revenue items, the capital items will be ignored. Then, you will also have to provide the necessary amount of depreciation on all fixed assets and make provisions for doubtful debts. These items do not appear in the Receipts and Payments Account, Let us now list the steps to be followed for preparing the Income & Expenditure Account from the Receipts & Payments Account.

1 *Go* through the receipts side for ascertaining all items of incomes and the payment side for all items of expenses and losses.

2 Ignore opening and closing balances.

3 Ignore capital receipts and capital payments.

4 Ignore receipts and payments relating to the preceding and the following years. If, however, a receipt or a payment includes any amount which relates to the preceding or the following year, the same should be deducted.

5 Add the outstanding amounts to the respective items of incomes and expenses.

6 Provide for depreciation and doubtful debts, if required.

7 If any fixed asset has been sold during the year, compute the amount of profit or loss on such a sale and show the same in the Income & Expenditure Account. **Note that** the **sale of** old **sports materials is not to be regarded as sale of a** fixed **asset. The total amount received from such sale is an income.**

Let us prepare the Income & Expenditure Account from the Receipts and Payments Account given in Illustration 1.

14.3.2 Self-balancing the Creditors Ledger

You know the Creditors Ledger contains the personal accounts of trade creditors only. As in case of Debtors Ledger, a General Ledger Adjustment Account is inserted in Creditors Ledger for purposes of making it self-balancing. This account provides the necessary corresponding debits and credits for all entries related to trade creditors. Let us now identify the items which usually appear on the debit and the credit sides of the trade creditor. They are as follows:

A Trade Creditor's Account

Dr. Cr.

	Rs.		Rs.
To Cash/Bank A/c (cash and cheques)		By Balance b/d	
To Purchases Returns A/c		By Purchases A/c (credit purchases)	
To Bills Payable A/c (bills accepted)		By Bank A/c (cheques, dishonoured)	
To Discount Received A/c		By Bills Payable A/c (B/P dishonored)	
To Allowances A/c			
To Bnlance c/d			

For self-balancing, all items appearing on the debit side of the personal accounts *of* trade creditors should be recorded on the credit side of the General Ledger Adjustment in Creditors Ledger and those appearing on their credit side should be recorded on its debit side. For this purpose; taking the total figures of such items the following journal entries will be passed:

1 For total credit purchases, cheques dishonoured and the bills payable dishonoured:
   General Ledger Adjustment Account Dr.
   (in Creditors Ledger)
   To Creditors Ledger Adjustment A/c
   (in General Ledger)

2 For total cash and cheques paid to creditors, purchases returns, bill payable accepted, discount received, other allowances:
   Creditors Ledger Adjustment A/c Dr.
   (in General Ledger)
   To General Ledger Adjustment A/c
   (in Creditors Ledger)

After passing the abovd two journal entries the General Ledger Adjustment Account in Creditors Ledger will appear as given in Figure 14.3,

Figure 14.3

General Ledger Adjustment Account ***in Creditors Ledger***

Dr. Cr.

	Rs.		Rs.
To Balance b/d		By Creditor's Ledger Adjustment A/c:	
To Creditor's Ledger Adjustment A/c:		Cnsh Paid (incl. cheques)	
Credit Purchases		Purchases Returns	
Cheques Dishonoured		Bills Accepted	
B/P Dishonoured		Discount Received	
		Allowances	
		By Balance c/d	

The figures for various items can be extracted from the concerned subsidiary books. For example, 'credit purchases' can be taken from the Purchase Book, cash paid to creditors from Cash Book, and so on. Look at Illustration 2 and see how General Ledger Adjustment in Creditors Ledger is prepared.

Illustration 2

From the following information prepare the General Ledger Adjustment Account in Creditors Ledger.

	Rs.
Opening Balance of Sundry Creditors	28,010
Credit Purchases	27,600
Payment to Creditors	26,500
Discount Allowed by Creditors	1,450
Returns Outwards	2,240
Bills Puyable Accepted	5,300
Allowances	400
Rills Payable Dishonoured	500

Solution:

General Ledger Adjustment Account
(In Creditors Ledger)

Dr.	Rs.		Cr. Rs.
To Balance b/d	28,010	By Creditors Ledger Adjustment A/c:	
To Creditors Ledger Adjustment A/c:		Cash Paid	26,500
Credit Purchases	27,600	Purchases Returns	2,240
B/P Dishonoured	500	Bills Accepted	5,300
		Discount Received	1,450
		Allowances	400
		By Balance c/d	20,220
	56,110		56,110

You will notice that the General Ledger Adjustment Account in Creditors Ledger has the necessary corresponding debits and credits for all the entries related to trade creditors. This makes it self-balancing and now a separate Trial Balance can be prepared also for the Creditors Ledger.

14.3.3 Self-balancing the General Ledger

You know the General Ledger contains all real and nominal accounts. In case of most of the transactions recorded in General Ledger both the debit and credit aspects would appear in this ledger itself. Take for example, depreciation on machinery, This involves Depreciation Account (a nominal account) and the Machinery Account (a real account). Both the accounts appear in the General Ledger and so both debit and credit aspects are recorded in this ledger itself. Bur, in case of transactions which involve the personal accounts of trade debtors or trade creditors, the situation is different. One aspect of such transactions appears in the General Ledger and the other in Debtors Ledger or Creditors Ledger. Hence, for Self-balancing the General Ledger it becomes necessary to provide the corresponding debits and credits for all entries related to trade debtors and trade creditors. For this purpose, we open the Debtors Ledger Adjustment Account and the Creditors Ledger Adjustment Account in the General Ledger. In fact these two accounts will automatically, be opened when journal entries are passed for opening the General Ledger Adjustment Accounts in the Debtors and the Creditors Ledgers as stated in sub-sections 14.3.1 and 14.3.2. Thus, the Debtors Ledger Adjustment Account and the Creditors Ledger Adjustment Account in General Ledger will be just the reverse of the General Ledger Adjustment Account in Debtors Ledger and the General Ledger Adjustment Account in the Creditors Ledger respectively. Let us now prepare these two accounts from the information given in Illustrations 1 and 2.

Debtors Ledger Adjustment Account (in General Ledger)

Dr.	Rs.		Cr. Rs.
To Balance b/d	1.220	By General Ledger Adjustment A/c:	
To General Ledger. Adjustment A/c :		Cash received	2,005
		Sales Retums	317
Sales	3,720	Discount Allowed	130
B/R Dishonoured	50	Bad Debts	371
		Allowances	42
		B/R Received	130
		By Balance c/d	1,995
	4,990		4,990

Creditors Ledger Adjustment Account (In General Ledger)

Dr.	Rs.		Cr. Rs.
To General Ledger		By Balance b/d	28,010
Adjustment A/c:		By General Ledger	
Cash Paid	*26,500*	Adjustment A/c:	
Purchases Returns	2.240	Credit Purchases	27,600
Bills Accepted	5,300	B/P Dishonoured	500
Discount Received'	1,450		
Allowances	400		
To Balance c/d	20,220		
	56,110		56,110

Now let us take a comprehensive illustration and prepare all Adjustment Accounts.

Illustration 3

A firm has three ledgers in use viz., Debtors Ledger, Creditors Ledger and General Ledger. These are all kept on the self-balancing system. From the following transaction, prepare the Adjustment Accounts as they would appear in each ledger.

Balances of Trade Debtors on 1-3-1988	28,500
Balances of Trade Creditors on 1-3-1988	47,800
Transactions during the month were:	
Credit Sales	43,800
Cash received from Trade Debtors	30,950
Discount allowed to Trade Debtors	2,600
Bills Receivable received from Debtors	5,000
Bad Debts Written off	200
Credit Purchases	68,800
Purchases Returns	2,000
Cash paid to Trade Creditors	59,000
Discount allowed now disallowed	100
Interest and Charges debited to Debtors.	200

Solution:

Debtors Ledger Adjustment Account (in General Ledger)

Dr.	Rs.		Cr. Rs.
To Balance b/d	28,500	By General Ledger Adjustment A/c:	
To General Ledger Adjustment A/c:			
Credit Sales	43,800	Cash received	30,950
Discount Disallowed	100	Discount Allowed	2,600
Interest and Charges	200	Bills receivable	5,000
		Bad Debts	*200*
		By Balance c/d	33,850
	72,660		72,600

Creditors Ledger Adjustment Account
(in General Ledger)

Dr.	Rs.		Cr. Rs.
		By Balance b/d	47,800
To General Ledger Adjustment A/c:		By General Ledger Adjustment A/c:	
Cash Paid	59,000	Credit Purchases	68,800
Purchases Returns	2,000		
To Balance c/d	55.600		
	1,16,600		1,16,600

General Ledgcr Adjustment Account
(in Debtors Ledgcr)

	Rs.		Rs.
To Sales Ledger Adjustment A/c:		By Balance b/d	28,500
		By Sales Ledger Adjustment A/c:	
Cash Received	30.950	Credit Sales	43,800
Discount Allowed	2,800	Discount Disallowed	100
Bills Receivable	5,000	Interest and Charges	200
Bad debts	200		
To Balance c/d	33,850		
	72,600		72,600

General Ledger Adjustment Accouni
(in Creditors Ledger)

	Rs.		Rs.
To Balance b/d	47,800		
To Bought Ledger Adjustment A/c:		By Bought Ledger Adjustment A/c:	
Credit Purchases	68,800	Cash Paid	59,000
		Purchases Returns	2,000
		By Balance c/d	55,600
	1,16,600		1,16,600

Note : 1 **Discount** Disallowed : Any amount of discount allowed to debtors, if disallowed later, is debited to the concerned debtor's personal account. Hence, it has been shown on the debit side of Debtors Ledger Adjustment Account In General Ledger and the credit side of the General Ledger Adjustment Account in Debtors Ledgcr,

2 Interest and Charges debited to **Debtors** : It is an amount charged to debtors on account of Iste payment or same errors. It has also been shown on the debit side of Debtors Ledger Adjustment Account in General Ledger nnd the credit side of General Ledger Adjustment Account in Debtors Ledger.

14.4 SOME PECULIAR POINTS

Contra **Balances :** Normally the personal accounts of debtors show a debit balance and the personal accounts of creditors a credit balance, Sometimes, a debtor's account may show a credit balance and a creditor's account a debit balance, It usually happens on accoeht of over-payments. In such a situation, both the debit and the credit balances are shown separately in the Adjustment Accounts. For example, the total of debit balances of various debtors is Rs. 60,000 and the total of credit balances Rs. 800. These will be shown in the respective Adjustment Accounts as follows:

Debtors Ledger Acljustment Account
(in General Ledger)

Dr.			Cr.
	Rs.		Rs.
To Balance bld	60,000	By Balance b/d	800

General Ledger Adjustment Account
(in Debtors Ledger)

To Balance b/d 8 0	0	By Balance b/d	60,000

If the creditors accounts also show both types of balances, they will appear in the concerned Adjustments Accounts separately.

Transfers : Sometimes goods are bought from the person who is also a customer to the business. In such a situation, his personal account will appear in both the Debtors Ledger and the Creditors Ledger. The settlement of such accounts is made by paying or receiving the net amount. Hence, it becomes necessary to transfer his account from the ledger whore it shows a lower balance to the other where his account shows a higher balance. For example, Ganesh's personal account in Debtors Ledger shows a debit balance of Rs. 10,800 and his personal account in Creditors Ledger shows a credit balance of Rs. 1,000. In such a situation, the credit balance of Rs. 1,000 in Ganesh's Account will be transferred from Creditors Ledger to his account in Debtors Ledger. Such transfer should, also be recorded in the Adjustment Accounts. Whether the transfer takes place from creditors Ledger to Debtors Ledger or from Debtors Ledger to Creditors Ledger, it shall be reflected in various Adjustment Accounts as follows :

In Debtors Ledger Adjustment Account	Credit side
In Creditors Ledger Adjustment Account	Debit side
In General Ledger Adjustment Account in Dcbtors Ledger	Debit side
In General Ledger Adjustment Account in Creditors Ledger	Credit side

Provision for Bad Debts : Sometimes you may find an item of provision for bad debts in the information from which the Adjustment Accounts are to be prepared, You know that this provision does not appear anywhere in the personal accounts of debtors. Hence it will not be included in the Adjustment Accounts. You may simply ignore it. The same thing is true of items like cash sales, bills discounted, old bad debts recovered, etc.

Look at illustration 4 and see how the above items have been treated.

Illustration 4

From the following details prepare General Ledger Adjustment Accounts and the Debtors Ledger and Creditors Ledger Adjustment Accounts as on 31 December 1988 :

		Rs.		Rs.
Debtors (1-1-1988)	Dr.	17,425	Discount Allowed to Debtors but disallowed later	100
Debtors -do-	Cr.	320		
Creditors -do-	Cr.	27.408		
Creditors -do-	Dr.	204		
Purchases		25,200	Cash received from Debtors	8,700
Sales		28,209		
Sales Returns		208	Cash paid to Debtors	25
Purchases Returns		714	Transfer from Debtors to Creditors Ledger	1,242
Cash puid to Creditors		12,700	Cash Purchases	4,320
Bills received from Debtors		9.300	Cash Sales	7,400
Bills dishonoured		200	Bad Debts written off	215
Bills accepted		7,400		
Discount allowed by Creditors		1,020	Discount allowed to Debtors	215

Solution :

Creditors Ledger Adjustment Account
(in General Ledger)

Dr.	Rs.		Cr. Rs.
To Balance b/d	204	By Balance b/d	27,408
To General Ledger Adjustment A/c (in Creditors Ledger)		By General Ledger Adjustment A/c (in Purchases Ledger):	
Cash Paid	12,700	Purchases	25,200
Purchases Returns	714		
Bills Accepted	7,400		
Discount	1,020		
Transfer	1,242		
To Balance c/d	29,328		
	52,608		52,608

Debtors Ledger Adjustment Account
(In General Ledger)

	Rs.		Rs.
To Balance b/d	17,425	By Balance b/d	320
To General Ledger Adjustment A/c (in Debtors Ledger):		By General Ledger Adjustment A/c (in Debtors Ledger):	
		Cash Received	8,700
Sales	28,209	Sales Returns	208
Cash Paid	25	Discount Allowed	215
B/R Dishonoured	200	B/R Received	9,300
Discount Disallowed	100	Bad Debts	215
		Transfers	1,242
		By Balance c/d	25,759
	45,959		45,959

General Ledger Adjustment Account
(In Creditors Ledger)

	Rs.		Rs.
To Balance b/d	27,408	By Balance b/d	204
To Creditors Ledger Adjustment A/c:		By Creditors Ledger Adjustment A/c:	
Purchases	25,200	Cash Paid	12,700
		Purchases Return	714
		Bills Accepted	7,400
		Discount Received	1,020
		Transfers	1,242
		By Balance c/d	29,328
	52,608		52,608

General Ledger Adjustment Account
(in Debtors Ledger)

	Rs.		Rs.
To Balance b/d	320	By Balance b/d	17,425
To Debtors Ledger Adjustment A/c:		By Debtors Ledger Adjustment A/c:	
Cash Received	8,700		
Sales Returns	208	Sales	28,209
Discount Allowed	215	Cash Paid	25
B/R Received	9,300	B/R Dishonoured	200
Bad Debts	215	Discount Disallowed	100
Transfers	1,242		
By Balance c/d	25,759		
	45,959		45,959

Illustration 5

From the following information prepare Dcbtors Ledger Adjustment Account in General Ledger.

	Rs.
Opening Credit'balance of Sundry Debtors	2.000
Opening Balance of Sundry Debtors	20,000
Cash and Cheques received	80,000
Credit Sales	1,00,000
Discounts Allowed	3,000
Returns Inwards	2,000
Bad Debts	1,500
Bills Receivable received	10.000
Bills Receivable Discounted	4.000
Provision for Bad Debts	1,000
Bad Debts Recovered	500
Closing Credit Bnlance in Sundry Debtors	3,000

Rs. 500 is to be transferred from Deblors Ledger to Creditors Ledger. Similarly, Rs. 600 is to be transferred from Creditors Ledger to Debtors Ledger.

Debtors' Ledger Adjustment Account
(in General Ledger)

Dr.	Rs.		Cr. Rs.
To Balance b/d	20,000	By Balance b/d	2,000
To General Ledger Adjustment Account (in Debtors Ledger):		By General Ledger Adjustment Account (in Debtors Ledger):	
Credit sales	1,00,000	Cash Received	80,000
		Returns Inwards	2,000
To Balance c/d	3,000	Discount Allowed	3,000
		Bad Debts	1,500
		B/R Received	10,000
		Transfers :	
		From Debtors Ledger to Creditors Ledger	500
		From Creditors Ledger to Debtors Ledger	600
		By Balance c/d	23,4(X)
	1,23,000		1,23,000

Notes: Provision for Bad Debt, Bad Debts Recovered and Bills Receivable Discounted do not appear in the personal accounts of Debtors, Hence no entry need be made in the Adjustment Accounts.

Check Your Progress A

1 What is a self-balancing system?

....
....
....

2 Name the three ledgers usually kept under Multiple Ledger System.

....
....
....

3 Fill in the blanks

i) Debtors Ledger Adjustment Account is opened in .... Ledger.

ii) Creditors Ledger Adjustment Account is opened in .... Ledger.

iii) The Adjustment Account opened in Debtors Ledger is termed as .... .Account.
iv) General Ledger contains all real and .... accounts.
v) Creditors Ledger contains personal accounts of all ....
vi) Adjustment Accounts help to 'complete ....in each ledger to make them self-balancing.

4 Indicate the Adjustment Account given in General Ledger in which each of the following items usually appears and write within brackets whether it will be on the debit or the credit side of that account.

i) B/P Dishonoured	....
ii) Bad Debts	....
iii) Transfers	....
iv) Cash Sales	....
v) Interest debited to a customer	....
vi) Refunds received from a creditor	....
vii) Discount disallowed	....
viii) Provision for Bad Debts	....

14.5 ADVANTAGES OF SELF-BALANCING SYSTEM

The main advantages of self-balancing system are as follows:

1 It is easy to locate the errors because we prepare separate Trial Balance for each ledger. If the Trial Balance of a particular ledger agrees, it implies that there are no errors in that ledger. The detection work is confined only to the accounts in a ledger whose Trial Balance does not agree: For instance, if an error is committed in the personal account of a customer neither the General Ledger nor the Creditors Ledger is affected. It is only the Debtors Ledger which is affected and its Trial Balance will not agree. Hence you will look for the errors in Debtors Ledger only.-Similarly, if the Trial Balance of General Ledger does not agree you will check entries in the nominal and real accounts only. This narrows down the area of detection work and the errors can be quickly detected.

2 The maintenance of ledgers can be divided amongst many persons. This helps in quick posting and fixation of responsibility in case of errors and frauds.

3 The main ledger becomes less bulky because the personal accounts of customers and suppliers are excluded. The system is very useful when the number of customers and suppliers is large.

4 It is easy to check the accuracy of each ledger independently with the help of Adjustment Accounts.

5 It facilitates the preparation of interim accounts whenever required by including the figure of total debtors and total creditors. There is no need to go through the Debtors and Creditors Ledgers.

14.6 SECTIONAL BALANCING

The sectional balancing refers to a system under which only a section of the group of ledgers is self-balanced. If a firm which uses three ledgers viz., Debtors Ledger, Creditors Ledger and General Ledger, makes only one ledger self-balancing (normally the General Ledger) it wilt be called 'Sectional Balancing System'. Under this system only two Adjustment Accounts viz., Debtors Ledger Adjustment Account and Creditors Ledger Adjustment Account are prepared. They are termed as Total Debtors, Account and Total Creditors Account respectively. They are also known as control accounts.

Most of the firms do not follow the self-balancing system. They simply prepare the Total Debtors and Total Creditors Accounts to check the accuracy of Debtors and Creditors Ledgers. These two accounts do not, in fact, form part of any ledger, Hence, no journal entries are passed for opening the accounts. They are prepared by extracting relevant figures from various subsidiary books. Like Debtors Ledger Adjustment Account, the Total

Receipts and Payments Account
for the year ended December 31, 1988

Dr.	Rs.		Cr. Rs.
To Balance on 1-1-1988	10,000	By Expenses 1987 1,400 1988 2,000	3,400
To Subscriptions 1987 380 1988 2,100 1989 150	2,630		2.500
		By Leasehold Land	4,000
		By Interest Paid	400
To Entrance Fees	800	By Refreshment Expenses	2,000
To Locker Kent	700	By Balance on 31.12.88	8,330
To Income from Refreshment	4,000		
	18,130		18.130

Balance Sheet as on December 31, 1987

Liabilities	Rs.	Assets	Rs.
Capital Fund	33,620	Building	30,000
Subscriptions received in advance	600	Outstanding Subscription	380
Outstanding Expenses	1,400	Outstanding Locker Rent	240
Loan	5,000	Cash in hand	10,000
	40,620		40,620

Adjustments

i) **Expenses Outstanding as on 31-12-1988** were Rs. *500.*

ii) **Subscriptions Outstanding on 31-12-1988 were Rs. 800.**

iii) **Salary due but not paid upto 31-12-1988 were Hi;. 200.**

iv) **Depreciation of Rs. 2,000 is to be charged on Buildings.**

v) **Entrance fees are to be capitalised.**

Solution :

Income and Expenditure Account
for the year ended December 31, 1988

	Rs.		Cr. Rs.
To Expenses 2,000 Add Outstanding 500	2,500	By Subscriptions 2,100 Add Outstanding in 1988 800 Add Received in Advance in 1987 600	3,500
To Interest Paid	400		
To Salary Outstanding	200		
To Depreciation on building	2,000	By Locker Rent 700 Less Outstanding in 1987 240	460

	Rs.		Rs.
To Excess of Income over Expenditure	860	By Income from Refreshments (4,000–2,000)	2,000
	5,960		5,960

Balance Sheet as on December 31, 1988

Liabilities	Rs.	Assets	Rs.
Capital Fund 33,620		Building 30,000	
Add Entrance		Less Depreciation 2,000	
Fees (capitalised) 800			28,000
		Leasehold Land	4,000
Add one ... 860	35,280	Outstanding Subscriptions	800
Loan	5,000		
Expenses Outstanding	500	Cash in hand	8,330
Salary Outstanding	200		
Subscription Received in Advance	150		
	41,130		41,130

Note : The income from refreshments has been shown after subtracting Rs. 2,000 spent on refreshment, This could also been shown separately, Rs. 2,000 as expense on the debit side of the Income & Expenditure Account and Rs. 4,000 as income on the credit side.

Illustration 6

From the following information relating to Indira Gandhi Cricket Club, prepare the Income & Expenditure Account for the year ended March 31, 1989 and Balance Sheet as on that date. Abstract of Honorary Secretary's. Cash Book. for the year is as follows:

Receipts and Payments Account
For the year ending March 31, 1989

Dr. Cr.

	Rs.		Rs.
To Member's Subscriptions		By Upkeep of field and pavilion	2,000
To Members Admission Fee	300	By Tournament Expenses	700
To Sale of old sports material		By Rates and Insurance	200
To Hire of Ground	300	By Telephone	50
To Subscription for Tournament		By Printing & Stationery	100
To Bank Drawn	4,000	By General Charges	50
To Donation	10,000	By Secretary's Honorarium	170
		By Grass seeds	30
		By Purchase of sports material	700
		By Bank lodged	16,650
	20,650		20,650

Assets at the beginning of the year were :

	Rs.
Play Ground	10,000
Cash at bank	3,000
Stock of sports material	1,500
Printing & Stationery	200
Subscriptions due	500

Liabilities were nil

Donation and surplus on account of tournament should be kept in reserve for a permanent pavilion. Subscriptions due on March 31, 1989 were Rs. 750. Write off 50 per cent of sports material and 25 per cent of the printing and stationery.

Solution :

Indirn Gnndhi Cricket Club
Incomes and Expenditure Account for the year ended March 31,1989

Dr.	Rs.		Cr. Rs.
To Upkeep of Field and Pavilion	2,000	By Subscriptions	5,250
To Rates & Insurance	200	By Admission Fee	300
To Telephone	50	By Hire of Ground	300
To Printing & Stationery	75	By Sale of old sports material	50
To General Charges	50		
To Secretary's Honorarium	170		
To Grass Seeds	30		
To Sports Material used	1,100		
To Excess of Income over Expenditure	2,225		
	5,900		5,900

Balance Sheet as on March 31,1989

Liabilities		Rs.	Asset	Rs.
Pavilion Fund		10,300	Cash at hank	15,650
Capital Fund	15,200		Subscriptions outstanding	750
Add Income	2,225	17,425	Stock of Sports material	1,100
			Stock of Stationery	225
			Play Grounds	10,000
		27,725		27,725

Working Notes

1 **Subscriptions :**

	Rs.
Subscription Received	5000
Add Outstanding at the end	750
	5,750
Less Outstanding at the beginning	500

Income from subscription	5,250

2 **Printing & Stationery Used :**

	Rs.
Opening Stock	200
Add Purchases	100
	300

25% of Rs. 300 i.e., Rs. 75 worth of stationery has been used, and the balance of Rs. 225 is now the closing stock.

3 **Sports Material used :**

	Rs.
Opening Stock	1,500
Add Purchases	700
	2,200

50% of Rs. 2,200 La., Rs. 1,100 worth of materials used, and the balance of Its. 1,100 is now the closing stock.

Sale of old material has been treated as income.

4 **Calculation of opening Capital Fund :**

		Rs.
Total Assets as on	1.4.1987	15,200
Less Liabilities	1.4.1987	NIL
Capital Fund	1.4.1987	15,200

5 **Calculation of Cash at bank :**

	Rs.
Opening Balance	3,000
Add Amount lodges	16,650
	19,650
Less Amount with drawn	4,000
Closing Balance	15,650

18.5 LET US SUM UP

The non-trading concerns like societies, clubs, educational institutions, hospitals, etc. also maintain a proper record of their financial transactions. It is not only a legal requirement for all registered bodies. But, it is also considered desirable for effective control of funds.

The accounting records of the non-trading concerns are based on the same principles as those applicable to trading concerns. However, the nature of their incomes and expenses is slightly different and most of their transactions are cash transactions. Hence, their main book of original entry is Cash Book. They also maintain ledger which shows all the concerned accounts.

The final accounts of non-trading concerns consist of (i) Receipts & Payments Account (ii) Income & Expenditure Account, and (iii) Balance Sheet. The Receipts & Payments Account is simply a summary of all cash transactions relating to the accounting year which begins with the opening cash and bank balances and ends with their closing balances. The Income & Expenditure Account, on the other hand, like Profit & Loss Account, is prepared for ascertaining the surplus (excess of income over expenditure) or deficiency (excess of expenditure over income). The Balance Sheet is prepared in the usual manner which shows the assets and liabilities of the organisation including the Capital Fund.

The non-trading concerns may prepare a Trial Balance, but the Receipts & Payments Accounts constitutes the major source for the preparation of Income & Expenditure Account and the Balance Sheet. Certain items like subscriptions, entrance fees, donations, legacies, special funds, etc, need special care while preparing the final accounts of such concerns.

18.6 KEY WORDS

Charitable Institutions : An institution set up for some charitable purpose such as orphanage, blind welfare society, etc.

Honorarium : Remuneration paid to persons (other than employees) who have done some work for the organisation.

Legacies : Property received as a result of the will of the deceased person.

Life membership fees : Lump sum subscription received from life members at the time of admission.

Locker Rent : Rents charged by a club for lockers provided to members.

Minutes Book : Register in which the proceedings of all meetings held by the society are recorded,

Members Register : A register in which information about members relating to their date of admission, names, addresses etc. is recorded.

Non-trading Concerns : Organisations not engaged in any business activity. They are usually engaged in some welfare activity and function without any profit motive.

Stock Register : A register showing record of all consumables and fixed assets.

Subscriptions : Annual fees realised by societies from its members.

18.7 SOME USEFUL BOOKS

Gupta R.L. and M. Radhaswamy, 1986. *Advanced Accountancy*, Sultan Chand & Sons, New Delhi (Chapter 14).

Maheshwari S.N., 1986. *Introduction to Accounting*, Vikas Publishing House : New Delhi. (Chapter 15)

Patil, V.A, and J.S. Korlahalli, 1986. *Principles and Practice of Accounting* R. Chand & Ca., New Delhi. (Chapter 15)

Shukla, M.C. and T.S. Grewal, 1987. *Advanced Accounts*, S. Chand & Co. (Pvt.) Ltd., New Delhi. (Chapter VII).

Willian Pickles, 1982. *Accountancy*, E.L.R.S. and Pitman, London, (Chapter 12)

18.8 ANSWERS TO CHECK YOUR PROGRESS

A 1 i) True ii) True iii) False iv) True v) False vi) False

2 i) credit ii) cash iii) accrual
iv) income, expenditure
v) Receipts and Payments
vi) Capital Fund

B 1 a) ii b) ii c) iii d) ii e) i f) iii
2 Rs. 1,20,000
3 Rs. 60,000

18.9 TERMINAL QUESTIONS/EXERCISES

1 What are the essential features of a Receipts and Payments Account? In what respect does it differ from Cash Book?

2 What do you mean by Income & Expenditure Account? How does it differ from Receipts & Payments Account?

3 Explain the meaning of the following terms and show how you will deal with them while preparing the final accounts of a non-trading concern.

i) Legacy
ii) Donation when purpose is not mentioned.
iii) Life Membership Fees
iv) Receipts for Tournament Fund
v) Sale of used sports materials

Exercises

1 From the following particulars taken from the Cash Book of Tenali Club, prepare a Receipts & Payments Account.

	Rs.
Opening Balance :	
Cash-in-hand	100
Cash at bank	500
Subscriptions	3,300
Donations	260
Investment Purchased	1,000
Rent paid	400
General Expenses	210
Postage & Stationery	70
Sundary Expenses	30
Closing Cash-in-hand	20

(Answer : Cash at bank (balancing figure) Rs. 2,430)

2 The Receipts & Payments Accounts of Harikrishna Charitable Institution is given :

Receipts and Payments Account
for the year ending March 31, 1988

Dr.	Rs.	Cr.	Rs.
To Balance b/d		By charities	14,500
To Cash at bank	5,000	By Salaries	2,600
To Cash in hand	2,700	By Rent & Taxes	1,200
To Donations	8,000	By Printing	300
To Subscriptions	4,000	By Postage	100
To Endowment Fund	15,000	By Advertisements	250
To Legacies	6,000	By Furniture	650
To Interest on Investment	9,500	By Insurance	1,200
To Interest on deposits	150	By Investments	14,000
To Sales of old newspapers	75	By Advance for building	5,000
		By Balance c/d	
		Cash at bank	8,000
		Cash in hand	2,625
	50,425		50,425

Prepare the Income & Expenditure Account for the year ended March 31,1988 after considering the following :

i) It was decided to treat one-half of the amount received on account of legacies and donations as income.

ii) Liabilities to he provided for are :
Rent Rs. 200; Salaries Rs. 300; Advertisement Rs. 50.

iii) Insurance premium was paid in advance for three months.

iv) Rs. 500 due for interest on investment was not actually received.

(**Answer : Excess** of Income over Expenditure Rs. 825).

3 Receipts & Payments Account of National Sports Club showed that Rs. 48,500 were received by way of subscriptions for the year ended September 30, 2988.

The additional information was as follows :

i) Subscription Outstanding as on 30.9.87 were Rs. 4,500
ii) Subscription received in advance as on 30.9.87 were Rs. 2,900
iii) Subscription Outstanding as on 30.9.88 were Rs. 3,400
iv) Subscription received in advance as on 30.9.88 were Rs. 1,500

Show how above information would appear in the final accounts for the year ended September 30, 1988 of National Sports Club.

(**Answer :** Subscription credited to Income & Expenditure Account for the year ended September 30, 1988 Rs. 48,800. Subscription outstanding as on 30.9.1988 is Rs. 3,400 and should be shown on the assets side of the Balance Sheet and subscriptions of Rs. 1,500 received in advance as on 30.9.1988 on the Iiabilities side.)

4 From the following Receipts & Payments Account prepare final accounts of a youth club for the year ended December 31,1988.

Receipts and Payments Account

Dr. Cr.

	Rs		Rs.
To Balance b/d	250	By Salaries	1,200
To Subscriptions :		By General Expenses	300
1987 300		By Electric Charges	200
1988 1,000		By Library Books	100
1989 200		By Newspapers	400
	1,500	By Postage	50
To Sale of old furniture costing Rs. 100	60	By Furniture	250
To Rent	1,740	By Stationery	1,080
To Profit from Entertainment	400	By Balance c/d	550
To Sale of Newspapers	180		
	4,130		4,130

Balance Sheet **as on** 1.1.88

Liabilities	Rs.	Assets	Rs.
Outstanding Salary	100	Cash	250
Capital Fund	11,550	Outstanding Subscriptions	300
		Library Books	500
		Furniture	600
		Land and Building	10,000
	11,650		11,650

Additional Information :

i) The club has 50 members each paying an annual subscription of Rs. 25.
ii) On December 31, 1988 salaries outstanding amounted to Rs. 200 and salaries paid included Rs. 100 for the year 1987.
iii) Provide 5% depreciation on land and building.

Hint : Total Subscriptions for the year 1988 $50 \times 25 = 1250$

Less Subscriptions received during 1988	1000
Subscription Outstanding in 1988.	250

(**Answer :** Excess of Expenditure over Income Rs. 300; Balance Sheet Total Rs. 11,950)

5 The following is the Receipts & Payments Account of Ajmer Literary Society for the year ended December 31,1988.

	Rs.		Rs.
To Balance b/d	12,500	By Salaries	2,500
To Subscriptions	52,500	By Printing & Stationery	1,250
To Adnual Day Receipts	49,300	By Annual Day Expenses:	11,500
To Interest	2,500	By Sundry Expenses	4,500
		By Investments	75,000
		By Postage & Telegrams	2,200
		By Repairs	6,340
		By Balance c/d	13,510
	1,16,800		1,16,800

Additional Information :

i) Buildings on 1.1.1988 was worth Rs. 50,000 Depreciation is to be charged @ 5%.
ii) Number of members was 2,000. Annual subscription was Rs. 25 per member.
iii) Other items :

	As on 1.1.1988 Rs.	As on 31.12.1988 Rs.
Outstanding Subscription	1,000	1,500
Investments	5,000	80,000
Annual day receipts outstanding	—	250
Annual day expenses owing	—	2,500
Prepaid Printing & Stationery	—	300

You are required to prepare an Income & Expenditure Account for the year ended December 31, 1987 and a Balance Sheet as at that date.

Hint : Total income from subscriptions for 1988 is Rs. 50,000, of this, Rs. 1,500 is still outstanding.
Hence the amount received for 1988 should be Rs. 48,500. The actual amount received is Rs. 52,500 (which includes Rs. 1,000 for 1987)
Hence Rs. 3,000 (52,500–1,000–48,500) is to be treated as subscriptions received in advance.

Answer : Surplus of Income Rs. 69,060;
Total of B/S Rs. 1,43,060.
Capital Fund Rs. 68,500).

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only,

Additional Information :

i) The club has 50 members each paying an annual subscription of Rs. 25.

ii) On December 31, 1988 salaries outstanding amounted to Rs. 200 and salaries paid included Rs. 100 for the year 1987.

iii) Provide 5% depreciation on land and building.

Hint : Total Subscriptions for the year 1988 50 x 25 = 1250

Less Subscriptions received during 1988	1000
Subscription Outstanding in 1988.	250

(**Answer :** Excess of Expenditure over Income Rs. 300; Balance Sheet Total Rs. 11,950)

5 The following is the Receipts & Payments Account of Ajmer Literary Society for the year ended December 31,1988.

	Rs.		Rs.
To Balance b/d	12,500	By Salaries	2,500
To Subscriptions	52,500	By Printing & Stationery	1,250
To Annual Day Receipts	49.300	By Annual Dry Expenses	11,500
To Interest	2,500	By Sundry Expenses	4,500
		By Investments	75,000
		By Postage & Telegrams	2,200
		By Repairs	6,340
		By Balance c/d	13,510
	1,16,800		1,16,800

Additional **Information :**

i) Buildings on 1.1.1988 was worth Rs. 50,000 Depreciation is to be charged @ 5%.

ii) Number of members was 2,000. Annual subscription was Rs. 25 per member.

iii) Other items :

	As on 1.1.1988 Rs.	As on 31.12.1988 Rs.
Outstanding Subscription	1,000	1,500
Investments	5,000	80,000
Annual day receipts outstanding	—	250
Annual day expenses owing	—	2,500
Prepaid Printing & Stationery	—	300

You are required to prepare an Income & Expenditure Account for the year ended December 31, 1987 and a Balance Sheet as at that date.

Hint: Total income from subscriptions for 1988 is Rs. 50,000, of this, Rs. 1,500 is still outstanding.
Hence the amount received for 1988 should be Rs. 48,500, The actual amount received is Rs. 52,500 (which includes Rs. 1,000 for 1987)
Hence Rs. 3,000 (52,500 – 1,000 – 48,500) is to be treated as subscriptions received in advance.

Answer: Surplus of Income Rs. 69,060;
Total of B/S Rs. 1,43,060.
Capital Fund Rs. *68,500).*

> Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 19 ACCOUNTS OF NON-TRADING CONCERNS – II

Structure

19.0 OBJECTIVES

After studying this unit you should be able to :

- prepare Income & Expenditure Account and Balance Sheet from a Trial Balance
- prepare Receipts & Payments Account from Income & Expenditure Account
- prepare opening and closing balance sheets from Receipts & Payments and Income & Expenditure Accounts
- prepare final accounts of professionals

19.1 INTRODUCTION

In Unit 18 you learnt about the preparation of final accounts of non-trading concerns which consists of the Receipts & Payments Account, the Income & Expenditure Account, and the Balance Sheet. In most cases, you are given the Receipts and Payments Account and you have to prepare the Income & Expenditure Account and Balance Sheet. But, sometimes, you are given the Income & Expenditure Account with some additional information from which you have to prepare the Receipts & Payments Account and the Balance Sheet. In some cases, you are given the Receipts & Payments Account as well as the Income & Expenditure and you may be required to prepare the opening and closing Balance Sheets. In this unit you will learn how the required statements are to be prepared from the given information. In addition you will also learn about the preparation of the final accounts of professionals like doctors, solicitors, etc, whose main job is to provide some personal service as consultants and not involved in trading of goods.

19.2 PREPARATION OF INCOME & EXPENDITURE ACCOUNT AND BALANCE SHEET

You have learnt that the Income & Expenditure Account and the Balance Sheet is usually prepared with the help of a Receipts & Payments Account and some additional information. You have also learnt about the treatment of various items of income and expenditure which are peculiar to non-trading concerns. Look at Illustration 1. This may help you to revise the preparation of Income & Expenditure Account and Balance Sheet from the Receipts & Payments Account and additional information.

Illustration 1

From the following Receipts & Payments Account and additional information supplied, prepare the final accounts of a club for the year ended December 31,1988.

Receipts and Payments Account
for the year ending December 31, 1988

Dr.	Rs.		Cr. Rs.
To Balance b/d	14,000	By Tournament Expenses	2,200
To Donations for Building	16,000	By Furniture Purchased	4,000
To General Donations	400	By Curtains	1,600
To Legacies	12,000	By Crockery	800
To Sale of Old Furniture (hook value Rs. 160)	150	By Sports Materials	2,400
		By Salaries	2,600
To Endowment Fund	20,000	By Honorarium	5,200
To Sale of Newspapers	800	By Charities	16,000
To Sale of Old Sports Material	160	By Advertisements	500
To Advertisements in the Year Book	3,800	By Rent and Taxes	2,800
To Proceeds of Concerts	2,400	By Advances for Construction of Building	10,000
To Subscriptions 1987 1,200; 1988 28,000; 1989 1,600	30,800	By Entertainment Expenses	2,900
		By Payment to Creditors of last year	800
		By Electric Installation Expenses	6,000
		By Library Books	1,600
To Tournament Fund	3,000	By Newspapers	2,600
		By Postage	1,400
		By Bar Purchases and Expenses	3,200
		By 7% Investments Purchased on July 1, 1988	20,000
		By Balance c/d	16,910
	1,03,510		1,03,510

Additional Information :

i) Balance on December 31,1988'.

Sports Materials	200
Bar Stock	240
Postage	40
Furniture	3,160

ii) Subscriptions outstanding on December 31, 1988 were Rs. 1,400 and Salaries outstanding on the same date were Rs. 100.

iii) Salaries paid included Rs, 160 for 1987 and Rs. 20 for 1989.

iv) investment included investments out of Building Donations Rs. 16,000,

v) Furniture is to be depreciated by 10%.

Solution :

Income and Expenditure Account
for the year ended December 31, 1988

Dr.	Rs.		Cr. Rs.
To Loss on Sale of Furniture	10	By General Donations	400
To Salaries 2,600 Add Salaries outstanding for 1988 100 2,700 Less Salaries outstanding for 1987 160 Less Salaries prepaid in 1988 20	2,520	By Sale of Newspaper	800
		By Sale of Sports Material	160
		By Advertisements in the Year Book	3,800
		By Concert Proceeds	2,400
		By Subscriptions 28,000 Add Subscription outstanding for 1988 1,400	29,400
To Honararium	5,200	By Interest on Investments (7% for 6 month on Rs. 4,000)	140
To Charities	16,000	By Excess of expenditure over income	2,650
To Depreciation on Furniture	700		
To Advertisements	500		
To Rent and Taxes	2,800		
To Entertainment Expenses	2,900		
To Newspapers	2,600		
To Postage 1,300 Less Stock 40	1,360		
To Bar Purchases 3,200 Less Bar stock 240	2,960		
To Sports Material 2,400 Less Stock 200	2,200		
	39,750		39,750

Balance Sheet for the year ended December 31, 1988

Dr.	Rs.		Cr. Rs.
Capital Fund 17,400 Less Excess of Expenditure over income 2,650	14,750	Cash	16,910
Endowment Fund	20,000	Furniture 7,160 Less Sale 160 7,000 Less Dep. 700	*6,300*
Building Fund 16,000 Add Interest on Investment from Building Fund 560	16.560	Crockery	800
		Curtains	1,600
		Advance for Construction of Building	10,000
Legacies	12,000	Electric Installations	6,000
Tournament Fund *3,000* Less Tournament Expenses 2,200	800	Library Books	1,600
		Investments	20,000
		Stock of Sports Material	200

Subscriptions received in advance	1,600	Bar Stock	240
		Postage	40
		Subscription outstanding	1,400
		Salaries paid in advance	20
Salaries Outstanding	100	Interest Accrued on Investment	700
	65,810		65,810

Working Notes :

Balance Sheet as on December 31, 1987

	Rs.		Rs.
Creditors	800	Cash in hand	14,000
Salary Outstanding	160	Subscription outstanding	1,200
Capital Fund (balancing figure)	17,400	Furniture	3,160
	18,360		18,360

Notes : 1 Donations for building being donations for specific purpose have been credited to Building Fund and shown as such on the liabilities side.

2 Investment of Rs. 20,000 include Rs 16,000 out of building fund. Hence, Rs. 560 of the income from investments (7% on Rs. 16,000 for 6 months) has been added to building fund and the balance (Rs. 140) has been credited to Income and Expenditure Account.

3 The total amount of income from investments (Rs. 700) is outstanding and has been shown on the assets side.

4 Legacies and endowment fund have been capitalised.

In Illustration 1 the Income & Expenditure Account and Balance Sheet have been prepared from the Receipts and Payments Account as per the usual practice. Sometimes you may be asked to prepare these statements from the Trial Balance itself as is the case with trading concerns. In fact, there is nothing peculiar about it. You already know how to prepare the Profit & Loss Account and the Balance Sheet from a given Trial Balance. Follow the same procedure for the preparation of the Income & Expenditure Account and Balance Sheer. Look at Illustration 2 and see how they are prepared from a given Trail Balance.

Illustration 2

From the Trial Balance of the Allahabad Club given below, prepare the Income and-Expenditure Account of the club and also its Balance Sheet as at December 31, 1987. Depreciate Furniture by 10% and billiard table by 20%. Subscriptions amounting to Rs. 500 were in arrears.

Trial Balance

Dr. Cr.

	Rs.		Rs.
Furniture	5,000	Membership Subscriptions	21,120
Billiard Table and Accessories		Sundry Receipts	3,486
China Glass Cutlery	666	Sale of Tickets	6,468
Repairs	1,468	Creditors	5,200
Salaries & Wages	4,524	Entrance Fee	896
Cash at bank	9,600	Capital Fund	
Cash in hand	348		
Rent & Telephone	6,388		

Fuel & Light	3,236		
Entertainment	4,380		
Sundries	3,200		
Annual Dinner	1,520		
Debtors	2,340		
	45,170		45,170

Solution :

Allahabad Club

Income and Expenditure Account
for the year ended December 31, 1987

Dr.		Rs.				Cr. Rs.
To Repairs		1,468	By Subscriptions			
To Salaries & Wages		4,524				
To Kent & Telephone		6,388	Received	21,120		
			Acid Outstanding	500		
To Fuel & Light		3,236				21,620
To Sundries		3,200	By Sale of Tickets			6,468
To Annual Dinner		1,520	By Sundry Receipts			3,486
To Entertainment		4,380	By Entrance Fee			896
To Depreciation						
Furniture	500					
Billard Table	500					
		1,000				
To Excess of Income over Expenditure		6,754				
		32,470				32,470

Balance Sheet of Allahabad Club
as on December 31,1987

		Rs.			Rs.
Sundry Creditors		5,200	Cash in hand		348
Capital Fund :			Cash at hank		9,600
Opening Balance	8,000		Debtors		2,340
Add Excess of Income over Expenditure	6,754		Subscriptions Outstanding		500
		14,754	Furniture	5,000	
			Less Depreciaiton	500	
					4,500
			Billard Table	2,500	
			Less Depreciaiton	500	
					2,000
			China Glass and Cutlery		666
		19,954			19,954

19.3 PREPARATION OF RECEIPTS & PAYMENTS ACCOUNT FROM INCOME & EXPENDITURE ACCOUNT

You have learnt that the Receipts and Payments Account is the summary of Cash Book. It commences with the opening cash and bank balances, shows all receipts and payments made during the year, and ends with the closing cash and bank balances. While recording the receipts and payments in this account, no distinction is made between capital and revenue items as both are to be included. Similarly, whether the amount received or paid relates to the current year the preceding years or the following years, it is fully recorded in the Receipts and Payments Account. You know it is prepared normally with the help of Cash Book and Ledger (or the Trial Balance). But, sometimes, you may be asked to prepare it from the Income and Expenditure Account and some additional information. In such a situation, you must remember that the Income and Expenditure Account shows those items which are of revenue nature and records only such amounts which relates to the current year. The capital items and the receipts and payments relating to the preceding and the following years are to be excluded. Then, it also includes the amounts of expenses and incomes which are yet to be paid or received (outstanding). Hence, while calculating the amount of each receipt and payment on the basis of the respective income and expenditure as given in the Income & Expendiure Account, you will have to make necessary adjustments in their amounts. Let us clarify this with the help of an example. Suppose, the Income and Expenditure Account for the year ending December 31, 1988 shows the income from subscriptions as Rs. 9,000 which includes Rs. 800 for subscriptions outstanding at the end and Rs. 600 for subscriptions received in advance during 1987. It is also observed that during 1988 Rs. 700 was received for subscriptions related to 1989 and Rs. 400 for subscriptions outstanding at the end of 1987. Now the amount received on account of subscriptions during 1988 will be worked out as follows :

	Rs.
Income from subscriptions	9,000
Less outstanding at the end	800
	8,200
Add outstanding at the beginning	400
	8,600
Less subs. received in advanced during 1987	600
	8,000
Add subs. received in advance during 1988	700
Amount of subs. received during 1988	8,700

Thus, you will notice that for calculating the amount of subscriptions received we make adjustments in the income from subscriptions which are just the reverse of what we would do while calculating the income from subscriptions with the help of the figure given in the Receipts and Payments Account and the additional information. This applies to all items of receipts and payments.

Look at Illustration 3 and see how the amount of each item of receipt and payment has been completed and the Receipts and Payments Account prepared.

Illustration 3

The Income and Expenditure Account of Lion's Club, Delhi for the year ended December 31, 1988 is given below.

Income and Expenditure Account
for the year ending December 31,1988

Dr	Rs.		Cr. Rs.
To Salaries	4,000	By Subscriptions	7,500
To General Expenses	1,250	By Entrance Fees	500
To Audit Fees	250	By Special Contribution for Annual Dinner	1,000
To Secretary's Allowance	1,000	By Profit on Special show	500
To Stationery & Printing	450		
To Annual Dinner Expenses	1,200		
To Interest and other charges	150		
To Depreciation on Sports Equipment	300		
To Excess of Income over Expenditure	900		
	9,500		9,500

The following adjustments were made while preparing the foregoing account

		Rs.
Subscriptions outstanding	(1.1.1988)	500
Subscriptions outstanding	(31.12.1988)	250
Subscriptions received in advance	(1.1.1988)	400
Subscriptions received in advance	(31.12.1988)	600
Salaries outstanding	(1.1.1988)	500
Salaries outstanding	(31.12.1988)	300

Insurance prepaid (included in General Expenses) on 31.12.1988 was Rs. 100. The audit fees for 1988 is still unpaid and the audit fees for 1987 amounting to Rs. 100 has been paid during 1988.

The Club owned freehold premises valued at Rs. 10,000. The club also had sports equipment valued at Rs. 2,500 as on 1.1.1988. The sports equipment in stock as on 31.12.1988 was for Rs. 2,700. During 1988, the club had taken a loan of Rs. 2,000 from a bank which was unpaid till the end of the year. 'Cash in hand amounted to Rs. 3,100 at the end of the year.

Prepare the Receipts and Payments Accounts for the year ended December 31,1988 and the Balance Sheets as at the beginning and at the end of the year 1988.

Solution :

Receipts & Payments Account
for the year ended December 31,1988

Dr.	Rs.		Cr. Rs.
To Balance b/d (balancing figure)	100	By Salaries (2)	4,200
To Entrance Fees	500	By General Expenses (4)	1,350
To Subscriptions (1)	7,950	By Audit Fees (3)	100
To Bank Loan	2,000	By Allowance to Secretary	1,000
To Special contributian for Annual Dinner	1,000	By Annual Dinner Exp.	1,200
		By Stationery & Printing	450

To Profit on Special Show	500	By Interest and other charges	150
		By Equipment (5)	500
		By Balance c/d	3,100
	12,050		12,050

Balance Sheet
as on January 1, 1988

	Rs.		Rs.
Advance Subscriptions	400	Cash in hand	100
Salary Outstanding	500	Subscription Outstanding	500
Audit Fee Outstanding	100	Freehold premises	10,000
Capital Fund (balancing figure)	12,100	Sports Equipment	2,500
	13,100		13,100

Balance Sheet
as on December 31, 1988

	Rs.		Rs.
Advance Subscriptions	600	Cash in hand	3,100
Salary Outstanding	300	Subscription Outstanding	250
Audit Fee Outstanding	250	Prepaid Insurance	100
Bank Loan	2,000	Freehold Premises	10,000
Capital Fund		Sports Equipment 2500	
Balance 12.100		Additions 500	
Add Surplus		3,000	
of current year 900	13,000	Less Depreciation 300	
			2,700
	16,150		16,150

Working Notes :

1 Subscriptions

	Rs.
Subscriptions as per Income & Expenditure Account	7,500
Less **Outstanding** at the end	250
	7,250
Less Received in advance during 1987	400
	6,850
Add Outstanding at the beginning	500
	7,350
Add received in advance for 1989 during 1988	600
Subscription received during the year	7,950

2 Salaries

	Rs.
Salaries as per **Income/Expenditure** Account	4,000
Add Outstanding at the beginning	500

	4,500
Less Salaries Outstanding at the end	300
Salaries paid during the year	4,200

3 Audit Fee	Rs.
Audit fees as per Income & Expenditure Account	250
Less Outstanding at the end	250
	000
Add Outstanding at the beginning	100
Audit fees paid during the year	100

4 General Expenses	Rs.
General Expenses as per Income & Expenditure Account	1,250
Add Insurance Prepaid at the end	100
General Expenses paid during the year	1,350

5 Sports Equipment Purchased	Rs.
Sports equipment in stock at the beginning	2,500
Less Depreciation during the year	300
Sports equipment in stock	2,200

The actual stock of sports equipment at the end is Rs. 2,700. It means sports equipment amounting to Rs. 500 was purchased during the year.

19.4 PREPARATION OF BALANCE SHEETS FROM RECEIPTS & PAYMENTS AND INCOME & EXPENDITURE ACCOUNTS

Sometimes the Receipts & Payments Account as well as the Income & Expenditure Account are given and you may be required to prepare the opening and closing balance sheets. In such a situation, you will have to ascertain the opening and closing balances of various items by making item-wise comparison of the Receipts & Payments Account and the Income & Expenditure Account. This willl help you mainly to ascertain the amounts of various outstanding and prepaid expenses and incomes. As for the fixed assets, the opening balances are generally given under additional information. Their closing balances can be easily ascertained by taking into account the additons (and disposal, if any) made during the year as given in the Receipts & Payments Account and after adjusting the amount of depreciation as given in the Income & Expenditure Account. Look at Illustration 4 and see how the opening and closing balance sheets have been prepared after ascertaining the opening and closing balances of all items involved.

Illustration 4

The Secretary of an Education Society submitted to you the following Receipts & Payments Account and the Income & Expenditure Account for the year ended March 31,1988 :

Receipts and Payments Account
for the year ending March **31,1988**

Dr.	Rs.		Cr. Rs.
To Balance b/d	450	By Printing	75
To Interest		By Advertisement	141
1986-87 100		By Staff Salary	1,300
1987-88 150		By Furniture Purchased	670
	250	By Rent	520
To Tuition Fees		By Misc. Expenses	110
1987-88 1000		By Balance c/d	1,374
1988-89 100			
	1,100		
To Entrance Fees			
1987-88	420		
To Membership Fees :			
1986-87 300			
1987-88 1,150			
1988-89 390			
	1,840		
To Miscellaneous income	120		
	4,190		4,190

Income and Expenditure **Account**
for the year ending March 31, **1988**

Dr.	Rs.		Cr. Rs.
To Printing	80	By Tuition Fees	1,100
To Advertisement	150	By Membership Fees	1,150
To Rent	600	By Miscellaneous Income	130
To Staff Salary	1,200	By Interest	160
To Misc. Expenses	110		
To Depreciation on Furniture	100		
To Excess of Income over Expenditure,	300		
	2,540		2,540

The Society had the following assets on 31.3.1987.

Investments	Rs. 4,000
Furniture	Rs. 1,000
Reference Books	Rs. 500

Prepare the Balance Sheet of the Society as on March 31, 1987 and March 31, 1988.

Solution :

Balance Sheet
as on **March 31,1987**

	Rs.		Rs.
Capital Fund (balancing figure)	6,350	Cash in hand	450
		Investment	4,000
		Interest Accrued	100
		Membership Fees Accrued	300
		Reference Books	500
		Furniture	1,000
	6,350		6,350

Balance Sheet
as on March 31,1988

		Rs.			Rs.
Tuition Fee received in advance (2)		100	Cash in hand		1,374
Membership Fees received in advanced		390	Investment		4,000
Printing Outstanding		5	Interest Accrued (1)		10
Advertisement Outstanding		9	Tuition Fees Accrued (2)		100
Rent Outstanding		80	Staff Salary paid in advance (3)		100
Capital Fund			Reference Books		500
as on 1.1.1987	6.350		Furniture	1000	
Add Entrance Fees (4)	420		Less Depreciation	100	
Add Excess of Income				900	
over expenditure	300	7,070	Add Furniture Purchased	670	1,570
		7,654			7,654

Working Notes

1 The Income & Expenditure Account shows interest income of the year for Rs. 160 whereas the Receipts & Payments Account shows receipts of Rs. 150 during the year. The difference of Rs. 10 represents interest income due but not yet received, hence shown on assets side.

2 Income from tuition fees as per the Income & Expenditure Account is Rs. 2,100. The Receipts & Payments Account reveals that Rs. 100 was received for the next year (received in advance) and Rs. 1,000 for **1987-88.** It means the tuition fees of Rs. 100 of 1987-88 is still outstanding. Hence, it has been shown as such in the Closing Balance Sheet.

3 The payment of staff salaries is Rs. 1,300 whereas the expenditure under this head is Rs. 1,200 only. Hence, tho excess paid relates either to the previous year or the succeding year. There is no evidence to show that there was any outstanding amount last year. Hence, it is presumed that the salary paid in excess relates to the next year **i.e.,** it is received in advance.

4 The entrance fees received during the year has not been shown as income in the Income &.Expenditure Account. Hence, it is assumed that intention is to capitalise it and so it is directly added to the capital fund.

Check Your Progress A

1 Tick the correct answer.

i) The Income & Expenditure Account shows an income from subscriptions at Rs. 20,000. Subscription accrued at the beginning of the year and at the end of the year were Rs, 2,000 and Rs. 3,000 respectively. The figure of the subscription received appearing in the Receipts and Payments Account will be
a) Rs. **19,000**
b) Rs. **22,000**
c) Rs. **20,000**

ii) The Income & Expenditure Account shows salaries and wages as Rs. 24,000. Salary paid for the previous year amounting to Rs. 2,000 and outstanding for the current year amounted Rs. 3,000. The amount of the salaries and **wages shown** in Receipts and Payments Account will be
a) Rs. **23,000**
b) **Rs.** 24,000
c) Rs. **22,000**

iii) Stock of Sports material at the beginning of the year is Rs. 3,000. Stock of Sports material after 50% depreciation is Rs. 2,200 at the end of the year. The figure of the purchase of sports material in Receipts & Payments Accounts will be
   a) Rs. 1,300
   b) Rs. 1,600
   c) Rs. 1,400

2 From the extracts given below find out the value of Buildings, Furniture and Instruments which will be shown in the opening Balance Sheet.

Receipts and Payments Account

Dr.	Rs.		Cr. Rs.
To Balance	...	By Payments :	
	...	Furniture purchased	1,000
	...	Instruments purchased	2,000

Income and Expenditure Account

Dr.	Rs.		Cr. Rs.
To..........		By..........	
To Depreciation			
Building @ $2\frac{1}{2}$%	5,000		
Furniture @ 10%	400		
Instruments @ 20%	1,200		

Depreciation on all assets has been worked out for the full year.

3 Fill in the blanks

i) The procedure for the preparation of Income & Expenditure Account from Trial Balance is same as that of the preparation of,...Account from Trial Balance.

ii) While calculating the amount of subscription to be shown on the receipts side of Receipts & Payments Account the figure of outstanding subscription at the end of the current year will be..........the income from subscriptions as per Income & Expenditure Account.

iii) By comparing the Income & Expenditure Account with the Receipts & Payments Account one can ascertain the amounts of........,and.........expenses and incomes.

iv) For calculating the amount of closing fixed assets the adjustments made in the opening balance are in respect of additions and disposals to the fixed asset during the year and the amount of.........

19.5 FINAL ACCOUNTS OF PROFESSIONALS

The professionals like doctors, solicitors etc., whose main job is to provide personal service as consultants and not trading in goods, maintain books of account like a non-trading concern. They prepare their final accounts also in the same manner. The only difference relates to the Income & Expenditure Account which in case of professionals is termed as 'Receipts & Expenditure *Account*'. It is so because they account for their income on cash basis though the expenses are included on accrual basis. In other words, they take into account the outstanding expenses, but not the outstanding incomes. They adopt cash basis for recording incomes on the ground that their debtors are of a very uncertain nature so that a fee may not be considered as earned until the cash is received. Not only that, the professionals can not file suit for recovery of their fees.

There are two methods which can be adopted with regard to the outstanding fees of the professionals: (i) ignore the amount of outstanding fees altogether i.e., do not include it in the incomes at all, or (ii) include it first in the income as outstanding fees and then make-provision for doubtful debts equal to 100% of this amount. The second method is'considered better because the outstanding fees is duly brought into account. As for the Balance Sheet, the outstanding fees are shown on the assets side and 100% provision for doubtful debts is deducted therefrom thus reducing its. amount to nil.

Look at Illustration 5 and see how the final accounts of a professional are prepared.

Illustration 5

Dr. Sandeep Gupta, a medical practitioner has furnished the following information for the year ended March 31,1988. He requests you to ascertain his income for the year and also to prepare a Balance Sheet as on that date.

Balances	As on 1.4.87 Rs.	As on 31.3.88 Rs.
Outstanding bills of patients	100	250
Provision for doubtful debts	100	250
Furniture	1,200	1,300
Equipment	3,500	4,600
Scooter	4,000	3,600
Stock of Medicines	600	450
Suppliers' bills outstanding	200	500
Dispensary expenses unpaid	300	400

Receipts and Payments Account
for the year ending March 31, 1988

Dr.	Rs.		Cr. Rs.
To Balance b/d	300	By Suppliers' bills paid	3,200
To Visiting Fees	600	By Dispensary Expenses	1,600
To Consultation Fees	1,000	By Furniture purchased	150
To Receipts from Patients	9,600	By Equipment purchased	1,200
		By Scooter Expenses	800
		By Private Expenses	4,000
		By Balance c/d	550
	11,500		11,500

The Scooter was used for private pur oses also. Half of the expenses (including depreciation) on scooter are to be treated as professional expenses. Medicines costing Rs. 50 were donated to refugee relief fund and medicines costing Rs. 20 were used for private purposes.

Solution :

Receipts and Expenditure Account
for the year ended March 31,1988

Dr.		Rs.			Cr. Rs.
To Cost of Medicines Used		3,580	By Receipts from Patients	9,600	
To Dispensary Expenses		1,700	Add outstanding at the end	250	
				9,850	
To Depreciation			Less Outstanding at the beginning	100	9,750
Furniture	50				
Equipments	100	150			
To Scooter Expenses		600	By Visiting Fees		600
To Donation		50	By Consultation Fees		1,000
To Provision for doubtful debts	250				
Less old provision	100	150			
To Surplus (Income)		5,120			
		11,350			11,350

Balance Sheet as on March 31, 1988

		Rs.			Rs.
Suppliers bill outstanding		500	Cash in hand		550
Expenses outstanding		400	Outstanding bills of patients	250	
Capital	9,100		Less provisions of doubtful debts	250	—
Add Surplus	5,120		Stock of Medicines		450
	14,220		Furniture.		1,300
Less Drawings	4,620	9,600	Equipments		4,600
			Scooter		3,600
		10,500			10,500

Working Notes :

1 Cost of Medicines Used :

a) Calculation of medicines purchases :

Suppliers' A/c

Dr.	Rs.		Cr. Rs.
To Cash received from suppliers	3,200	By Balance b/d	200
To Balance c/d	500	By Purchases (balancing figrue)	3,500
	3,700		3,700

b) Calculation of Cost of Medicines Used

		Rs.
Opening Stock		600
Add Purchases		3,500
		4,100
Less Closing Stock		450
		3,650
Less Medicines donated	50	
Less Medicines used personally	20	70
Cost of Medicines used		3,850

2 Calculation of Dispensary Expenses :

	Rs.
Paid	1,600
Add Outstanding at the end	400
	2,000
Less : Outstanding at the beginning	300
	1,700

3 Calculation of Depreciation

a) Furniture A/c

	Rs.		Rs.
To Balance b/d	1,200	By Depreciation (balancing figure)	50
To Cash (purchases)	150	By Balance c/d	1,300
	1,350		1,350

b) Equipment A/c

	Rs.		Rs.
To Balance b/d	3,500	By Depreciation (balancing figure)	100
To Cash (purchases)	1,200	By Balance c/d	4,600
	4,700		4,700

4 Calculation of Scooter Expenses Charged to Receipts and Expenditure Account :

	Rs.
Cash Expenses	800
Add Depreciation (4,000 – 3,600)	400
	1200
Less 1/2 for private use	600
Charged to Receipts and Exependiture Account	600

5 Provision for Doubtful Debts is to be equal to the outstanding bills of patients for Rs. 250. Since the provisions for doubtful debts is already Rs. 100, therefore, it has been rai ed to Rs. 250 by creating additional provisions for Rs. 150. The oustanding bills at the beginning are treated as received.

6 **Calculation** of Opening Capital

Opening Balance Sheer

	Rs.			Rs.
Suppliers Bills due	200	Cash in hand		300
Expenses Unpaid	300	Outstanding Bills of Patients	100	
Capital (balancing figure)	9,100	Less Provision for Doubtful Debts	100	—
		Stock of Medicines		600
		Furniture		1,200
		Equipment		3,500
		Scooter		4,000
	9,600			9,600

19.6 LET US SUM UP

In case of non-trading concerns, we normally prepare the Income and Expenditure Account **and** the Balance Sheet from the Receipts and Payments Account **and** other informations. These statements can also be prepared from a Trial Balance, if given, Sometimes, however, the Receipts and Payments Account itself may have to be prepared from the Income and Expenditure Account and other **information.** In such a situation, each item of receipt and payment will have to be worked out by making necessary **adjustments** in the respective incomes and expenses. The capital receipts and capital payments will also have to be found out and included in the Receipts **and** Payments Account. The **opening** and closing balances of cash and bank may be taken from the opening and closing balance sheets.

In some cases, the Receipts and Payments Account as well as the Income and Expenditure Account are given and the opening and closing balance sheets may have to be prepared. **This** would require a comparison of each item of receipt and payment with each respective item of **income** and expenditure so as to work out the **outstanding** amounts and the advance payments.

The professional like doctors, solicitors etc., also **keep** their accounting records in the same manner as the non-trading concerns do. Of course, instead of Income and Expenditure Account they prepare the Receipts and Expenditure Account because they account for their professional fees on cash basis and not on accrual basis as they do for expenses.

19.7 SOME USEFUL BOOKS

Gupta, R.L. and M. Radhaswamy, 1986. ***Advanced Accountancy*** Sultan Chand & Sons, New Delhi (Chapter 14).

Maheshwari **S.N., 1987.** ***Introduction to Accounting, Vikas Publishing House : New Delhi (Chapter 15).***

Patil, V.A. and J.S. **Korlahalli,** 1986. ***Principles and Practice of Accounting,*** R. Chand & Co. New Delhi (Chapter 5 Volume-11)

Shukla, M.C. and T.S. Grewal, 1987. *Advanced Accounts*, S. Chand & Co. (Pvt.) Ltd., New Delhi. (Chapter 7).

William Pickles, 1982. *Accountancy*, E.L.B.S. and Pitman, London (Chapter 12)

19.8 ANSWERS TO CHECK YOUR PROGRESS

A 1 i) a ii) a iii) c

2 Building Rs. 2,00,000
Furniture Rs. 3,000
Instruments Rs. 4,000

3 iv) Profit and Loss, ii) deducted from, iii) outstanding, prepaid, iv) depreciation

19.9 TERMINAL QUESTIONS/EXERCISES

Questions

1 State the steps involved in the preparation of Receipts and Payments Account from the Income and Expenditure Account. Give examples.

2 Why is an Income and Expenditure Account termed as Receipts and Expenditure Account in case of professionals? How do they account for the outstanding fees?

Exercises :

1 Delhi Cricket Club provides you the following Receipts and Payments Account for the year ended June 30,1987

Receipts nnd **Payments** Account

	Rs.		Rs.
To Balance in hand	150	By Salaries and Wages	8,700
To Balance at bank	4,200	By Sports Equipments purchased	1,500
To Life Member's Fees	2,000	By Stationery & Printing	1,500
To Admission Fees	500	By Maintenance of Ground	2,100
To Subscriptions 1985-86 400 1986-87 11,300 1987-88 600	12,300	By Prizes awarded By Investments (against donation for building) By Balance in hand	400 3,000 320
To Sale of old Balls and Bats	300	By Balance at bank	5,430
To Interest on Prize Fund Investments (@ 5%)	500		
To Donations for Building	3,000		
	22,950		22,950

Additional Information :

1 **The club possessed** on July 1,1986, leasehold of a ground valued at Rs. 10,000 and **sports equipments** at Rs. 1,000. On that **date,** it **also owed** Rs. 800 for salaries and **wages.**

2 **The bats and balls sold during** the year had no book value.

3 Investments against the donation for building were made on January 1, 1987 and consisted of Rs. 3,500, 4% Government loan.
4 Subscriptions for 1986-87 outstanding were Rs. 500. 50% of the sports equipments as st June 30,198'7 is to be written off.
5 Rs. 700 of stationery and printing is to be carried forward.

Hint Investment of Prize Fund is Rs. 10,000 i.e.,

$$\frac{100}{5} \times 500 = 10,000$$

(Answer : Excess of Income over Expenditure Rs. 550; total of Balance Sheet as at June 30, 1987 Rs. 31,270, and Balance total as at July 1, 1986 Rs. 25,750 ;Capital Fund Rs. 14, 950)

2 Prepare a Receipts and Payments Account for the year ending December 31, 198'7 and a Balance Sheet as on that date from the following informations:

Income and Expenditure Account
for the year ending December 31, 1987

	Rs.		Rs.
To Maintenance of Playground	4,060	By Subscriptions	10,500
To Rent & Rates	500	By Entrance Fees	600
To Stationery	150	By Sale of Sports Material	100
To Sports Material Used	2,200	By Entertainment	600
To Salaries	440		
To Surplus of Income	4,450		
	11,800		111,800

Additional Information :

	On 1.1.1987	On 31.12.87
Cash at Bank	6,000	?
Stock of Sports Material	3,000	?
Tournament Fund	2,000	800
Donation for Building	—	20,000
Stationery in Stock	400	450
Entrance Fee Fund	—	600

Spores Material (including purchases) was to be written off by 50%.

(Answer : Closing Balance Rs. 330,600; Total of B/S Rs. 33,250).

3 The following particulars relate to the None such Sports Club.

Income end Expenditure Account
for the year ended December 31 1987

	Rs.		Rs.
To Salaries	1,500	By Entrance Fees	500
To Printing and Stationery	2,200	By Subscriptions	25,600
To Advertising	1,600	By Rent	4,000
To Auditing Fees	500		
To Fire Insurance	1,000		

To Depreciation on sports eqpt. 8.000 on furniture 1.000				
To Excess of Income over expenditure	14,300			
	30,100			30,100

Receipts and Payments Account
for the year ended December 31, 1987

	Rs.		Rs.
To Balance b/d	4,200	By Salaries	1,000
To Entrance Fees	500	By Printing & Stationery	2,600
To Subscriptions		By Advertising	1,600
" 1986	600		
" 1987	25,000	By Fire Insurance	1,200
" 1988	400		
To Rent reeceived	3,500	By Investments	20,000
		By Balance c/d	7,800
	34,200		34,200

The assets on January 1, 1987 included Club ground and Pavilion Rs. 44,000; Sports Equipment Rs. 25,000; and Furniture & Fixtures Rs. 4,000; Subscriptions in arrear on that date were Rs. 800. Prepare the Balance Sheets as on December 31,1986and 1987.

(Answer : Total of Balance Sheet on 31.12.1986 — Rs. 78,000;
Total of Balance Sheet on 31.12.1987 — Rs. 93,700)

4 As at March 31,1988 the following balances have been extracted from the books of the Indian Chartered Accounts Recreation Club and you are asked to prepare (1)Trading Account for ascertaining gross profit derived from running bar and dining room and (2) income and Expenditure Account for the year ended March, 31, 1988 and (3) a Balance Sheet as at that date.

Debit Balances	Rs.	Credit Balances	Rs.
Stock-in-hand		Receipts—Bar	39,150
Bar—(1.4.87)	90	Dining Room	48,510
Dining Room (1-4-87)	1,080		
Purchases-Bar	24,660	Subscriptions	9,450
Dining Room	32,370		
Rent	10,470	Billiard's Receipts	7,300
Wages	18,690	Sundry Receipts	410
Repairs and Renewals	5,400	Interest on Fixed Deposit	270
Fuel and Light	5,280	Sundry Creditors	5,370
Misc. Expenses	4,050	Grant from Institute (permanent)	42,000
Cash in hand	560	Income and Exp. A/c (1.4.87)	1,380
Cash at bank	2.760		
Fixed Deposit	8,500		
Sundry Debtors	2,250		

China glass, cutlery & linen	600		
Billiard Table	2,070		
Fixtures and Fittings	870		
Furniture	4,140		
Club Premises	30,000		
	1,53,840		1,53,840

On March 31,1988 stock of bar and dining room consisted of Rs. **900** and Rs. 60 respectively. Provide depreciation Rs. 60 on fixtures and fittings, Rs. 390 on billiard table and Rs. 560 on furniture.

(Answer : Excess of income over expenditure—Rs. 2,950 :
Total of Balance Sheet Rs. 51,700)

5 Dr. Iodine commenced practice as an eye-specialist investing Rs. 25,000 in equipment on January 1,1987. The Receipts and Payments Account for the year was as follows :

Receipts and Payments Account

Receipts	Amount	Payments	Amount
	Rs.		Rs.
To Fees	50,000	By Rent	3,000
To Miscellaneous Receipts	100	By Salaries to Assistants	7,500
To Equipment Sold	2,000	By Journals	1,000
		By Library Books	3,000
		By Equipments Purchased	4,000
		By Drawings	12,000
		By Balance at bank in hand	 21,500 100
	52,100		52,100

Rs. 1500 of the fees was still outstanding. Equipment was sold and purchased on October 1, **1987;** the cost of the equipment sold being Rs. 3,000. Depreciation on equipment is 20% and on Library Books **5%.** Salaries to assistants outstanding Rs. 1,000. Prepare the Receipts & Expenditure Account and the Balance Sheet relating to **1987.**

(Answer : Surplus Rs. 31,850; Total of **Balance** Sheet Rs. 45,850).

Note: These questions will help you to understand the unit better. **Try** to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 20 DEPRECIATION - I

Structure

20.0 OBJECTIVES

After going through this unit you should be able to :

- define depreciation
- distinguish depreciation from other related concepts
- state the causes of depreciation
- describe the objectives of providing depreciation
- state the factors influencing the amount of depreciation
- explain the methods of recording depreciation
- list various methods of providing depreciation
- prepare accounts under fixed instalment and diminishing balance methods of providing depreciation.

20.1 INTRODUCTION

While preparing final accounts you have to provide for depreciation on all fixed assets so as to work out the correct amount of profit or loss for the accounting period. Adjustments usually contain an item asking you to charge depreciation on various fixed assets at some given rate and you know how to show it in final accounts. In this unit we shall have a detailed discussion on depreciation and study the basic factors influencing the amount of depreciation and various methods of providing and accounting for the same.

20.2 WHAT IS DEPRECIATION?

You are already familiar with the distinction between revenue expenditure and capital expenditure. You are aware that when the benefit of an expenditure is available beyond the accounting year (for one or more years) such an expenditure is treated as capital expehditure and it often results in acquisition of an asset. Since many accounting years are likely to receive benefits on account of the use-of such an asset, the cost of investment must necessarily be allocated over the period of its useful life and charged to the Profit and Loss Account. Allocation of the appropriate

China glass, cutlery & linen	600		
Billiard Table	2,070		
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(**Answer** : Excess of income over expenditure—Rs. 2,950 : Total of Balance Sheet Rs. 51,700)

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To Equipment Sold	2,000	By Journals	1,000
		By Library Books	3,000
		By Equipments Purchased	4,000
		By Drawings	12,000
		By Balance at bank	21,500
		in hand	100
	52,100		52,100

Rs. 1500 of the fees was still outstanding. Equipment was sold and purchased on October 1,1987; the cost of the equipment sold being Rs. 3,000. Depreciation on equipment is 20% and on Library Books 5%. Salaries to assistants outstanding Rs. 1,000. Prepare the Receipts & Expenditure Account and the Balance Sheet relating to 1987.

(**Answer** : Surplus Rs. 31,850; Total of Balance Sheet Rs. 45,850).

> Note: These questions will help you to understand the unit better. **Try** to write answers for them. But do not submit your answers to the **University**. *These* are for your practice only.

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Structure

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- prepare accounts under fixed instalment and diminishing balance methods of providing depreciation.

20.1 INTRODUCTION

While preparing final accounts yc, have to provide for depreciation on all fixed assets so as to work out the correct amount of profit or loss for the accounting period. Adjustments usually contain an item asking you to charge depreciation on various fixed assets at some given rate and you know how to show it in final accounts. In this unit we shall have a detailed discussion on depreciation and study the basic factors influencing the amount of depreciation and various methods of providing and accounting for the same.

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amount to each **period is called depreciation** which represents **the expired portion** of **the** cost of an asset.

It would be useful to discuss different definitions given by various authorities in the subject for a proper appreciation of the meaning of depreciation.

Pickles defined depreciation as "the permanent and continuous diminution in the quality, quantity or value of an asset."

According to Spicer and Pegler, "Depreciation may be defined as a measure of the exhaustion of the effective life of an asset from any cause during a given period."

These definitions refer to certain basic aspects like permanent and continuous diminution, exhaustion of effective life but they are not comprehensive. Let us see some more definitions.

According to ICMA (Institute of Cost and Management Accounts, London) terminology, "Depreciation is the diminution in intrinsic value of the asset due to use and/or lapse of time."

According to Walter B. Meigs and others, "The concept of depreciation is closely linked to the concept of business income. Since part of the service potential of the depreciable asset is exhausted in the revenue getting process each period, the cost of these services must be deducted from revenue in measuring periodic income; the expired cost must be recovered before a business is considered as well off as at the beginning of the period. Depreciation is a measure of this cost."

According to the Institute of Chartered Accountants in Austria, "Depreciation represents 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 assets and is not dependent upon the amount of profit cleared."

From the above definitions it is clear that depreciation refers to that part of the cost of fixed asset which has expired on account of its usage and or the passage of time. It is thus the 'lost usefulness', 'expired utility', or 'reduction in the intrinsic value' of a fixed asset.

Depreciation is charged on almost all fixed assets, possible exceptions being land, antiques, etc. Usually the value of land and antiques appreciates over a period of time, because they do not have finite economic life as in the case of machinery or furniture.

28.3 DEPRECIATION AND OTHER RELATED CONCEPTS

Sometimes the terms depletion, amortisation etc., are used interchangeably with depreciation. These terms in fact are used in a different context. Let us understand the distinction between depreciation and such related concepts.

Depreciation and Depletion: The term 'depletion' is used in respect of the extraction of natural resources from wasting assets such as quarries, mines, etc. and refers to the reduction in the available quantity of the material. As a matter of fact, depletion' is regarded as a method of computing the depreciation on wasting assets. Thus, it has a limited application. Depreciation, on the other hand, is a wider term and refers to a reduction in the value of all kinds of fixed assets arising from their wear and tear.

Depreciation and Amortisation: The terms 'amortisation' refers to writing off the proportionate value of the intangible assets such as copyrights, patents, goodwill, etc., while depreciation refers to the writing off the expired cost of the tangible assets like machinery, furniture, building etc.

Depreciation and Obsolescence: Obsolescence refers to the decrease in usefulness arising on account of the external factors like change in technology, new inventions, change of style, etc. Thus, it is caused mainly on account of the asset becoming out of date, old fashioned. Depreciation on the other hand, is a functional loss generally arising on account of wear and tear. Obsolescence, in fact, is regarded as one of the causes of depreciation.

Depreciation and Fluctuation : Fluctuation refers to an increase or decrease in the market price of an asset. Such a change is usually temporary. Depreciation differs from fluctuation in the following respects.

i) Depreciation is concerned with book value of assct while fluctuation is related to the market value.

ii) Depreciation refers only to the decrease while fluctuation refers to either increase or decrease.

iii) Depreciation reflects a permanent decrease while fluctuation is only a temporary phenomenon.

20.4 CAUSES OF DEPRECIATION

The causes of depreciation can be stated as follows:

1 **Wear and Tear** : Wearing out of the asset on account of its constant use is called wear and tear. This causes a definite reduction in the value of the asset and is regarded as the major source of depreciation.

2 **Lapse of Time** : Normally, the passage of time also causes some reduction in the value of fixed assets because as they become old their value stands reduced. That is why the depreciation is usually charged on time basis. In case of certain assets like least., patents, etc., the value decreases with passage of time as they generally have a fixed number of years of legal life. For example, a building is taken on lease for a period of 10 years costing Rs. 1,00,000. The yearly depreciation of lease will amount to Rs. 10,000 (1/10 of Rs. 1,00,000) and charged as such to the Profit and Loss Account every year.

3 **Obsolescence** : The acquisition of an improved *model* may render the existing machine obsolete. As the new machine performs the same operation more quickly and/or more economically existing machine is said to have become out of date or obsolete. This causes a drastic reduction in the value of existing machinery and the amount of depreciation is bound to be heavy.

4 **Depletion** : Some assets are of a wasting character. For example mines, quarries, oil wells etc. Due to continuous extraction of materials the natural resources get depleted. Depreciation, in case of such assets is often computed on the basis of actual depletion. For example, a coal mime has the coal deposits of 200 million tons. In the first year we extract 10 m. tons of coal. The depreciation in the first five years shall amount to 10/200 of the cost of mine.

On She basis of the causes mentioned above, it can be said that depreciation is a permanent and continuous reduction in the value of an assct due to wear and tear, passage of time, obsolescence, depletion or any other cause.

20.5 OBJECTIVES OF PROVIDING DEPRECIATION

You know depreciation is treated as a loss and is chargeable to the Profit and Loss Account every year. The justification for charging depreciation can be explained as follows :

1 **Ascertaining the true profits :** Depreciation represents the expired cost of a fixed assct caused by its usage in business. This cost is a part of the total expenses incurred in earning the revenue during an accounting period and must be taken into account for arriving at the correct amount of profit or loss for the period. If depreciation is not charged, the expenses and losses will be understated and the Profit and Loss Account will show higher profits making the concern pay higher taxes.

2 **Ascertaining the true cost of production :** Depreciation on machinery and other fixed assets in the factory is an important component of the cost of production specially when the unit is not labour intensive. So if no provision is made for depreciation, the cost calculations will be incorrect.

3 **Presentation of true Financial position :** The value of fixed assets reduces from year to year on account of their usage and passing of time. They must be shown in the Balance Sheet at their reduced values otherwise it will not reflect the true financial position of the business. Hence depreciation must be taken into account. It will enable the concern to show fixed assets at their proper values in the Balance Sheet.

4 **Funds for replacement of assets :** Charging depreciation reduces the profits available for distribution. It enables the concern to retain a part of its profit and thus accumulate funds for the replacement of the assets as and when necessary.

Cheek Your Progress A

1 What is depreciation?

....

....

....

....

2 How is depreciation different from amortisation?

....

....

....

....

3 State whether the following statements are True or False.

i) Depreciation is charged also on current assets. ....
ii) Profits will be overstated if depreciation is not charged. ....
iii) Expenses will be understated if depreciation is not charged ....
iv) If adequate maintenance expenditure is incurred, depreciation need not be charged. ....
v) Depreciation is charged to reduce the value of asset to its market value, ...
vi) Depreciation is charged only on the original purchase price of the asset. ....
vii) When market value of an asset is higher than book value, depreciation is not charged. ....
viii) The main cause of depreciation is wear and tear caused by its usage. ....

20.6 FACTORS INFLUENCING DEPRECIATION

The amount of depreciation to be charged to the Profit and Loss Account in respect of a particular fixed asset is affected by following factors :

1 **Cost of the asset :** Cost of the asset should include purchase price and all other costs incurred to bring the asset to usable condition like transportation costs, erection charges, etc. It is to be noted that financial charges; such as interest on loan taken for the purchase of the asset is not to be included in the original cost of an asset.

2 **Estimated working life of the asset :** The useful or economic life of the asset can be stated in terms of time i.e., years, months, hours or in terms of quantity, i.e., number of units of output or any other operating measure such as kilometres in the case of lorries, motor vans, etc.

3 **Estimated scrap** value : Scrap Value (also called salvage value, residual value) refers to the estimated amount expected to be realised when the asset is sold at the end of its useful life. While the original cost of an asset can be correctly determined, useful life and salvage value can only be estimated, based on certain assumptions.

The total amounts of depreciation to be written off during the life time of an asset is calculated as follows :

	Rs.
Total Cost of Asset	...
Less Estimated Scrap Value	...
Total amount of Depreciation to be written off during its useful life	...

For example, a machine was bought for Rs. 1,00,000 and a sum of Rs. 24,000 was spent towards its transportation and erection charges. It was estimated that the machine has a useful life of 10 years and that the residual value expected to realise at the end of its useful life is Rs. 14,000. The total amount of depreciation to be written off during the economic life of an,asset can be calculated as shown below :

	Rs.
Original cost of the asset	1,00,000
Add Transportation and erection charges	24,000
	1,24,000
Less Estimated residual value	14,000
Total amount of depreciation to be written off during its useful life	1,10,000

After determining the total amount of depreciation to be written off during the life time of an asset the next step is to decide the amount of depreciation to be charged every year. In the above situation the annual amount of depreciation to be written off may be considered as 1/10 of the total amount of depreciation because its estimated life is 10 years.

However, there are various methods of calculating the'amount of depreciation to be charged from year to year. There are discussed in Section 20.8 of this unit.

20.7 METHODS OF RECORDING DEPRECIATION.

There are essentially two methods of recording depreciation in the books of account: (1) when Provision for Depreciation Account is maintaincd. and (2) when Provision for Depreciation Account is not maintained. Under the first method, the amount of depreciation is credited to the 'Provision for Depreciation Account' every year and the concerned asset account continues to appear at its original cost. Of course, while preparing the Balance Sheet, the accumulated balance of the Provision for Depreciation Account is shown by way of deduction from the cost of the asset. Under the second method, no Provision for Depreciation Account is opened. The amount of depreciation is directly credited to the concerned asset account every Year. The asset account would thus appear in books at the depreciated value (written down value). Of course, it will be shown in the Balance Sheet giving the details of the opening balance, purchase and sale of the asset, and the depreciation provided during the year.

The following are the journal entries passed for the related transactions under the two methods.

1 When Provision for Depreciation Account is maintained

a) For charging depreciation :

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

b) For transferring depreciation to Profit and Loss Account :

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

c) When the asset is sold :

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

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

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

or

Profit and Loss Account Dr.
To Asset Account
(Being transfer of loss on sale of the asset)

2 When Provision for Depreciation Account is not maintained

a) For charging depreciation :

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

b) For transferring depreciation to Profit and Loss Account

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

c) When the asset is sold :

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

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

or

Profit and Loss Account Dr.
To Asset Account
(Being transfer of loss on sale of the asset)

A firm can adopt any method for recording depreciation, But in practice, most of the firms follow the second method under,which provision for Depreciation Account is not opened and all entries'are made directly in the concerned asset account. Hence, we shall follow this method for the treatment of depreciation.

20.8 METHODS FOR PROVIDING DEPRECIATION

As stated earlier there are various methods of calculating the amount of depreciation to be charged from year to year. Different methods are adopted to suit the nature of each asset. It is also possible that different concerns may follow different methods for depreciating the same asset, The following are the principal methods for providing depreciation.

1 Fixed Instalment Method
2 Diminishing Balance Method
3 Annuity Method .
4 Depreciation Fund Method
5 Insurance Policy Method
6 Revaluation Method
7 Depletion Method
8 Machine Hour Rate Method

Of the above eight methods used for providing depreciation, the first two viz., Fixed Instalment Method and Diminishing Balance Method are the most commonly used methods. These are taken up in this unit and the remaining method shall be discussed in Unit 21.

20.8.1 Fixed Instalment Method

This method is also called 'equal instalment method' or 'straight line method'. Under this method, a fixed and equal amount is charged as depreciation every year during the life time of an asset. When this amount of depreciation is presented on a graph paper it would show a straight line parallel to the X-axis, and hence the alternative name 'straight line method'. This method writes off a fixed percentage of the original cost of the asset every year so that the asset is reduced to zero or its salvage value at the end of its working life. The annual amount ofdepreciation to be charged under this method can be calculated with the help of the following formula :

$$\text{Annual Depreciation} = \frac{\text{Original Cost} - \text{Scrap Value}}{\text{Life of the Asset in number of years}}$$

$$\text{or } D = \frac{C - S}{N}$$

Look at Illustration 1 and see how the amount of annual depreciation has been calculated and the concerned asset account prepared from year to year.

Illustration 1

Ravikiran & Sons purchased machinery on January 1,1983 for Rs. 22,000 and spent Rs. 3,000 on its erection. The asset is expected to last for four years after which its break up value is estimated to Rs. 5,000, Find out the amount of depreciation to be charged every year and show how the Machinery Account would appear for four years assuming that the machine is sold for Rs. 1,000 at the end. Also show how the balance of Machinery Account would appear in the Balance Sheet.

Solution :

The annual depreciation is calculated as follows :

$$D = \frac{C - S}{N}$$

$$= \frac{(22{,}000 + 3{,}000) - 5{,}000}{4}$$

$$= \frac{20{,}000}{4}$$

= Rs. 5,000

Machinery' Account

Dr.					Cr.
1983		Rs.	1983		Rs.
Jan. 1	To Bank A/c	22,000	Dec. 31	By Depreciation A/c	5,000
Jan. 1	To Cash A/c .(erection charges)	3,000	" 31	By Balance c/d	20,000
		25,000			25,000
1984			1984		
Jan. 1	To Balance bld	20,000	Dec. 31	By Depreciation A/c	5,000
			" 31	By Balance c/d	15,000
		20,000			20,000
1985			1985		
Jan. 1	To Balance bld	15,000	Dec. 31	By Depreciation A/c	5,000
			" 31	By Balance cld	10,000
		15,000			15,000
1986			1986		
Jan. 1	To Balance b/d	10,000	Dec. 31	By Depreciation A/c	5.000
			" 31	By Bank A/c	1,000
			" 31	By Profit and Loss A/c (Loss on sale)	4,000
		10,000			10,000

Bnlance Sheet as on December 31, 1983

			Rs.
	Machinery	22,000	
	Add : Erection charges	3,000	
		25,000	
	Less : Depreciation	5,000	20,000

Bnlance Sheet as on December 31,1984

	Machinery	20,000	
	Less : Depreciation	5,000	15,000

Bnlance Sheet as on December 31, 1985

			Rs.
	Machinery	15,000	
	Less : Depreciation	5,000	10,000

Balance Sheet as on December 31, 1986

			Rs.
	Machinery	10,000	
	Less : Depreciation	5,000	
		5,000	
	Less : Sale proceeds	1,000	
		4,000	
	Less : Loss written off	4,000	

In practice, the purchase and sale of an asset, is a continuous exercise. Hence, you should know how the calculation of depreciation will be made in such situations and the transactions recorded in the concerned asset account. Look at Illustration 2 and study how the asset account appears in such situations.

Illustration 2

Arivind & Co. purchased a plant worth Rs. 2,00,000 on January 1, 1987, On June 30, 6987 an additional plant was bought for Rs. 50,000, On December 31,1988 a part of the plant bought on January 6, 1987 costing Rs. 4,000 was sold for Rs. 3,000,

Prepare Plant and Machinery Account for years 1987 and 1988 providing depreciations at 10% per annum on fixed instalmcnt method. The accounts are closed on December 31, every year.

Solution :

Plant and Machinery Account

Dr. Cr.

		Rs.			Rs.
1987			1987		
Jan. 1	*To Bank A/c*	[redacted]	Dec. 31	By Depreciation A/c	*22,500*
June 30	*To Bank A/c*	[redacted]	" 31	By Balance c/d	2,27,500
		[redacted]			2,50,000
1988			1988		
Jan. 1	To Balance b/d	2,27,500	Dec. 31	By Bank A/c	3,000
			" 31	By Depreciation A/c	25,000
			" 31	By P & L A/c (Loss on sale)	200
			" 31	By Balance c/d	1,99,300
		2,27,500			2,27,500

Working Notes :

1 **Depreciation for 1987**

	Rs.
On Rs. 2,00,000 for one year (10/100 of 2,00,000)	20,000
On Rs. 50,000 for six months (10/100 x 50,000 x 6/12)	2,500
	22,500

2 **Depreciation for 1988**

On Rs. 2,50,000 for one year (10/100 of 2,50,000)	25,000

3 **Loss on Sale of Plant**

Depreciated value of plant sold as an December 31, 1988 (Rs. 4,000 – Rs. 800)	3,200
Less : Sale Proceeds	3,000
Loss on Sale	200

Advantages

1 It is easily understandable and is simple to apply.
2 Amount of depreciation does not vary from year to year,
3 Under this method the book value of asset is reduced either to zero or scrap value as the case may be,

4 In this method depreciation charge spreads equally over 'the entire period of its anticipated working life. Therefore, it is considered particularly suitable for those assets which get depreciated more on account of lapse of time such as lease-holds, patents etc.,

Disadvantages

1 It does not reflect the correct charge on account of depreciation when the effective utilisation of the asset varies from year to year.
2 It does not recognise the reality that as an asset becomes older, the amount spent for repairs and renewals goes on increasing. It is common knowledge that when the asset is brand new, repair bill would be either nil or very small. But, as the machine is progressively subjected to wear and tear, the repairs bill would increase considerably. Thus the combined charge on account of depreciation and repairs will not be uniform throughout the life of the asset. The increasing repairs bill unjustifiably burden the later years of asset life with heavier combined charges.
3 It does not take into account the loss of interest on the money invested in the asset. Certain other methods (annuity method) while calculating depreciation also take interest aspect into account.

20.8.2 Diminishing Balance Method

Under this method, though the rate of depreciation is fixed, it is calculated on the written down value of the asset. Consequently the amount of depreciation to be charged goes on reducing from year to year. For example, a machine was purchased on January 1,1986 for Rs. 10,000. It is to be depreciated at 15% per annum under the diminishing balance-method. In this case, the depreciation for 1986 would be Rs. 1,500 (15% of 10,000), for 1987 it would be Rs. 1,275 (15% of 8,500), and for 1988 it would work out as Rs. 1,084 (15% of 7,225). Thus you will notice that the annual depreciation goes on reducing. Hence, it is also known as 'reducing instalment method'. This method is considered better than the fixed instalment method because with reducing instalments of depreciation the combined effect of repairs and depreciation will be more or less uniform throughout the life of the asset.

Look at Illustration 3 and see'how the amount of depreciation is computed every year and recorded in the concerned asset account.

Illustration 3

Kishore Ltd. purchased a tractor costing Rs. 1,00,000 on January 1, 1982. The rate of depreciation to be charged was fixed at 20% per annum. Write up Tractor Account for five years ending December 31, 1986, under diminishing balance method.

Tractor Account

Dr.					Cr.
1982		Rs.	1982		Rs.
Jan. 1	To Bank A/c	1,00,000	Dec. 31	By Depreciation A/c	20,000
			" 31	By Balance c/d	80,000
		1,00,000			1,00,000
1983			1983		
Jan. 1	To Balance b/d	80,000	Dec. 31	By Depreciation A/c	16,000
			" 31	By Balance c/d	64,000
		80,000			80,000
1984			1984		
Jan. 1	To Balance b/d	64,000	Dec. 31	By Depreciation A/c	12,800
			" 31	By Balance c/d	51,200
		64,000			64,000

1985			1985		
Jan. 1	To Balance bld	51,200	Dec. 31	By Depreciation A/c	10,240
			" 31	By Balance cld	40,960
		51,200			51,200
1986			1986		
Jan. 1	To Balance bld	40,960	Dec. 31	By Depreciation A/c	8,192
			" 31	By Balance c/d	32,768
		40,960			40,960

Now look at Illustration 4. It deal with the situation when additions and disposals are made during the course of the year and a part of the asset is replaced.

Illustration 4

Harinath purchased on January 1, 1984, a plant for Rs. 50,000. On July 1, 1984 an additional plant worth Rs. 20,000 was purchased and on July 1, 1985, the plant purchased on January 1, 1984 having become obsolete is sold off for Rs. 20,000. On July 1, 1986, a new plant was purchased for Rs. 60,000 and the plant purchased on July 1, 1984 was sold for Rs. 15,000. Depreciation is to be provided at 10% p.a. on the written down value every year. Show the Plant Account.

Plant Account

Dr.					Cr.
1984			1984		Rs.
Jan. 1	To Bank A/c	50,000	Dec. 31	By Depreciation A/c	6,000
July 1	To Bank A/c	20,000	31	By Balance cld	64,000
		70,000			70,000
1985			1985		
Jan, 1	To Balance bld	64,000	July 1	By Bank A/c	20,000
			Dec. 31	By P & L A/c (loss on sale)	22,750
			" 31	By Depreciation A/c	4,150
			" 31	By Balance cld	17,100
		64,000			64,000
1986			1986		
Jan. 1	To Balance b/d	17,100	July 1	By Bank A/c	15,000
July 1	To Bank A/c	60,000	Dec. 31	By P & L A/c (loss on sale)	1,245
			" 31	By Depreciation A/c	3,855
			" 31	By Balance c/d	57,000
		77,100			77,100

Working Notes:

1 **Depreciation tor 1984**

	Rs.
10% on Rs. 50,000 for one year	5,000
10% on Rs. 20,000 for six months	1,000
	6,000

2 **Depreciation for 1985**

10% on Rs. 45,000 for six months (upto June 30, 1985)	2,250

10% on Rs. 19,000 for one year	1,900
	4,150

3. Loss on plant sold on July 1, 1985

Depreciated value as on 1985	
50,000 − 5,000 − 2,250	42,750
Less : Sale proceeds	20,000
Loss on sale	22,750

4. **Depreciation for 1986**

10% on Rs. 37,100 for six months	855
10% on Rs. 60,000 for six months	3,000
	3,855

5. Loss on plant sold **on July 1, 1986**

Depreciated value as on 1.7.1986	
20,000 − 1,000 − 1,900 − 855	16,245
Less : Sale proceeds	15,000
Loss on sale	1,245

Advantages

This method is also simple to understand and easy to follow, though calculation of depreciation is slightly complicated. It ensures a fairly even charge to Profit and Loss Account on account of both depreciation and repairs. This is possible because the amount of depreciation decreases year after year while the charge for repairs goes on increasing year after year.

Disadvantages

One of the important limitations of this method is that the value of an asset cannot be brought down to zero. Hence, even after the asset is put out of use it may have, certain book value. This method also does not take into account the loss of interest on the money invested in the asset. The determination of a suitable rate of depreciation is also difficult under this method. The formula generally used for this purpose is as follow :

$$\text{Rate of Depreciation} = 1 - \sqrt[n]{\frac{\text{Scrap Value}}{\text{Original Cost}}}$$

This looks quite complicated as compared to the fixed instalment method.
This method is considered suitable for assets like plant and machinery where the repairs are insignificant in earlier years but increase considerably in later years. It is popularly known as 'written down value method' because the depreciation is computed on the written down value every year. There are however, other methods of computing depreciation under the diminishing balance method such as 'sum of year digits method' and 'double declining balance method'. These are also called accelerated depreciation method, because under all these methods the amount of depreciation charged in earlier years is more compared to that of the later years.

20.8.3 Difference between Fixed Instalment Method and Diminishing Balance Method

The difference between the fixed instalment method and the diminishing balance method can be summarised as follows :

Fixed Instalment Method	Diminishing Balance Method
1 Depreciation is calculated on the original cost.	Depreciation is calculated on the written down value.
2 Depreciation instalment is the same every year.	Depreciation instalment goes on reducing every year.
3 The balance in the asset account will reduce to zero at the expiry of the working life of the asset.	The balance in the asset account will never reduce to zero.
4 The combined cost on account of depreciation and repairs is low during the initial years and high during later years.	The combined cost on account of depreciation and repairs is more or less equal throughout.
5 Calculation of the rate of depreciation is easy.	Calculation of the rate of depreciation is difficult.
6 It is suitable for assets which get depreciated more on account of the expiry of time.	It is suitable for assets which require heavy repairs in later years of their working life.

Check Your Progress B

1 List the factors influencing the amount of depreciation.

....

....

....

....

2 Name various methods of computing depreciation.

....

....

....

....

3 State whether the following statements are True or False,

i) Depreciation is a temporary change in the value of an asset. ....

ii) While calculating depreciation, the scrap value (salvage value) must be taken into account. ....

iii) Under fixed instalment method of providing depreciation the combined effect of repairs and depreciation is uniform over the year. ....

iv) Under the diminishing balance method it would be possible to reduce the value of an asset to zero. ....

v) The interest involved in the investment on assets purchased is ignored under both the fixed instalment and the diminishing balance methods. ....

vi) When a Provision for Depreciation Account is maintained, the asset is shown at the original cost in the Balance Sheet. ....

20.8.4 Change of Method

Sometimes a firm may decide to change the method of depreciation it had adopted i.e., it may change the method of depreciation from fixed instalment method to reducing instalment method or vice versa. If it decides to implement the change with prospective effect, there is no problem because no adjustment is necessary in respect of depreciation charged in earlier years. All that is necessary is to charge depreciation from that year onwards according to the new method decided, However, when it is decided to change the method with retrospective effect i.e., with effect from a prior date (usually from the date of acquisition of an asset) it would be necessary to adjust the depreciation charged till date. Suppase a firm was depreciating its machinery under the fixed instalment method during the past three years. It has now decided to change the method to written down value method with retrospective effect. In such a case it would be necessary to take the following steps :

1 Calculate the amount of depreciation already charged till the date of change according to old method.

2 Calculate the amount of depreciation that would have been charged under the new method now proposed to be adopted.
3 If the amount of depreciation under the new method is more than what was charged under the old method, such difference should be credited to the asset account in current year and debited to the Profit and Loss Account.
4 If, on the other hand, the amount of depreciation under the new method is less than what was charged under the old method such a difference should be debited to the asset account in current year and credited to the Profit and Loss Account.
5 As the difference in depreciation amount is adjusted to the current value of asset in the asset account, the asset account will appear at its new value, from the date of change and depreciation will be charged according to the new method in subsequent years.

Look at Illustration 6. It will help you to clearly understand the procedure to be followed when a change of method is desired with retrospective effect.

Illustration 5

Sharat & Sons purchased a car for Rs. 1,00,000 on January 1,1983. The car was depreciated at 10% under the written down value method. On January 1, 1986 they wanted to change the method of depreciation from reducing instalment method to straight line method without changing the rate. Show the asset account from 1983 to 1.986.

Solution :

Car Account

Dr.					Cr.
1983		Rs.	1983		Rs.
Jan. 1	To Bank A/c	1,00,000	Dec. 31	By Depreciation A/c	10,000
			" 31	By Balance c/d	90,000
		1,00,000			1,00,000
1984			1984		
Jan. 1	To Balance b/d	90,000	Dec. 31	By Depreciation A/c	9,000
			" 31	By Balance cld	81,000
		90,000			90,000
1985			1985		
Jan. 1	To Balance b/d	81,000	Dec. 31	By Deprecintion A/c	8,100
			" 31	By Balance c/d	72,900
		81,000			81,000
1986			1986		
Jan. 1	To Balance b/d	72,900	Dec. 31	By P & L A/c (dif.)	2,900
			" 31	By Depreciation A/c	10,000
			" 31	By Balance c/d	60,000
		72,900			72,900
1987					
Jan. 1	To Balance bld	60,000			

Notes : 1 If the firm had followed the fixed instalment method right from the beginning (1.1.1983), the value of car as on 1.1.1986 would be Rs. 70,000 worked out as follows :

Original cost	1,00,000
Less : Depreciation for years at Rs. 10,000 p.a. (10% of 1,00,000)	30,000
Value of Car as on 1.1.86	70,000

But from the Car Account you find that the opening balance on 1.1.1986 is Rs. 72,900..This means that under the written down value method the amount of depreciation charged during the three years was Rs. 27,100 (1,00,000 – 72,900) as against Rs. 30,060 required under the fixed instalment method. Hence, the difference between the two amounts i.e., Rs. 2,900 (30,000 – 27,100) must be charged as additional depreciation so as to adjust the asset account.

2 The depreciation to be charged for the year 1986 would be Rs. 10,000 i.e., 10% on Rs. 1,00,000 as required under the fixed instalment method. From this year onwards Rs. 10,000 will be charged as depreciatian every year.

20.9 LET US SUM UP

Depreciation is a permanent and gradual diminution in the value of an asset caused by' usage and effluxion of time.

It represents the expired cost of a fixed asset which must be charged to the Profit and Loss Account and deducted from the value of the asset concerned. Unless it is; so treated, the Profit and Loss Account will not show true profit or loss for the year and the Balance Sheet will not reflect the correct financial position.

The amount of depreciation to be charged is determined by taking into account : (i) the cost of asset, (ii) the estimated useful life, and (iii) the estimated salvage value.

There are essentially two methods of recording the depreciation in books of a account (i) By maintaining a Provision for Depreciation Account, and (ii) Without maintaining a Provision for Depreciation Account.

When a provision for Depreciation Account is maintained the depreciation is credited to this account from year to year. Its accumulated balance is transferred to the asset account only at the end of the life of the asset or when the same is sold. But when provision for Depreciation Account-is not maintained, the depreciation is directly credited to the asset account every year. Of course, in the Balance Sheet the asset will always be shown at the depreciated value.

There are various methods of calculating the amount of depreciation. Of these, the two most common method? are : (i) fixed instalment method, and (ii) diminishing balance method. Under the fixed instalment method an equal amount is charged as depreciation year after yearwhile under the diminishing balance method the amount of depreciation goes on reducing year after year. Both have their merits and demerits, But, the diminishing balance method is considered better because the combined cost on account of depreciation and repairs is uniformly distributed over the working life of an asset. Although the amount of depreciation under these two methods differ, the method of recording it in the books of account is the same.

Sometimes, a concern may decide to change the method of depreciation. If the change is to take effect from current years, it does not involve much problem. But if it is with retrospective effect, it would require the calculation of depreciation according to both the methods and the difference will have to be adjusted before the depreciation can be charged accarding to changed method.

20.10 KEY WORDS

Amortisation : Writing off the expired cost of an intangible asset.
Depreciation : Permanent and gradual diminution in value of a fixed asset.
Obsolescence : Becoming out of date, a cause for depreciation in value of asset.
Residual Value : Expected realisable amount, when the asset is sold out at the end of its useful life,
Salvage **Value :** Same as residual or scrap value.
Written Down Value : Book value of an asset after deducting depreciation from the original cost. It is also called depreciated value.

20.11 SOME USEFUL BOOKS

Gupta R.L and M. Radhaswamy, 1986. *Advanced Accountancy*, Volume 1, Sultan Chand & Sons, New Delhi. (Chapter 3 Section II)

Maheshwari S.N. 1986. *Introduction to Accounting*, Vikas Publishing House : New Delhi. (Chapter 13)

Patil, V.A. and J.S. Korlahalli, 1986. *Principles and Practice of Accounting*, R. Chand & Co., New Delhi. (Chapter 4 Volume II)

Shukla, M.C. and T.S. Grewal, 1987. *Advanced Accounts*, S. Chand & Co., New Delhi. (Chapter 7)

William Pickles. 1982. *Accountancy*, E.L.B.S. and Pitman, London. (Chapter 7)

20.12 ANSWERS TO CHECK YOUR PROGRESS

A 3 i) False ii) True iii) True iv) False
v) False vi) False vii) False viii) True

B 3 i) False ii) True iii) False iv) False
v) True vi) False.

20.13 TERMINAL QUESTIONS/EXERCISES

Questions

1 Define depreciation. Distinguish it from depletion, amortisation and obsolescence.
2 Explain the need and significance of depreciation. What factors should he considered for determining the amount of depreciation?
3 Enumerate the methods of calculating depreciation. Discuss the advantages and disadvantages of fixed instalment method.
4 What are the merits and demerits of written down value method? Distinguish it from the straight line method.
5 Describe the methods of recording depreciation in books of account:. How is the balance of the Provisions for Depreciation Account shown in the Balance Sheet?

Exercises

1 A cold storage plant was purchased on July 1, 1980 for Rs. 1,00,000. Show the plant Account under (a) the Straight Line Method and (b) the Written Down Value Method. Rate of depreciation charged is 20%. What is the balance of plant at the end of the third year?

(**Answer** : Balance at the end of the third year (a) under Straight Line Method : Rs. 40,000; and (b) under Written Down Value Method : Rs. 51,200)

2 Suresh purchased plant and machinery far Rs. 50,000 on July 1, 1983. The asset was to be depreciated at the rate of 10 per cent per annum on written down value basis. The machinery was sold on January 1, 1987 for Rs. 32,000. Write up Machinery Account assuming accounting year to end on December 31 every year.

(**Answer** : Loss on sale Rs. 2,627)

3 On 1-8-1983, a machine was purchased by a manufacturing concern for Rs. 60,000 and it spent for its overhaul and installation Ks. 10,000. Its effective life was estimated to be ten years and residual value at the end of its life time was estimated to be Rs. 10,000.
Show Machine Account for the first three years assuming that the concern decided to depreciate it under the fixed instalment method. The accounting year ends on December 31.

(**Answer** : Balance of Machine Accounts as on January 1, 1986: Rs. 55,000)

4 Ashok Ltd. has bought machinery for Rs. 1,00,000 including a boiler worth Rs. 10,000. The Machinery Account hut! been credited for depreciation on the written down value method for the past four years at the rate of 10%. During the fifth year the boiler became useless on account of damage to some of its vital parts; the damaged boiler is sold for Rs. 5,000. Write up the Machinery Account.

(Answer : Loss on sale of machinery Rs. 1,561; Balance of Machinery Account as at the end of fifth year Rs. 59,049.)

5 Navrang & Co., whose accounting year is the calendar year, purchased machinery costing Rs. 60,000 on July 1, 1984. It purchased further machinery on September 1, 1984 costing Rs. 30,000.
On January 1, 1986 one-third of the Machinery installed on June 1, 1984 became obsolete and was sold for Rs. 5,000.
Depreciation is being written off on fixed instalment system at 10% per annum.
Prepare the machinery account as would appear in the ledger of the company for the years 1984, 1985 and 1486.

(Answer : Balance of Machinery Account as on January 1, 1987 : Rs. 53,000).

6 On October 1, 1983 Raghavan & Sons purchased machinery for Rs. 30,000 and spent Rs. 3,000 on installing it. On January 1, 1984, the firm purchased another machinery fur Rs. 20,000. On June 30, 1985 the machinery purchased on January 1, 1984 was sold for Rs. 16,000 and on the same date a fresh plant was installed at a cost of Rs. 25,000.

The company writes off 10% depreciation on the diminishing balance method. The accounts are closed every year on December 31. Show the Machinery account for the years 1983, 1984 and 1985.

(Answer : Balance of Machinery Account as on January 1, 1987 : Rs. 39,950)

7 On July 1, 1980, a company purchased a plant for Rs. 2,00,000. Depreciation was provided at 10% per annum on straight line method on December 31, every year. With effect from January 1, 1982 the company decided to change the method of depreciation to diminishing balance method @ 15% per annum with retrospective effect. On July 1, 1983, the plant was sold for Rs. 1,20,000. Prepare Plant Account from 1980 to 1983).

(Answer : Loss on sale of plant : Rs. 3,637.

8 Work out problem No. 7 assuming that (a) the asset was originally depreciated on written down value method at 20% and that (b) now it is desired to change the method to fixed instalment method with retrospective effect, rate of depreciation remaining same.

(Answer : Profit on sale of plant Rs. 40,000).

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

UNIT 21 DEPRECIATION – II

Structure

21.0 OBJECTIVES

After studying this unit you should be able to :

- compute the amount of depreciation upder various methods of providing depreciation
- prepare accounts under different methods of providing depreciation
- identify the method of providing depreciation for various fixed assets.

21.1 INTRODUCTION

In Unit 20 you learnt how depreciation is trqated in the books of account and what are the various methods of providing depreciation. In that unit we discussed the two most important methods viz., (i) fixed instalment method and (ii) diminishing balance method. In this unit we shall take up the remaining methods of providing depreciation and study their main features, merits, demerits and the accounting treatment.

21.2 ANNUITY METHOD

The amount invested in an asset has an opportunity cost i.e., if that amount had been invested in some other form it would have earned some interest. The fixed instalment and the diminishing balance methods ignore such cost. Normally depreciation does not take such lass of interest into account. But in some cases it is codsidered desirable to include it. For example, when-some property is taken on lease we have to pay a lump sum amount at the initial stage and then a nominal amount as rent every year, The amount paid at the initial stage is a sort of advance payment of rent. It is treated as the cost of lease and written off duting the lease period by way of providing depreciation.

In such a situation, the loss of interest on advance payment must also be treated as a part of the cost of using the asset: The method by which the interest is also included in the amount of depreciation is known as Annuity Method. This method is usually employed for providing depreciation on leasehold property. But it can also be used far other fixed assets provided it is decided to account for the loss of interest on the account invested in the asset.

Under this method the interest is calculated on the opening balance of the asset each year and debited to the asset account, credit being given to interest Account. As

depreciation is to be inclusive of interest, the amount of depreciation charged every year is higher than what it would have been under any other method. Although the amount of interest varies **from** year to year (it goes on decreasing) the instalment **of** depreciation is uniform which is **computed** with reference to the annuity table. Which is given below :

Annuity Table
Amount *required* to write off Re. 1 *by* Annuity *Method*

Years	10 per cent	11 per cent	12 per cent	13 per cent	14 per cent	15 per cent
1	1.1000000	1.1100000	1.1200000	1.1300000	1.1400000	1.1500000
2	0.5761902	0.5839335	0.5916978	0.5994833	0.6072896	0.6151161
3	0.4021148	0.4092129	0.4163489	0.4235218	0.4307314	0.4379709
4	0.3154707	0.3223262	0.3292344	0.3361941	0.3432047	0.3502653
5	0.2637974	0.2705702	0.2774096	0.2843145	0.2912835	0.2983155
6	0.2296073	0.2363765	0.2432257	0.2501532	0.2571574	0.2642369
7	0.2054054	0.2122152	0.2191177	0.2261107	0.2331923	0.2403603
8	0.1874439	0.1943210	0.2013028	0.2083866	0.2155700	0.2228500
9	0.1736405	0.1806016	0.1876788	0.1948688	0.2021683	0.2095740
10	0.1627453	0.1698014	0.1769841	0.1842895	0.1917135	0.1992520

Let us take an **illustration** to see **how** the amount of depreciation is determined by **referring** to the annuity table. Suppose a lease has been **taken** for Rs. **10,000** for **5** years. It is decided to charge **depreciation** under annuity method, interest being calculated at 12% per **annum**. Refer to **the** 'years' **column and** move down up to fifth year. Now **move** horizontally towards the right to read the figure under 12% column which is **0.2774096.** It **means** that to **write** off Pie. 1, which earns interest at 12% per annum, must be depreciated by **(4.2774096each year** for five years. Since the amount to be written off is Rs. 10,000 the annual depreciation **would** be Rs. 10,000 × **0.2774096 = Rs. 2774.096. You** can take it as Ks. **2,774** (approximately).

Look at **Illustration** 1 aria see how the asset account would be prepared under annuity **method.**

Illustration 1

A company acquires a lease costing Ks. **1,00,000** for a term of five years. You find from the Annuity Table that in order to write **off** the lease on the annuity method at 13% per **annum** interest, the amount to be **written** off annually **works** out to be Rs. **0.2843145** for **every rupee.** Prepare the Lease Account for all the five years and **show** the annual charge to Profit and Loss **Account** during each of these five years.

Solution :

Lease Account

Dr.					Cr.
I year		Rs.	I year		Rs.
Jan. 1	To Bank	1,00,000	Dec. 31	By Depreciation A/c	28,431
Dec. 31	To Interest A/c	13,000	" 31	By Balance c/d	84,569
		1,13,000			1,13,000
II year					
Jan. 1	To Balance b/d	84,569	Dec. 31	By Depreciation A/c	28,431
Dec. 31	To Interest A/c	10,994	" 31	By Balance c/d	67,132
		95,563			95,563
III year					
Jan. 1	To Balance b/d	67,132	Dec. 31	By Depreciation A/c	28,431
Dec. 31	To Interest A/c	8,727	" 31	By Balance c/d	47,428
		75,859			75,859

IV year						
Jan. 1	To Balance b/d	47,428	Dec. 31	By Depreciation A/c	28,431
Dec. 31	To Interest A/c	6,165	31	By Balance c/d	25,162
		53,593			53,593
V year					
Jan. 1	To Balance b/d	25,162	Dec. 31	By Depreciation A/c	28,431
Dec. 31	To Interest A/c	3,269			
		28,431			28,431

Notes : 1 The annual charge on account of depreciation has been worked out as follows:

Rs. 1,00,000 x 0.2843145

= Rs. 28,431.45

This has been rounded off to Rs. 28,431.

2 Interest debited to the asset account every year has also been rounded off to the nearest rupees.

3 On account of these approximations, the actual amount of interest to be taken into account in the last year works out to Rs. 3,269 as against Rs. 3,271.

You know that depreciation is debited to the Profit and Loss Account. When you prepare the Interest Account, the amount of interest debited to the asset account will be credited to this account. This will ultimately be transferred to the Profit and Loss Account. Thus each year the Profit and Loss Account will have debit in respect of depreciation and credit in respect of interest. This will, in effect, reduce the net charge (debit) to the Profit and Loss Account to the level of depreciation based on **original** cost. Look at the following statement which shows the net charge to Profit and Loss Account.

Statement Showing the Amount Chargeable to P & L Account

Year	Depreciation (debited) Rs.	Interest (credited) Rs.	Net charge against profits Rs.
I	28,431	13,000	15,431
II	28,431	10,994	17,437
III	28,431	8,727	19,704
IV	28,431	6,165	22,266
V	28,431	3,269	25,162
	1,42,155	42,155	1,00,000

From the above table it is clear that the net charge to Profit and Loss Account increases year after year even though the depreciation is a fixed sum. This is **because** of the interest amount decreases year after year. However, the total net charge to Profit and Loss Account is equal to the cost of lease.

Merits and Demerits

The annuity method has the merit of considering the amount invested in the purchase of an asset as an investment capable of earning some interest. However, when additions are made to the asset, fresh computations have to be made and the calculation becomes difficult. Another limitation of this method arises on account of debiting the asset account with interest. This increases the book value of asset particularly in the initial years. As stated earlier, this method is generally used for leases in respect of which a lumpsum payment is made in advance.

21.3 DEPRECIATION FUND METHOD

None of the methods discussed so far ensure the provision of necessary funds fur replacement of asset at the end of its useful Rife. It is so because the amount of depreciation charged results in conserving the resources, but such resources join the mainstream and lose their independent identity. Actual replacement of the asset requires liquid funds and preferrably such funds should he provided without disturbing the working capital of the business. Depreciation Fund method, also known as 'Sinking Fund Method' takes care of this aspect and ensures that funds are provided for replacement of the asset. Under this method an amount equal to depreciation is taken out of business and invested in some outside securities carrying a particular rate of interest. At the end of the useful life of the asset such securities are sold out and with the funds so realised the new asset can be conveniently purchased.

As the amount invested in securities earns some interest it will not be necessary to write off the full amount of the cost of asset as depreciation. The total depreciation written off and the interest earned on securities together will be equal to the original cost of the asset. Hence, depreciation charged under this method will be lower as compared to other method.

Under this method the amount required for investment annually at a given rate of interest for a given number of years can be determined by referring to Sinking Fund Table.

Sinking Fund Table
Periodic deposit which will amount cb Re. 1

Years	10 per cent	11 per cent	12 per cent	13 per cent	14 pel. rent	15 per cent
1	1.0000000	1.0000000	1.0000000	1.0000000	1.0000000	1.0000000
2	0.4761904	0.4739336	1.0000000	1.0000000	0.4672897	0.4651162
3	0.3021148	0.2992130	0.4716981	0.4694835	0.2907314	0.2879769
	0.3021148	0.2992130	0.2963489	0.2935219	0.2032048	0.2002653
	[illegible]	[illegible]	[illegible]	[illegible]	0.1512835	0.1483155
6	0.1296073	[illegible]	[illegible]	[illegible]	0.1171575	0.1142369
7	0.1054054	[illegible]	[illegible]	[illegible]	0.0931923	0,0903603
8	0.0874440	0.084321.0	[illegible]	[illegible]	0.0755700	0.0728500
9	0.0736405	0.0706016	[illegible]	[illegible]	0.0621683	0.0595740
10	0.0627453	0.0598014	[illegible]	[illegible]	0.0517135	0.0492520
			0.0569841	0.0542895	(	

Supp6 n amount of Rs. 20,000 is to be written off over a period of three years and it is c ed to invest the depreciation amount in securites yielding *14%* interest per annu7 hen the amount to be written off every year is determined as explained belo8

Loca9 the years column the relevant figure for three years under 14% and you find 10 e Re. 0.2907314. This means if Re. 0.2907314 is invested each year at 14% per annum, it will accumulate to Re. 1 at the end of three years. As Rs. 20,000 is required to be written off, the depreciation amount to be charged every year is calculated as under :

Re. 0.2907314 × 20,000 = Rs. 5,814.628, say Rs. 5,815 (approximately).

Under this method a fixed amount as calculated above is charged every year as depreciation by debiting it to the Profit and Loss Account and crediting it to the Depreciation Fund Account. You should note that the asset account is not credited with the amount of depreciation as in the case of other methods.

The asset account appears at its original cost till the last year of its useful life. Every year an amount equal to depreciation is invested in some outside securities. These investments accumulate at compound interest and make available adequate funds for replacement of the worn out asset. In the last year of the life of the asset the balance in Depreciation Fund Account is transferred to asset account and thus the accounts will be closed (after due adjustment in respect of profit or loss on sale of investment).

The following journal entries are passed when this method is followed :

1 At the end of 1st year:

a) For depreciation instalment
Depreciation A/c Dr.
To Depreciation Fund A/c

b) For investing the amount equal to depreciation
Depreciation Fund Investment A/c Dr.
To Bank A/c

2 At the end of 2nd year and subsequent years :
(up to the last but one year)

a) For depreciation instalment
Depreciation A/c Dr.
To Depreciation Fund A/c

b) For receipt of interest on investment
Bank A/c Dr.
To Depreciation Fund A/c

c) For investing the amount (depreciation and interest) in securities
Depreciation Fund Investments A/c Dr.
To Bank A/c

3 At the end of the last year

a) For depreciation instalment
Depreciation A/c Dr.
To Depreciation Fupd A/c

b) For receipt of interest on investment
Bank A/c Dr.
To Depreciation Fund A/c

c) For sale of investments
Bank A/c Dr.
To Depreciation Fund Investments A/c

d) For profit on sale of investments :
Depreciation Fund Investments A/c Dr.
To Depreciation Fund A/c

OR

For the loss on sale of investments
Depreciation Fund A/c Dr.
To Depreciation Fund Investments A/c

e) For transferring the balance of Depreciation Fund A/c
Depreciation Fund A/c Dr.
To Depreciation Fund Investments A/c

f) For sale of Asset if it has some residual value :
Bank A/c Dr.
To Asset A/c

g) For transferring debit balances in the Asset account, if any
Profit and Loss A/c Dr.
To Asset A/c

You should also note the following points in this regard.

1 At the end of every year the debit balance on Depreciation Account representing total amount of depreciation charged on all fixed assets will be transferred to the Profit and Loss Account with the help of the following entry :

Profit and Loss A/c Dr.
To Depreciation A/c

2 Usually the annual charge of depreciation and interest received are rounded off to the nearest rupee with a view to simplify the calculations,.

3 Sometimes, the interest is received half yearly. In such a situation, the entries for receipt of interest on investments and investing the amount of interest in securities, will have to be passed twice a year.

Look at Illustrations 2 and 3 and see how the relevant accounts are prepared under Depreciation Fund Method.

Illustration 2

Satish Ltd. purchased a four years lease on January 1, 1983 for Rs. 1,00,000. It is decided to provide for the renewal of the lease at the end of the four years by setting up a depreciation fund. It is expected that investments will fetch interest at 10% per annurn. Sinking Fund tables show that the 0.2154708 invested each year will produce Re. 1 at the end of four years at 10% per annuni.

On December 31, 1986, the depreciation fund investments are sold for Rs. 70,000. Pass the necessary journal entries and prepare the ledger accounts. Also show how these accounts are shown in the Balance Sheet.

Solution :

Journal of Satish Ltd.

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1983			Rs.	Rs.
Jan. 1	Lease A/c Dr. To Bank A/c (Being lease taken for four years)		1,00,000	 1,00,000
Dec. 31	Depreciation A/c Dr. To Depreciation Fund A/c (Being depreciation written off)		21,547	 21,547
" 31	P & L A/c Dr. To Depreciation A/c (Being depreciation charged to P & L A/c)		21,547	 21,547
" 31	Dep. Fund Investment A/c Dr. To Bank A/c (Being dep, amount invested)		21,547	 21,547
1984 Dec. 31	Depreciation A/c Dr. To Dep. Fund A/c (Being depreciation written off)		21,547	 21,547
" 31	P & L A/c Dr. To Depreciation A/c (Being dep. charged to P&L A/c)		21,547	 21,547
" 31	Bank A/c Dr. To Dep. Fund A/c (Being interest received on DF investments)		2,155	 2,155

Dec. 31	Dep. Fund Investment Nc To Bank A/c (Being amount of interest and depreciation invssted')	Dr.	23,702	23,702
1985 Dec. 31	Depreciation A/c To Dep. Fund A/c (Being dep. written off)	Dr.	21,547	21,547
" 31	P & L A/c To Depreciation A/c (Being dep. charged to P & L A/c)	Dr.	21,547	21,547
" 31	Bank A/c To Dep. Fund A/c (Being interest received on DF investments)	Dr.	4,525	4,525
" 31	Dep. Fund Investment A/c To Bank A/c (Reing interest and Dep. invested)	Dr.	26,072	26,072
1986 " 31	Depreciation A/c To Dep. Fund A/c (Being depreciation written off)	Dr.	21,547	21,547
" 31	P & L A/c To Depreciation A/c (Being dep. charged to P & L A/c)	Dr.	21,547	21,547
" 31	Bank A/c To Dep. Fund A/c (Being interest received on DF Inv.)	Dr.	7,132	7,132
" 31	Bank A/c To Dep. Fund Investment A/c (Being DF Investment sold)	Dr.	70,000	70,000
" 31	Dep. Pund A/c To Dep. Fund Investment A/c (Being loss on sale of DF Investment)	Dr.	1,321	1,321
" 31	Dep. Fund A/c To Lease A/c (Being the balance of dep. fund transferred)	Dr.	98,679	98,679
" 31	P & L A/c To Lease A/c (Being the debit balance on Lease A/c transferred)	Dr.	1,321	1,321

Lease Account

Dr.					Cr.
1983		Rs.	1983		Rs.
Jan. 1	To Bank A/c	1,00,000	Dec. 31	By Balance c/d	1,00,000
1984 Jan. 1	To Balance b/d	1,00,000	1984 Dec. 31	By Balance cld	1,00,000
1985 Jan. 1	To Balance b/d	1,00,000	1985 Dec. 31	By Balance c/d	1,00,000

1986 Jan. 1	To Balance b/d	1,00,000	1986 Dec. 31	By Depreciation Fund A/c	98,679
			" 31	By P & L A/c (loss)	1,321
		1,00,000			1,00,000

Depreciation Fund Account

		Rs.			Rs.
1983 Dec. 31	To Balance c/d	21,547	1983 Dec. 31	By Depreciation A/c	21,547
1984 Dec. 31	To Balance b/d	45,249	1984 Jan. 31	By Balance b/d	21,547
			Dec. 31	By Bank A/c	2,155
			" 31	By Depreciation A/c	21,547
		45,249			45,249
1985 Dec. 31	To Balance b/d	71,321	1985 Jan. 31	By Balance b/d	45,249
			Jan. 3.1	By Bank A/c	4,525
			Dec. 31	By Depreciation	21,547
		71,321			71,321
1986 Dec. 31	To Depreciation Fund Investment A/c	1,321	1986 Jan. 1	By Balance b/d	71,321
			Dec. 31	By Bank A/c	7,132
" 31	To Lease A/c	98,679	" 31	By Depreciation A/c	21,547
		1,00,000			1,00,000

Depreciation Fund Investments Account

		Rs.			Rs.
1983 Dec. 31	To Bank A/c	21,547	1983 Dec. 31	By Balance c/d	21,547
1984 Jan. 1	To Balance b/d	21,547	1984 Dec. 31	By Balance c/d	45,249
Dec. 31	To Bank A/c	23,702			
		45,249			45,249
1985 Jan. 1	To Balance b/d	45,249	1985 Dec. 31	By Balance c/d	71,321
Dec. 31	To Bank A/c	26,072			
		71,321			71,321
1986 Jan. 1	To Balance b/d	71,321	1986 Dec. 31	By Bank A/c (sale)	70,000
			Dec. 31	By Depreciation Fund A/c (loss on sale)	1,321
		71,321			71,321

Balance Sheet as on December 31, 1983

	Rs.		Rs.
Depreciation Fund	21,547	Lease Depreciation Fund Investments	1,00,000 21,547

Balance Sheet as on December 31, 1984

	Rs.		Rs.
Depreciation Fund	45,249	Lease Depreciation Fund Investments	1,00,000 45,249

Balance Sheet as on December 31, 1985

	Rs.		Rs.
Depreciation Fund	71,321	Lease Depreciation Fund Investments	1,00,000 71,321

Balance Sheet as on December 31,1989

	Rs.		Rs.
		Lease Less Depreciation Fund Investments	1,00,000 1,00,000

Note : Depreciation Fund balance can also be shown as a deduction from asset value in the Balance Sheet.

Illustration 3

Ramesh bought a plant on January 1,1982 for a sum of Rs. 50,000 having a useful life of 5 years. The estimated scrap value of the plant was Rs. 8,000. Ramesh decided to charge depreciation according to depreciation fund method. The investment expected to earn interest @ 5% p.a. Sinking fund table showed that Re. 0.180975 if invested yearly at 5% p.a. would produce Re. 1 at the end of 5 years. The investment were sold at the end of 5th year for Rs. 32,500. The asset was sold and its scrap released Rs. 8,500.

Prepare necessary ledger accounts in the books of Ramesh.

Solution :

Plant Account

Dr. Cr.

		Rs.			Rs.
1982 Jan. 1	To Bank A/c	50,000	1982 Dec. 31	By Balance c/d	50,000
1983 Jan. 1	To Balance b/d	50,000	1983 Dec. 31	By Balance c/d	50,000
1984 Jan. 1	To Balance b/d	50,000	1984, Dec. 31	By Balance c/d	50,000
1985 Jan. 1	To Balance b/d	50,000	1985 Dec. 31	By Balance c/d	50,000
1986 Jan. 1 Dec. 31	To Balance b/d To P & L A/c (Profit on sale of asset)	50,000 239	1986 Dec. 31 " 31	By Dep. Fund A/c By Bank A/c (sale)	41,739 8,500
		50,239			50,239

Depreciation Fund Account

Dr.					Cr.
1982		Rs.	1982		Rs.
Dec. 31	To Balance c/d	7,601	Dec. 31	By Depreciation A/c	7,601
1983			1983		
Dec. 31	To Balance c/d	15,582	Jan. 1	By Balance b/d	7,601
			Dec. 31	By Bank A/c	380
			" 31	By Depreciation A/c	7,601
		15,582			15,582
1984			1984		
Dec. 31	To Balance c/d	23,962	Jan. 31	By Balance b/d	15,582
			Dec. 31	By Bank A/c	779
			" 31	By Depreciation A/c	7,601
		23,962			23,962
1985			1985		
Dec. 31	To Balance c/d	32,761	Jan. 1	By Balance b/d	23,962
			Dec. 31	By Bank A/c	1,198
			" 31	By Depreciation A/c	7,601
		32,761			32,761
1986			1986		
Dec. 31	By D.F. Investment A/c (Loss transferred)	261	Jan. 31	By Balance b/d	32,761
" 31	By Plant A/c (accumulated depreciation)	41,739	Dec. 31	By Hank A/c	1,638
			" 31	By Depreciation A/c	7,601
		42,000			42,000

Depreciation Fwd Investment Account

Dr.					Cr.
1982		Rs.	1982		Rs.
Dec. 31	To Bank Nc	7,601	Dec. 31	By Balance c/d	7,651
1983			1983		
Jan. 1	To Balance b/d	7,601	Dec. 31	Ry Balance c/d	15,582
Dec. 31	To Bank A/c				
		[illegible]			15,582
1984			1984		
Jan. 1	To Balance b/d	15,582	Dec. 31	By Balance c/d	23,962
Dec. 31	To Bank A/c	8,380			
		23,962			23,962
1985			1985		
Jan. 1	To Balance b/d	23,962	Dec. 31	Ey Balance c/d	32,761
Dec. 31	To Bank A/c	8,799			
		32,761			32,761
1986			1986		
Jan. 1	To Balance b/d	32,761	Dec. 31	By Bank A/c	32,500
				By Dep. Fund A/c (loss transferred)	261
		32,761			32.761

Merits and Demerits

The main advantages of this method is that it provides the firm with necessary funds required for replacing the asset. If the amounts were not invested outside the business and accumulated, the withdrawal of funds from regular business operations would have crippled the normal financial working of the business. The disadvantage however, is that the combined charge of depreciation and repairs will not be uniform throughout the life of an asset. This method is used in respect of assets like plant and machinery, lease etc.

21.4 INSURANCE POLICY METHOD

The Depreciation Fund Method involves the investment of funds in outside securities. This requires an expert knowledge of the investment market and risk of loss due to price fluctuations in the market. Moreover the specific securities may not always be available in the market. To avoid such uncertainties, the firm instead of investing the money in purchasing securities, may take an insurance policy from a general insurance company fur the sum required for replacement of she asset. For this it will have to pay certain amount as premium every year. In return the insurance company promises to pay agreed policy amount at the end of the specified period i.e., useful life of the asset which will be utilised for replacement of the asset, The money received from insurance company is usually a little higher than the amount insured because of bonus. Thus, there is certainty about receiving the anticipated amount. From the accounting point of view, this method is very similar to Depreciation Fund Method. In fact, it is also called Depreciation Fund Policy Method. Following are the journal entries required under this method.

1 **During the first and subsequent years (except in the last year)**

a) For payment of the premium :
  Depreciation Fund Policy A/c ... Dr.
    To Bank A/c

b) For charging depreciation
  Depreciation A/c ... Dr.
    To Depredation Fund A/c

2 **During the last year**

a) For payment of the premium
  Depreciation Fund Policy A/c ... Dr.
    To Bank A/c

b) Fur charging depreciation
  Depreciation A/c ... Dr.
    To Depreciation Fund A/c

c) For receipt of amount on insurance policy :
  Bank A/c ... Dr.
    To Depreciation Fund Policy A/c

d) For transferring the credit balance in the Policy A/c
  Depredation Fund Policy A/c ... Dr.
    To Depreciation Fund A/c

e) For transferring the balance in the Fund A/c to Asset Account.
  Depreciation Fund A/c ... Dr.
    To Asset A/c

f) For realisation of salvage value, if any, on the sale of asset :
  Bank A/c ... Dr.
    To Asset A/c

g) For transferring debit balance, if any, in the asset account.
  Profit and Loss A/c ... Dr.
    To Asset A/c

Look at Illustration 4 and set: how various accounts are prepared under the Insurance Policy Method.

His assets and liabilities in the beginning and in the end were:

	1-10-87	30-9-88
	Rs.	Rs.
Stock	18,000	20,440
Cnsh in hand	950	150
Cash at bank	1,000	7
Creditors	16,000	10,000
Debtors	44,000	7
Furniture	2,000	2.000
Land & Buildings	30,000	30,000

Additional Information

i) Credit sales for the year Rs. 18,100.
ii) Discount allowed to Debtors Rs. 2,100.
iii) Returns Outwards during the year Rs. 500.
iv) Salaries Outstanding on 30-9-88 Rs. 3,000.
v) Provision for doubtful debts is to be created to the extent of Rs. 3,000.
vi) 5% depreciation is to be provided on Furniture and Land & Building.

(Answer: Cash at bank on 30-9-88 Rs. 4,850; Opening Capital Rs. 79,950; Closing Debtors Rs. 60,000; Credit Purchases Rs. 25,500; Gross Profit Rs. 63,540; Net Profit Rs. 22,890; Balance Sheet Total Rs. 1,12,840).

Note: These questions will help you to understand the unit better. **Try** to write answers for them. But do not submit your answers to the **University.** These are for your practice **only.**

UNIT 22 PROVISIONS AND RESERVES

Structure

22.0 OBJECTIVES

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

- explain the meaning of term 'provision' and 'reserve'
- distinguish between provision and reserve
- prepare provision for repairs and renewals account
- describe the nature of different types of reserves.

22.1 INTRODUCTION

Business firms maintain their accounts as going concerns on the assumption that the business will continue to exist indefinitely, Hence, at the end of each accounting year, they must also take into account the future contingencies and the requirements of funds before determining the amount of net profit available for distribution among the owners. Provisions and reserves actually relate to the future needs for which a part of the current earning has to be set aside. In this unit you will learn about the meaning of provision and reserve, the difference between provision and reserve, and also the various types of reserves which are usually created before distribution of profits.

22.2 WHAT IS A PROVISION?

It is a generally accepted accounting principle that while measuring income for an accounting year, all possible losses and expenses must be taken into account. Hence we usually provide for depreciation on fixed assets and their repairs, renewal etc. Similarly, there may be certain liabilities/losses the amounts of which cannot be ascertained with substantial accuracy such as dispute claims for damages, bad debts, and so on. We must charge their estimated amounts to Profit and Loss Account before working out the net profit. Such charge to the Profit and Loss Account is called 'Provision', The Indian Companies Act has defined it as ***"any amount written off or retained by way of providing for depreciation, renewal diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy"***

Thus, provisions are the amounts set aside out of profits and other surpluses to provide for (i) depreciation, renewals, or diminutionin the value of assets, and (ii) any known liability of which the amount cannot be determined with substantial accuracy.

It must be noted that any known liability the amount of which can be determined accurately does not fall within the definition of a provision and should be described as 'accrual' or 'accrued liabilities'. In other words, provision for outstanding salaries, rent, etc., in the strict sense of the term, cannot be called provisions. They will be termed as 'accruals'.

The provisions are usually created by debiting the Profit and Loss Account and are either shown on the liabilities side of the Balance Sheet or deducted from the concerned asset. You learnt about the provision for bad and doubtful debts, provision for discount on debtors and provision for depreciation in Unit 7. Let us now study about the provision for repairs and renewals.

Provision for Repairs and **Renewals :** Certain assets used for business purposes need repairs and renewals which may not be significant in initial years when any asset is purchased, but it may increase with its constant use and passage of time. To equalise the charge on Profit and Loss Account over the year in respect of repairs and renewals, we make a provision for repairs and renewals by debiting the Profit and Loss Account and crediting the Provision for Repairs and Renewals Account. The actual expenditure incurred on repairs and renewals is charged to the Provision for Repairs and Renewals Account every year. Look at Illustration 1 and see how this account appears in books.

Illustration 1

A business concern decided to provide Rs. 1000/- every year for the repairs and renewals of a machine used in the process of manufacture from the year 1981. In the first five years the amount spent on repairs was Rs. 3001-, Rs. 3251-, Rs. 4801-, Rs. 7001-, Rs. 1,2001-. Prepare a Provision for Repairs and Renewals Account for five years.

Solution :

Provisions for Repairs and Renewals A/c

Dr. Cr.

Date	Particular	Amount	Date	Particulars	Amount
1981		Rs.	1981		Rs.
Dec. 31	To Repair A/c	300	Dec. 31	By P & L A/c	1,000
,, 31	To Balance c/d	700			
		1,000			1,000
1982			1982		
Dec. 31	To Repair A/c	325	Jan. 1	By Balance b/d	700
,, 31	To Balance c/d	1,375	Dec. 31	By P & L A/c	1,000
		1,700			1,700
1983			1983		
Dec. 31	To Repair A/c	480	Jan. 1	By Balance b/d	1,375
,, 31	To Balance cld	1,895	Dec. 31	By P & L A/c	1,000
		2,375			2,375
1984			1984		
Dec. 31	To Repair A/c	700	Jan. 1	By Balance bld	1,895
,, 31	To Balance c/d	2,195	Dec. 31	By P & L A/c	1,000
		2,895			2,895
1985			1985		
Dec. 31	To Repair A/c	1,200	Jan. 1	By Balance b/d	2,195
,, 31	To Balance cld	1,995	Dec. 31	By P & L A/c	1,000
		3,195			3,195

22.3 WHAT IS A RESERVE?

The term reserve refers to the amount set aside out of profits and other surplus which are not designed to meet any liability or diminution in value of assets known to exist at the date of the Balance Sheet. The Indian Companies Act has not given any clear definition of the term 'Reserve'. It states, however, that *"the expression 'reserve' shall not........ include any amount written off or retained by way of providing for depreciation, renewal or diminution in value of an asset, or retained by way ofproviding for any known liability.* In other words, any amount set aside out of profits to meet unexpected future losses and liabilities is called reserve. Not only that if any amount retained by way of providing for any known liability in excess of the amount actually needed for the purpose, shall also be treated as reserve and not a provision.

The basic purpose of creating a reserve is to provide for unexpected losses in future and also retain profits within business (not distribute them to the owners or shareholders) to provide funds for expansion of the business. Most well managed companies make it a point not to distribute the whole of their profits to the shareholders. They retain good portion of their profit in the form of general reserve (also called contingency reserve). This also enables them to pay dividend even during the year when the profits are low or there are losses.

Reserves are created by debiting their amounts to the Profit and Loss Appropriation Account. But reserve is not a compulsory charge on profits. It is purely voluntary and is regarded as an appropriation of profits. It means that reserve represents an undistributed portion of net profit and not a loss or expense which ought to have been charged before calculating the net profit, as is done in case of the provisions.

Reserve Fund : The term 'reserve fund' is used for the amount of reserve which has been invested in outside securities. The instructions given in the Companies Act for the preparation of Balance Sheet, the word 'fund' in relation to any reserve can be used only when such reserve is specifically represented by earmarked investments. Examples of Reserve fund are employees' welfare fund, pension fund, gratuity fund, debenture redemption fund, etc. If, however, the amount of reserve is being utilized by the business itself and not invested in some outside securities, it cannot be called reserve fund.

22.4 DISTINCTION BETWEEN PROVISION AND RESERVE,

You have learnt the meaning and purpose of creating a provision and also a reserve. Various points of distinction between the two can be summarised as follows :

	Provision		Reserve
1	Provision is made to meet a known liability for depreciation/renewal of assets.	1	Reserve is created to meet unexpected contingencies likely to arise in future.
2	The amount set aside is used only to meet the specific purpose for which provision was made.	2	Amount can be used for any liability or loss.
3	Provision is to be made even if there are no profits.	3	It is created only when there are sufficient profits,
4	It is a charge on profits and must be debited before arriving at the figure of net profit.	4	it is an appropriation of profits and represents undistributed profits.
5	It cannot be used for the payment of dividends.	5	Except in some cases, it can be used for payment of dividends.
6	It cannot be invested outside the business.	6	It can be invested outside the business, when created For a specific purpose.

Check Your Progress A

1 Define Provision.

....

....

....

....

2 Which of the following statements are true and which are false.

i) Provision for discount on debtors is a charge on Profit and Loss Account. ......

ii) Creation of reserve may lead to reduction of net profit. ......

iii) Provision made can be distributed among shareholders if the directors so decide. .....

iv) Reserves are always invested outside the business. ......

v) Amount set aside out of profits is known as reserve if it is created for meeting unexpected future contingencies. ......

vi) Reserve is a charge on net profit. ......

3 How is 'Reserve Fund' different from 'Reserve'?

....

....

....

22.5 TYPES OF RESERVES

To have a clear understanding of the nature and purpose of reserves we may classify them into different categories as follows:

- Reserve
  - Open Reserve
    - Capital Reserve
    - Revenue Reserve
      - General Reserve
      - Specific Reserve
  - Secret Reserve

22.5.1 Open Reserves

There are two ways of creating reserves: (1) by debiting the amount to Profit and Loss Account and clearly showing it in the Balance Sheet in one form or the other, and (2) by undervaluation of assets or overproviding for losses. The first category of reserves can be easily identified from the financial statements and are termed as open reserves. The second category of reserves cannot be identified by the reader of financial statements. They are known only to the management. Shch reserves are called 'secret reserves'. These will be discussed later in this unit.

Open reserves are further classified as capital reserves and revenue reserves depending on the nature of profit out of which they are created.

Capital Reserve : A reserve created out of capital profits is called 'Capital Reserve'. Capital profits may arise on account of revaluation or sale of fixed assets. In case of companies the following items are also regarded as capital profits.

i) credit balance left in Forefeited Shares Account after the re-issue of such shares,
ii) premium received on issue of shares on debentures,
iii) profit realised on the purchase of company's own debentures from the market, and
iv) profits made prior to incorporation.

Capital profits cannot normally be used for distribution of dividends and therefore are transferred to capital reserve. If at all the company, at some stage, wants to utilize capital reserve for the distribution of dividends, it has to satisfy certain specified conditions.

You should note that ***reserve capital*** is not the same thing as capital reserve. The reserve capital refers to the uncalled amount of share capital which can be called only in the event of liquidation of the company. You will learn about this in a separate course (ECO-04 Accountancy II).

Revenue Reserve : Any reserve other than capital reserve can be called a revenue reserve. Revenue reserves are usually created out of business profits which are available for distribution of dividends. They are meant for specific purposes or general purposes and are accordingly known as ***specific reserves*** or ***a 'general reserve'.*** The specific purposes for which they are usually created are dividend equalisation (known as dividend equalization reserve), redemption of debenture (known as debenture redemption fund), workmen's compensation (known as workman's compensation fund); etc. A general reserve, on the other hand, is meant for meeting the unforseen contingencies and to strengthen the financial position of the business. All these reserves are debited to the Profit and Loss Appropriation Account and shown on the liabilities side under the head 'Reserves and Surplus'. As a matter of fact, ***they reflect the undistributed profits of the business.***

Distinction between Capital Reserve and Revenue Reserve

The capital reserves and revenue reserves differ in many respects. The main points of distinction are as follows :

	Capital Reserve		Revenue Reserve
1	It is created out of capital Profits.	1	It is created out of business profits.
2	It can be used for distribution of dividends only if the company satisfies certain conditions' prescribed by'the Companies Act.	2	It can be used for distribution of dividends without any pre-condition.
3	It is created for meeting capital losses or to be used for purposes specified by Companies Act.	3	It is created for strengthening the financial position, and meeting the unforeseen contingencies or some specific purpose.

Sinking Fund : A sinking fund is a specific reserve created with the object of providing funds for the redemption of long term liabilities like redeemable debenture. It is created by setting aside a fixed sum out of profits every year for a definite period. Such a sum is invested at a compound interest so that at the end of the period, the annual amounts with accumulated interest will be sufficient to discharge the liability. If, for example, a company has to redeem debentures worth Rs. 1,00,000 at the end of ten years, it may set aside certain amount of profits every year and invest it in some securities carrying certain rate of interest. The interest earned every year is also re-invested. At the end of ten years, the total amount of investment (including interest) will be equal to the amount needed for redemption i.e., Rs. 1,00,000. The securities are then sold and the amount so realized is used for the redemption of the debenture. The amount of yearly instalment can be determined by reference to the sinking fund table. The same is debited to Profit and Loss Appropriation Account and credited to the Debenture Redemption Fund.

The term sinking fund is also used for the provision made for the replacement of a fixed asset. In that case, it is called Depreciation Fund which, in fact, is not a reserve in the strict sense of the term. You learnt about the depreciation fund in Unit 21. The ***journal entries for creation of debenture redemption fund are more or less the same as those of depreciationfund.*** (You will study in detail about the accounting treatment of debenture redemption fund in a separate course ECO-04 Accountancy II).

The sinking fund to redeem a'liability (debenture redemption fund) and the sinking fund to replace an asset (depreciation fund), however, differ in various ways. Look at Chart 22.1 and not the main points of difference.

Chart 22.1
Distinction Between Sinking Fund for Redemption of Liability and Sinking Fund for Replacement of an Asset

Sinking Fund for redemption of liability	Sinking Fund for replacement of an asset
1 The purpose is the redemption of a long term liability.	1 The purpose is the replacement of a fixed asset.
2 It is designated as 'Debenture Redemption Fund' or 'Loan Redemption Fund'.	2 It is designated as 'Machinery Replacement Fund' or 'Depreciation Fund'.
3 It is an appropriation of profit and so is debited to the Profit & Loss Appropriation Account.	3 It is a charge on profit and so debited to Profit and Loss Account.
4 At the time of redemption the accumulated fund is transferred to the credit of General Reserve.	4 At the time of replacement the accumulated fund is transferred to the credit of the concerned asset account.

Dividend Equalisation **Fund** : This fund is created by setting aside a portion of distributable profits during prosperous years as a provision for lean period so that company is able to declare usual dividend even if sufficient profits are not there. The amount representing this fund need not be invested in outside securities. Even if there is no specific dividend equalisation fund, a company can always use its reserves, if any, for the purpose of equalising dividends.

Investment Fluctuation Fund : This is a reserve created to provide for the loss by way of fluctuation in the values of investments made by the company in outside securities. This is generally provided by banks and insurance companies who invest huge funds in government securities.

Workman's Compensation Fund : Under Workmen Compensation Act, the workers are entitled to certain amount of compensation in case of accidents in the factory. When an accident takes place, the amount of compensation involved may be heavy. Hence, in order to avoid such loss being charged to the Profit and Loss Account of the year in which it occurs, the companies set aside a portion of profits every year and create a special fund for this purpose. It is called, 'Workmen's Compensation Fund'. As and when some compensation is paid, the same can be debited to this fund.

22.5.2 Secret Reserves

The term 'Secret Reserve' is applied to a reserve, the existence of which does not appear on the face of the Balance Sheet. When secret reserves exist, the financial position of the business is better than what may appear on the face of the balance sheet.

The main purpose of creating secret reserve is to reduce the disclosed profit so that during bad period this hidden profit, or a portion of it, may be merged into the earnings and thus help in equalising the dividends.

Methods of creating Secret Reserves : Secret Reserves may be created in one of the following ways :

i) Writing off excessible depreciation
ii) Undervaluation of closing stock
iii) Charging capital expenditure to Profit and Loss Account
iv) Making excessive provision for bad and doubtful debts
v) Showing contingent liabilities as actual liabilities
vi) Retaining appreciating assets at cost price

In all the above cases the value of the assets are reduced without disclosing the fact in the financial statements, As such they become 'secret' and are known only to the **management.**

Merits **and Demerits :** Creation of secret reserves, within certain limits, is justifiable on the ground of expediency and prudence. Secret Reserves enable the business to meet extra-ordinary losses without the same being disclosed and thus prevent the public confidence being shaken. The concealment of huge profits is also essential in order to prevent competition from other firms.

Despite certain merits, the following objections are raised against the practice of creating secret reserves.

i) Secret Reserves prevent the financial statements from showing the true and fair position of the business. The Profit and Loss Account charged with fictitious amount in respect of excessive depreciation, doubtful debts, or repairs etc, fails to disclose the true profits. Similarly, when the value of certain asset is understated or some liabilities are overstated, the Balance Shet cannot be said to represent the true state of affairs of the business. Thus, the financial statements become unreliable.
ii) The shareholders cannot assess the value of their holding correctly.
iii) Management can conceal its inefficiency by making use of secret reserves.
iv) It permits misuse of secret reserves for personal gain by managers. Sometimes the management, or those close to them, having knowledge of wilful suppression of net profits, inay indulge in certain nialpractices in the stock markets.

Before the enactment of the Companies Act, 1956, there were no restrictions on the creation of secret reserves. But, at present such reserves cannot be created by a company because the auditor has to certify that the Balance Sheet of the company gives a true and fair view of the state of affairs of the company. In case some secret reserves have been created, the auditor cannot give such a report without disclosing the extent of such reserves.

Check Your Progress B

1 Fill in the blanks

i) Open reserves can be of two broad categories.................and................
ii) Capital Profits may arise on the sale of......................
iii) If the amount of reserve is invested outside the business it is known as.,.........
iv) Premium received on issue of shares is treated as...........reserve.
v) Secret reserve can be created by treating..........expenditure as..........expenditure.

2 Which of the following stateinents are True and which arc False.

i) Dividend equalisation reserve is a type of capital reserve ......
ii) Keserve fund is only that part of reserve which is invested outside the business. ......
iii) Revenue reserves of company can he distributed as profits. ......
iv) A sinking fund may or may not be inve'sted outside the business. ......
v) Secret reserves affect the credibility of financial statements. ......

22.6 LET US SUM UP

Provision means any amount set aside from current earnings for depreciation. repairs and renewals, ctc. or for meeting a known liability the amount of which cannot be determined with substantial accuracy. It is a charge on profits and must for the ascertainment of true profits of the business.

The term 'reserve' refers to the amount set aside out of profits for meeting Cnforeseen contingencies and provide funds for business expansion. Reserves can be classified into two broad categories : (1) open reserves and (ii) secret reserves.

Open reserves are reserves which are clearly shown in the books of account, and may be in the nature of capital reserve or revenue reserve. Capital reserves are those reserves which are created out of capital profits. Such reserves cannot be normally used for the distribution of dividends. Kevenue reserves, on the other hand, are created out of normal business profits and are allowed to be used fur the distribution of dividends. They may be created for general purposes (meet any contingency in future) or for specific purposes. Dividend Equalization Fund, Debenture Redemption Fund (Sinking Fund), Investment Fluctuation Fund, Workmen's Compensation Fund are' some examples of specific reserves.

Secret reserves refer to such reserves that are not disclosed in the Balance Sheet. They are created by providing excessive depreciation undervaluation of closing stock or by charging capital expenditure to Profit and Loss Account. Such rkserves may be justified on grounds of Prudence and discouraging competitors from entering the market. But, they prevent disclosure of true and fair view of the financial position of the business and are likely to be misused by management:

22.7 KEY WORDS

Capital Reserve : Reserve created out of capital profits.
Open Reserves : Reserves which are clearly shown in the financial statements.
Provision : Amount set aside of current earnings of a business for depreciation, repairs or renewals or meeting a known liability the amount of which is uncertain.
Reserve : Amount set aside out of profits or surplus to meet unexpected contingencies or provide funds for growth.
Revenue Reserve : Reserve created out of normal business profits.
Reserve Fund : That part of reserve which is invested outside the business.
Sinking Fund : A fund created out of earnings to repay a long term liability or replace an asset.
Secret Reserves : Reserves, the existence of which is not revealed in the financial statements.

22.8 SOME USEFUL BOOKS

Maheshwari S.N. 1986. *Introduction to Accounting,* Vikas Publishing House : New Delhi. (Chapter 13)

Patil, V.A. and J.S. Korlahalli, 1986. ***Principles and Practice of Accounting,*** R. Chand & Co., New Delhi. (Chapter 4 V)

Shukla, M.C. and T.S. Grewal, 1987. ***Advanced Accounts,*** S. Chand & Co., New Delhi. (Chapter 7)

William Pickles. 1982. ***Accountancy,*** E.L.B.S. and Pitman London. (Chapter 7)

22.9 ANSWERS TO CHECK YOUR PROGRESS

A 2 i) True ii) False iii) False iv) False v) True vi) False
B 1 i) Capital reserve and revenue reserve ii) fixed asset (iii) reserve fund iv) capital v) capital, revenue
2 i) False ii) True iii) True iv) False v) True.

22.10 TERMINAL QUESTIONS/EXERCISES

1 What is a reserve? Examine critically the policy of some concerns in building up huge reserves and others totally ignoring it.

2 Distinguish between :
a) Reserve and Provision
b) Capital Reserve and Revenue Reserve
c) Specific Reserve and General Reserve
d) Sinking fund to repay a liability and sinking fund to replace an asset

3 What is a secret reserve? Enumerate methods employed by a firm to create secret reserves. Critically evaluate the practice from the viewpoint of general investors and shareholders.

4 In a concern where the current expenditure on repairs is comparatively less but where it is known that the expenditure at a subsequent period will be considerable: you find that a Provision for Repairs Account is created and credited every year with Rs. 90,000. What is the object of creating such an account, and how is the amount of Rs. 90,000 ascertained.

If the actual repairs amounted to Rs. 9,000 in the first year, Rs. 21,000 in the second year, and Rs. 33,000 in the third year, what could be the Revenue Charges for the respective years?

Show the Provision for Kepairs Account for the three years.

ECO-02 ACCOUNTANCY-I
Course Components

BLOCK	UNIT NO.	PRINT MATERIAL
1		**Accounting Fundamentals**
	1	Basic Concepts of Accounting
	2	The Accounting Process
	3	Cash Book and Bank Reconciliation
	4	Other Subsidiary Books
	5	Bills of Exchange
2		**Final Accounts**
	6	Concepts Relating to Final Accounts
	7	Final Accounts-I
	8	Final Accounts-II
	9	Errors and their Rectification
3		**Consignments and Joint Ventures**
	10	Consignment Accounts-I
	11	Consignment Accounts-II
	12	Consignment Accounts-III
	13	Joint Venture Accounts
4		**Accounts from Incomplete Records**
	14	Self Balancing System
	15	Accounting from Incomplete Records-I
	16	Accounting from Incomplete Records-II
	17	Accounting from Incomplete Records-III
5		**Accounts of Non-trading Concerns, Depreciation, Provisions and Reserves**
	18	Accounts of Non-trading Concerns-I
	19	Accounts of Non-trading Concerns-II
	30	Depreciation-I
	31	Depreciation-II
	22	Provisions and Reserves